CHAPTER 2 : ECONOMIC OUTLOOK FOR 2017 AND THE MEDIUM TERM

Summary

- *In 2016, global economic growth was the weakest since the global financial crisis, yet it showed some encouraging signs of improvement in the latter half of the year. International organisations generally expect a moderate recovery of global economic growth in 2017, with the US economy gathering further momentum and the Mainland economy maintaining solid growth. With the rebound of major commodity prices, some commodity-exporting emerging market economies, including Russia and Brazil, should also see better prospects this year.*

- *Uncertainties, however, still abound, particularly those related to political events are apparently rising. First, while recent indicators for the US economy have remained relatively strong, any protectionist policy that might be adopted by the new US administration would pose an inevitable threat to global trade and economic growth, hitting Asia in particular. Second, economic growth in Europe could be hindered not only by the lingering structural issues but also by various political risks, including Brexit-related developments and the upcoming general elections in several major European economies. Third, the risks of renewed global financial volatility are still notable, given the uncertain pace of interest rate normalisation in the US, increasing monetary policy divergence among major central banks, and other fluid economic and political developments. Emerging market economies relying on external financing would likely be more vulnerable to a tightening of global financial conditions and swings in exchange rate movements. Heightened geopolitical pressures and the possible rise in protectionist sentiment are also causes for concern.*

- *Barring abrupt negative shocks to the global economic, financial and trading environment, the Hong Kong economy should stage some relative pick-up in 2017, after the weak growth last year. The externally-oriented sectors are poised to benefit from improving trade and investment flows if global economic growth can indeed gain more traction in 2017. As for exports of services, the recent rebounds in visitor arrivals and in regional trade flows should help pave the way for a recovery this year. Moreover, the solid growth of the Mainland economy will also lend support to cross-border financing and fund-raising activities.*

- *Domestic demand should stay resilient this year, as private consumption expenditure is likely to see further growth on the back of a stable labour market and improving household income conditions. On the other hand, investment will still be rather volatile, given the lingering uncertainties in the external environment. In particular, if the US interest rate upcycle proceeds at a faster pace than expected, the resultant asset market fluctuations could swing economic sentiment. Nevertheless, building and construction works are expected to expand further, rendering some support to overall investment.*

- *Barring any significant external shocks which would derail the current recovery of global trade, the Hong Kong economy is projected to grow by 2-3% in 2017, representing a relative improvement from the 1.9% growth in 2016, though may still be a notch lower than the average annual growth of 2.9% achieved in the past ten years.*

- *On inflation, consumer price pressures will likely stay moderate this year. Imported inflation is expected to remain contained at least in the near term, as inflation in Hong Kong's major import sources stays modest and the US dollar remains strong. Locally, the moderate economic growth and the gradual feed-through of softer rentals in earlier periods should continue to keep cost pressures at bay. Overall, the underlying Composite Consumer Price Index (CPI) is forecast to increase by an average of 2% in 2017, down slightly from 2.3% in 2016.*

- *The medium-term outlook for the Hong Kong economy remains positive. However, many advanced economies are facing structural, demographic and political challenges, which will inevitably limit their future growth. This underscores the importance of enhancing economic co-operation with the Mainland and economies along the Belt and Road. Hong Kong is well positioned to leverage on the opportunities arising from the eastward shift of the world's economic centre of gravity. The Government will continue to invest in education, training and infrastructure to raise Hong Kong's productivity and growth potential. This will help meet the challenge from population ageing, as the size of our labour force is expected to peak in 2018. The trend GDP growth rate in real terms is forecast at 3% per annum from 2018 to 2021. The trend rate of underlying consumer price inflation is forecast at 2.5% per annum.*

Major external developments

2.1 The global economy has returned to a modest expansion path after experiencing a disappointing performance in the first quarter of 2016, characterised by faltering trade flows and heightened financial volatility amid concerns about the global economic outlook and the monetary policy directions in major economies. With the US economy steadily regaining momentum after the first quarter and the Mainland economy continuing its solid expansion, the external environment soon stabilised and gradually improved in the subsequent quarters. Regional trade flows also showed some improvements in tandem. If these positive trends continue into 2017, global economic activity should hopefully pick up further, rendering a firmer support to international trade and investment flows. As an open economy and an international trading and business hub, Hong Kong stands to benefit from such a development.

2.2 Several key external uncertainties, however, still warrant close monitoring, as they could significantly alter the global economic outlook in the near term. These include the economic policy directions of the new US administration and their impacts on the US economic and interest rate outlook; risks related to Brexit and the general elections in several major European economies; and increasing monetary policy divergence among major central banks amid the uneven recovery in the advanced economies and the US interest rate upcycle. Elevated geopolitical tensions and possible changes in the political situations around the world could also give rise to an increase in protectionist and anti-trade sentiments. How these economic and political events will unfold is still subject to an exceptionally large degree of uncertainty at the present juncture. Any abrupt unfavourable turn could dent global economic sentiment and disrupt the current momentum of the global economy.

Global economic outlook

2.3 The US economy has picked up gradually after hitting a soft patch in the beginning months of 2016. On the back of solid consumption growth and improving labour market conditions, the Federal Reserve (Fed), after some repeated delays, raised interest rates in December 2016, the second increase since it kick-started the interest rate upcycle in December 2015. While recent indicators have generally pointed to a more sanguine outlook for the US economy in 2017, the lack of details about the new administration's economic policy agenda has created much uncertainty. The expected increase in infrastructure spending, if materialised, would help support a faster expansion of economic activity, thereby possibly quickening the pace of interest rate normalisation. However, the lack of sufficient clarity regarding its other economic policies, particularly on the trade front, remains a primary concern. Any significant changes in fiscal, trade and other economic policies in the US, the largest economy in the world, would inevitably carry notable ramifications for global trade, investment and financial flows.

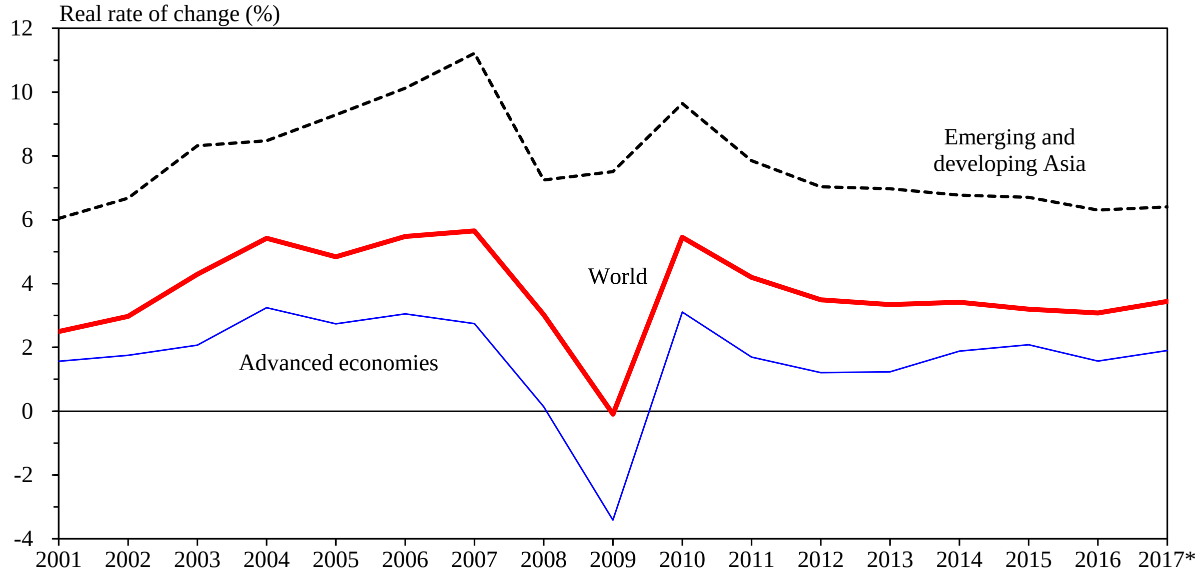
2.4 The EU economy maintained modest growth in 2016. Although the contagion effects of Brexit generally have been contained so far, the event, including the uncertainties relating to the future negotiations between the UK and the EU, continues to cast a shadow over the outlook for the region in 2017. In Italy, the health of its banking system is also a concern. Deep-seated structural issues in some member states of the euro area, including the overhang of private and public debts, unsustainable fiscal positions and market rigidities, are yet to be resolved and will remain a key drag on the region's economic recovery. Moreover, on the political side, general elections will be held in several major European economies this year, constituting another prominent source of uncertainty. The outcomes of these elections could have significant consequences for the political and economic developments in the EU. Other non-economic factors, including heightened geopolitical tensions in Eastern Europe and the Middle East, the influx of refugees and the threats of terrorist attacks, could also dampen the region's growth. The European Central Bank (ECB) may be inclined to keep a highly accommodative monetary policy stance this year, given the still-low inflation and all these uncertain developments.

2.5 Japan's economic performance remained weak in 2016, although its growth momentum picked up slightly in the latter part of the year. In the face of the fragile economic situation, the sales tax hike was further postponed from 2017 to 2019 and a new fiscal stimulus package was launched. In addition, the Bank of Japan (BOJ) introduced a new monetary policy framework to fend off deflation risks, but the effectiveness is yet to be seen. The challenges from such structural issues as market rigidities, elevated debt levels and an ageing population are persisting despite the Japanese government's efforts to initiate structural reforms. Against this background, Japan's economic growth is likely to remain modest in 2017.

2.6 Supported mainly by the expected strengthening of the US economy, the advanced economies as a whole should see some improvement in growth prospects, provided that the more acute risks associated with Brexit and other political and geopolitical developments do not materialise. The International Monetary Fund (IMF) in January 2017 projected the advanced economies as a whole to grow by 1.9% in 2017, representing a slight pick-up from the 1.6% growth in 2016.

2.7 Emerging market economies as a whole has displayed a more resilient performance recently. The downturns of Russia and Brazil, the two major emerging market economies, showed signs of bottoming out over the course of 2016, partly helped by the rebound of international commodity and energy prices. Meanwhile, Asian emerging market economies remained the key driving force of the global economy, underpinned by solid domestic demand expansion and relatively sound economic fundamentals. Barring any significant financial market disruptions and sizeable reversals in capital flows, emerging market economies should continue to expand steadily this year. Moreover, if the recovery of import demand in the advanced economies gathers further pace, it will bolster Asia's production and trading activities going forward. Still, the potential negative repercussions on export-dependent economies arising from the possible rise in protectionism and shifts towards more inward-looking trade policies need to be closely watched. According to the IMF's latest projections, emerging market and developing economies as a whole would grow by 4.5% this year, up from 4.1% in 2016. Within this, emerging and developing Asia was projected to grow even more notably by 6.4% in 2017, compared to the 6.3% expansion in 2016.

Diagram 2.1 : Asian emerging economies will likely remain the key growth driver of the global economy in 2017



Source : IMF World Economic Outlook Update, January 2017.
Note : (*) Forecasts from the IMF.

2.8 The Mainland economy expanded solidly by 6.7% in 2016, well within the official growth target. The sustained robust growth in domestic consumption and the services sector amid the Mainland's structural rebalancing process provided a strong anchor to the overall economy against the downward pressure from the external side. In 2017, domestic demand looks set to remain firm. The 2016 Central Economic Work Conference, which sets the overall strategy of economic work in the coming year, emphasised on the importance of containing financial risks and ensuring the stable and healthy development of the property market, while pledging to deepen supply-side structural reforms. The Belt and Road Initiative will also help unleash new growth opportunities. Overall, the Mainland authorities should have ample policy room to maintain growth at a sustainable medium-high speed and it is widely expected that the Mainland's economic growth in 2017 will continue to outperform many other major economies. In January, the IMF projected the Mainland economy to grow by 6.5% in 2017.

2.9 Overall, the IMF in January projected that the global economy would expand by 3.4% in 2017, after the weak 3.1% growth in 2016, with the support primarily coming from emerging market and developing economies. The moderate recovery in global economic growth from its post-crisis low in 2016 was based on certain benign assumptions, including some near-term fiscal stimulus in the US, a less gradual monetary policy normalisation process by the Fed without causing a sharper-than-expected tightening in global financial conditions, and a firming of oil prices. Given the uncertainty associated with the policy stance of the new US administration and its global ramifications, the IMF also pointed out the wide dispersion of possible outcomes regarding its projections. While the IMF deemed that the balance of risks are skewed towards the downside, particularly those related to a possible shift toward more inward-looking policies and protectionism amid fraying consensus about the benefits of cross-border economic integration, and secular stagnation in advanced economies, there could also be upsides to global activity should there be larger-than-projected policy stimulus in the US and the Mainland.

Table 2.1 : Growth forecasts for major economies in 2017

		2017	
	2016* (%)	**IMF*** (%)	**Private sector forecast^** (%)
World (PPP## weighted)	3.1	3.4	-
Advanced economies	1.6	1.9	-
US	1.6#	2.3	2.3
Euro area	1.7#	1.6	1.4
UK	2.0#	1.5	1.4
Japan	1.0#	0.8	1.1
Emerging market and developing economies	4.1	4.5	-
Emerging and developing Asia	6.3	6.4	-
Mainland China	6.7#	6.5	6.4
India	6.6	7.2	7.5
Middle East and North Africa	3.8	3.1	-

Notes : (*) World Economic Outlook Update, IMF, January 2017.
(^) Average forecasts as at January 2017.
(-) Not available.
(#) Actual figures.
(##) PPP refers to purchasing power parity.

Box 2.1

US fiscal policy developments after the Great Recession of 2009

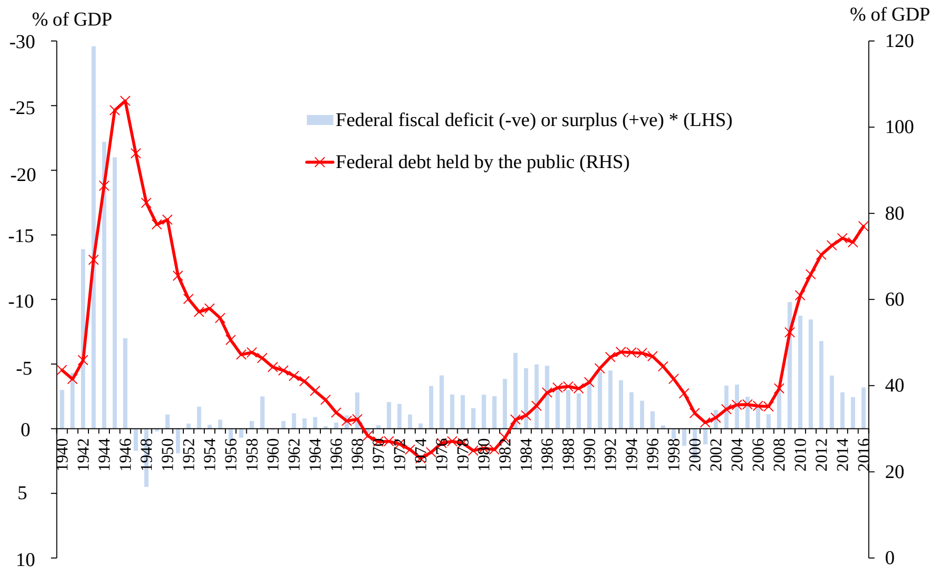
US fiscal landscape has undergone significant changes over the past decade, reflecting the far-reaching impacts of the Great Recession during 2008 and 2009 and the ensuing efforts to fix the public finance. Moreover, the influences of demographic shifts in the US will likely become increasingly visible in the longer term. This article reviews the changes in US federal fiscal balance and debt position after 2008, and analyses their possible implications for the US economy.

In late 2008 and 2009, the US economy suffered the worst recession since the Great Depression, with millions of people losing their jobs. To avert the economic crisis, bold fiscal packages were rolled out, with attendant surge in discretionary spending. Unemployment benefits also rose in tandem with the marked deterioration in the US labour market. Over the same period, government revenue dropped amid economic contraction, and tax cuts exacerbated the declines. Consequently, federal fiscal deficit leapt to 9.8% of GDP in Fiscal Year (FY) 2009(1), the highest in the post-Second World War era (***Chart 1***). The deficit continued to hover above 8% in the subsequent two years, despite some recovery of the US economy during the period.

The high fiscal deficits resulted in a notable jump in the US government debt. By end-FY2011, federal debt held by the public(2) reached US$10.1 trillion, amounting to 66% of GDP and representing the double of the debt level at end-FY2007.

Persistently high fiscal deficit and ballooning government debt aroused concern, triggering intensive debate about how to contain it in the US Congress. Yet, the road to action was bumpy, as the Republican lawmakers then controlled the House of Representative only, while the Senate was led by the Democrats. The two parties had very divergent stances on the deficit reduction strategy and wider fiscal reform issues. The confrontation between the two parties had heightened market concerns, cumulating in a downgrade on US sovereign credit

Chart 1: Federal fiscal deficit surged after the outbreak of Global Financial Crisis



Note: (*) Deficit is inverted in scale for easier comprehension.
Source: Congressional Budget Office.

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(1) Federal budget related statistics are compiled on a fiscal year basis, referring to the period from 1 October to 30 September, unless otherwise specified. Fiscal year 2009 refers to 1 October 2008 to 30 September 2009.

(2) Federal debt held by the public is made up of public debt securities issued by the US Treasury and a small amount of securities issued by government agencies, excluding the portion of the debt that is held by the government accounts.

Box 2.1 (Cont'd)

rating by Standard and Poor's in 2011 and global financial market turbulence. In the end, the fiscal issues were temporarily resolved by sequestration, which set caps on government spending and additional reductions to reduce fiscal deficit over US$1 trillion in ten years.

The targeted reduction in discretionary government spending mandated by sequestration was rather visible, resulting in a corresponding fall of US$84 billion in FY2013. Moreover, some of the Bush era tax cuts were no longer extended. Together with some revival in government revenue amid continued US economic expansion, the federal fiscal deficit shrank distinctly, to 4.1% of GDP in FY2013 and further to 2.8% and 2.4% respectively in FY2014 and FY2015, before rising slightly to 3.2% in FY2016.

While the fiscal deficit fell to a level closer to the average picture between 2002 and 2007, the debt position facing the federal government was radically different. With continued deficit and moderate economic growth, federal debt held by the public increased further, albeit at a moderated pace, reaching 77% of GDP by the end of FY2016. In the past few years, the net interest outlay did not rise, as the aggressive unconventional monetary policy has pressed Treasury bond yield to extra-ordinarily low level. The US 10-year Treasury Notes yield stood at a low level of around 2% in 2016, much less than that of around 4% in 2007. But if US interest rate normalisation continues, the interest payment burden by the federal government will rise.

The long-term budget outlook also looks less sanguine than a decade ago given the gradual shift in demographic structure. As population ages, the ensuing rises in health care and social security spending would contribute to an increase in fiscal deficit over time. According to Congressional Budget Office's (CBO) Budget and Economic Outlook Report released in January 2017, even assuming that current laws governing taxes and spending generally remaining unchanged, the federal fiscal deficit was projected to increase to 4.5% of GDP in FY2025, and the federal debt held by the public is estimated to rise to over 80% of GDP in end-FY2022.

Recent changes in US political situation have put US fiscal policy in the coming years in the market spotlight. In particular, the newly-elected US president has advocated for radical tax cuts and massive infrastructure investment plan to bolster the US economy. With Republican lawmakers controlling both the House and Senates in Congress, a smoother legislative process in support of the Republican president is now possible in the period ahead. In addition, there are worries that financial risks could become more threatening the longer the unconventional monetary easing measures are extended, thereby justifying the shift to the use of fiscal policy tools to boost economic growth.

Fiscal stimuli, if finally rolled out, would bring support to US economic growth, despite the fact that fiscal stimulus could have implementation time lag. However, there are still considerable uncertainties about US fiscal policy and its possible impacts on the US economy. Obviously, it will depend on the scale and duration of the fiscal stimuli. The US government would have to strike a balance between stimulating the US economy while taking account of the long-term fiscal sustainability, particularly in light of the likely increases in government spending in social security and health care in the period ahead and the relatively high US federal government debt. The legislative process in Congress could still be bumpy and lengthy, especially when touching on wider fiscal reform matters.

Box 2.1 (Cont'd)

The effects of US fiscal policy on US economic growth would also depend on the monetary policy response. As the minutes of the Federal Open Market Committee meeting in December 2016 rightly pointed out, fiscal stimuli might raise aggregate demand above sustainable level, necessitating a faster rate hike pace. In this scenario, a tighter monetary policy would in turn offset the positive impacts of fiscal stimuli on US economic growth.

The impact of fiscal policy on the economy will depend on its scale and composition, for which the lack of details about the US fiscal stimuli to be implemented by the new US administration has hampered a further assessment at this juncture. Economists at the International Monetary Fund as well as many other institutions generally projected that US economic growth in the coming two years will pick up from the subdued situation in 2016, with fiscal stimuli widely cited as a supporting factor (***Table 1***).

Table 1: Economic growth forecasts for the US

	IMF January 2017	Consensus Forecast January 2017	US Federal Reserve December 2016	OECD November 2016
2016	1.6%			
2017	2.3%	2.3%	2.1%	2.3%
2018	2.5%	2.3%	2.0%	3.0%

The more favourable economic outlook for the US economy, as projected at this moment, is still subject to considerable uncertainties, including the ambiguity about the US fiscal policy at this stage, not to mention other US economic policies under the new administration, particularly its policies on trade and investment. These policy factors will interact with other US and international economic forces and shape the US economic performance in the period ahead. Potentially, the pace of US monetary policy normalisation could also be affected. As the US economy has a prominent position in international trade and finance, its growth prospects and policy changes would have notable repercussions on the global economy. The Government will stay tuned to these developments.

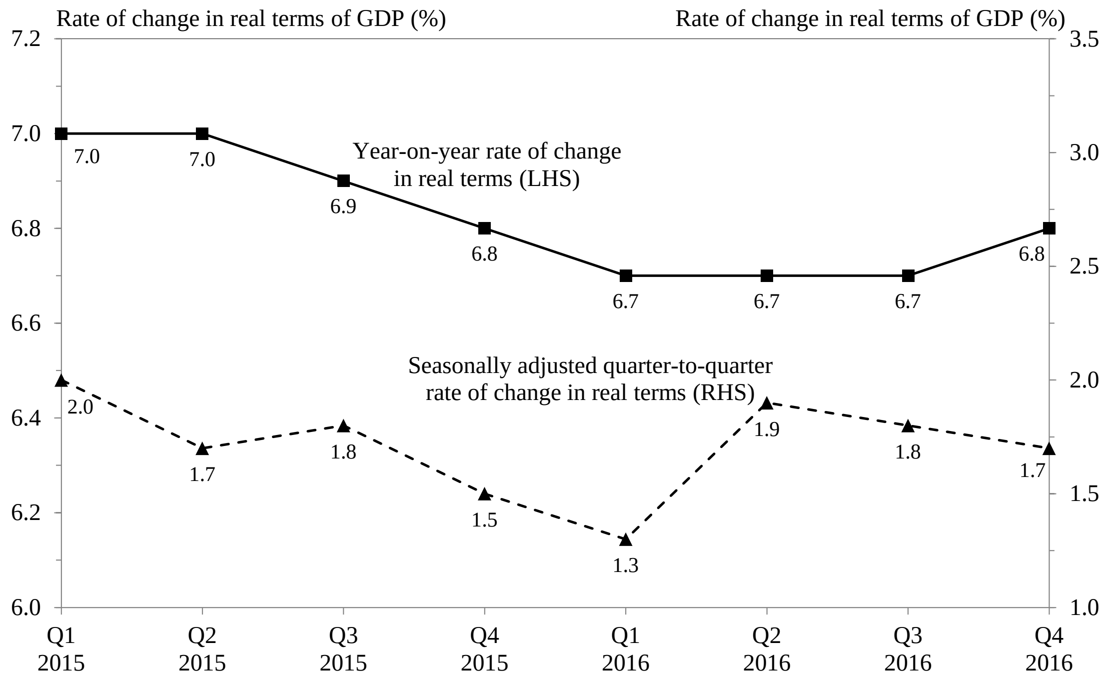
Box 2.2

Economic performance of the Mainland in 2016

Given its close economic ties with Hong Kong, the Mainland's economic development is highly important to our economy. This article briefly reviews the Mainland's macroeconomic performance in 2016, and some salient developments in its structural reform over the year.

In 2016, the Mainland economy maintained growth at a medium-high rate of 6.7% in real terms. Despite a slight deceleration by 0.2 percentage point as compared to 2015, the economic growth rate in 2016 met the annual growth target of 6.5-7% set by the Mainland authority early last year, surpassing what many had then expected[(1)]. Analysed on a quarterly basis, the seasonally adjusted quarter-to-quarter growth rates had stabilised since the second quarter of 2016 (***Chart 1***). All in all, although the Mainland's economic growth in 2016 was somewhat slower as compared to recent years, it was still notably faster than many other major economies. Moreover, as the Mainland economy became much bigger in size[(2)], its corresponding incremental growth volume in real terms was hence larger than those in the past.

Chart 1: The Mainland economy maintained steady growth



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(1) For instance, the International Monetary Fund (IMF) projected early last year that the Mainland economy would grow by 6.3% in real terms in 2016.

(2) The Mainland economy grew at an average of 9% per annum in real terms for the 10 years from 2007 to 2016, indicating that the actual size of the Mainland economy had more than doubled in real terms over the period.

Box 2.2 (Cont'd)

Important structural changes in the Mainland economy were evidenced by the diverse developments in different economic segments. On the front of retail sales, the consumption demand in the Mainland remained resilient. Total retail sales of consumer goods recorded a real growth of 9.6% last year, slightly lower than that of 2015 but exceeding the overall economic growth rate notably. This shows that the overall economy of the Mainland was underpinned by the sustained resilience of its domestic demand. The enhanced role of consumption in economic growth also tied in with the Mainland's broad direction of enhancing its economic structure (see below for details).

On investment, affected by factors such as excess capacity in some traditional industries and high inventory in property markets outside the first- and second-tier cities, investment in fixed assets increased by 8.8% in real terms last year, decelerated from the 12.0% increase in 2015. Nevertheless, investment in infrastructure continued to grow at a faster pace. The growth of investment was particularly notable in such industries as "management of water conservancy, environment and public facilities", "education", "health and social work" and "culture, sports and entertainment". All these contributed to the further enhancement of the long-term economic development potential of various Mainland regions.

Relatively speaking, external demand remained weak, imposing greater downward pressure on the Mainland's external sector in 2016. Total goods exports in US dollar terms declined by 7.7%, a drop widened by 4.8 percentage points as compared with that in 2015. Export performance, however, stabilised in the late months of last year. Total goods exports in the fourth quarter of 2016 declined year-on-year by 5.2%, slightly narrower than the 8.6% drop in the first three quarters, indicating that the relevant downward pressure had eased slightly(3). In fact, a similar trend was observed in the total value of goods re-exported through Hong Kong from the Mainland, which registered a 0.8% year-on-year increase in the fourth quarter of 2016, a reverse from the 5.1% year-on-year decline in the first three quarters.

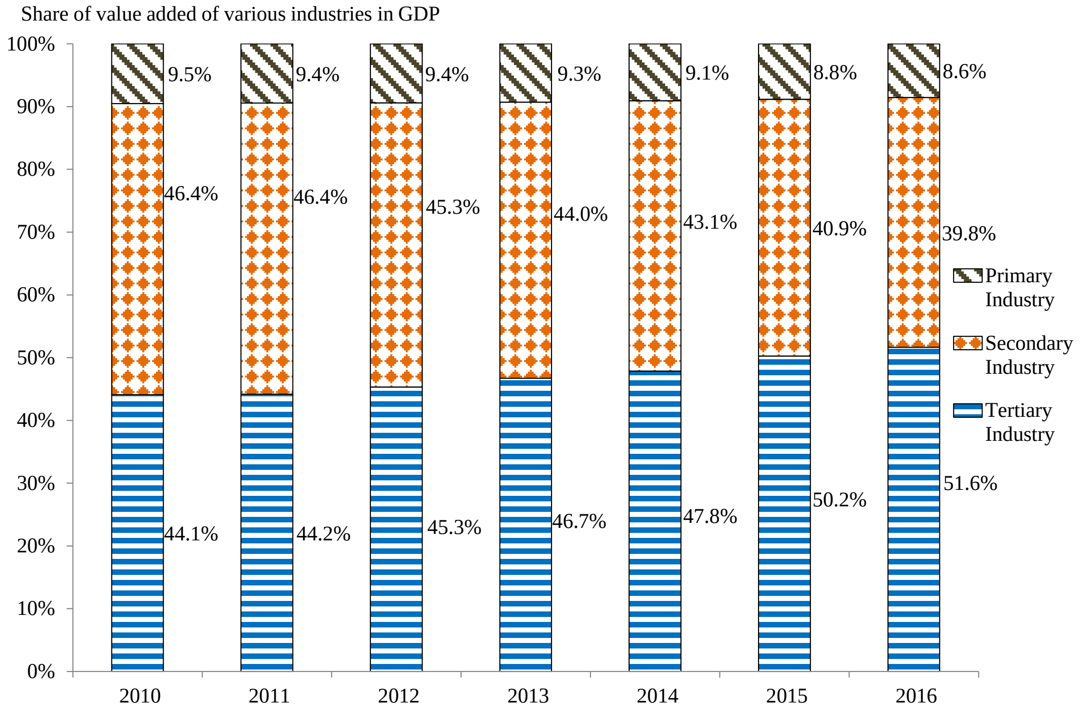
While maintaining a medium-high growth pace, the Mainland economy continued with its structural transformation and enhancement, and progressed steadily towards a development model based on domestic consumption and services, driven by innovation and technological upgrading. First of all, the role played by consumption in economic growth became more prominent. In 2016, the contribution of final consumption expenditure to GDP growth was 64.6%, 4.7 percentage points higher than that in 2015. The services industry also played a more vital role in the Mainland's economic development. The value added of the tertiary industry accounted for 51.6% of GDP in 2016, 1.4 percentage points higher as compared with last year(4) (***Chart 2***). The tertiary industry grew by 7.8% in 2016, a rate faster than the overall economic growth. Moreover, the Mainland's industrial sector was moving towards high-tech-oriented development in 2016. The value added of the high-tech industry grew by 10.8% in real terms, 0.6 percentage point faster than in 2015 and visibly higher than the 6.0% real growth of the total value added of the industrial enterprises above the designated size over the same period. This indicated a development trend of industrial upgrading and transformation with more emphasis on technological enhancement. Investment relating to the high-tech industry also maintained double-digit growth last year, a sign of continuous improvement of investment structure conducive to the further upgrading of production technology.

(3) When denominated in Renminbi (RMB), the Mainland's exports even recorded year-on-year growth in certain late months of 2016. The exports in November, for example, increased year-on-year by 4.2% in RMB terms.

(4) Almost 12 percentage points higher than the 39.8% growth in 2000.

Box 2.2 (Cont'd)

Chart 2: Tertiary industry took up an increasing share of GDP



As for prices, the Mainland's consumer price inflation remained steady throughout 2016. The Consumer Price Index (CPI) rose modestly, at an average annual rate of 2.0%. Some service components such as health care, education services and housing rental saw faster price increases, an indication of continuous transformation towards a service-based economy. As regards industrial prices, with a marked rise in prices of commodities such as coal and steel due to the cutting of excess capacity by individual sectors, the Producer Price Index for the Industrial Sector reverted to a year-on-year increase since September last year after registering year-on-year declines for 54 consecutive months. The index registered greater increases towards the end of the year, despite an average annual decline of 1.4% for the whole of 2016.

On promoting the supply-side structural reform, the main objectives of the Central Government in 2016 included cutting the excess capacity in certain industries, reducing inventory in the property market, preventing and controlling financial risks, lowering business costs and enhancing effective supply. These initiatives were gradually yielding results. On cutting excess capacity, substantive progress was made in the steel and coal industries, attaining the target set at the beginning of the year. On reducing property market inventory, the floor space of commercial buildings for sale decreased in 2016, while the inventory of residential buildings even recorded a double-digit decline. Besides, relevant authorities including the People's Bank of China, China Banking Regulatory Commission, China Securities Regulatory Commission and China Insurance Regulatory Commission stepped up prevention and control of financial risks, and further enhanced the risk surveillance and regulatory system on financial institutions. Furthermore, by adopting diversified monetary policy instruments, the People's Bank of China adjusted the liquidity of the financial markets with greater flexibility and precision. Separately, a market-oriented debt-for-equity swap programme was also implemented to reduce the debt leverage of certain enterprises. These initiatives also began to bear fruit. In 2016, the RMB broad money supply increased by 11.3%, a drop of 2.0 percentage points from 2015, while the increase in the stock of loans of non-financial enterprises also moderated.

Box 2.2 (Cont'd)

During the Central Economic Work Conference held in December last year, it was clearly stated that the Mainland government would continue to deepen the supply-side structural reform in 2017 so as to further enhance the Mainland's economic structure. Besides, in view of the exuberance in the property market of the first- and second-tier cities in the Mainland last year, it was also emphasised in the Conference that stable and healthy development of the property market should be promoted to fend off asset market bubble risks. On the other hand, it was also reiterated that efforts should be made to support the real economy, to raise the quality of economic development and to strengthen core competitiveness. Support was also pledged to foster strategic emerging industries and to upgrade the traditional industries by adopting new technologies.

Looking into 2017, it is expected that the Mainland economy, with the support of solid fundamentals, will continue to attain medium-high speed growth. Although external uncertainties will continue to put pressure on the Mainland's external sector, the resilient and robust domestic demand will provide significant anchor to the overall economy. Also, there are ample policy room and tools for the relevant Mainland authorities to stabilise economic development. In January 2017, the IMF projected that the Mainland economy would grow by 6.5% this year. With the continuous implementation of the aforementioned initiatives under the supply-side structural reform, the structural transformation and upgrading of the Mainland economy will advance, yielding an economic development with better quality and greater sustainability. Throughout this process, more development opportunities will also be created for various sectors of Hong Kong, to the benefit of its long-term economic development.

Monetary conditions

2.10 The global monetary and financial conditions are still subject to notable risks of heightened volatility, as the world economy continues to navigate in uncharted waters. The Fed is poised to proceed further with the US interest rate upcycle in 2017, against the background of the continuation of the exceptionally accommodative monetary policy stances among other major central banks and the looming political uncertainties in some major advanced economies. The Fed raised interest rates in December last year, while both the ECB and the BOJ signalled readiness to roll out additional monetary easing measures to support growth if needed. Monetary policy divergence is expected to persist or even deepen during 2017, and its impact on global monetary conditions and hence the global economy is hard to predict.

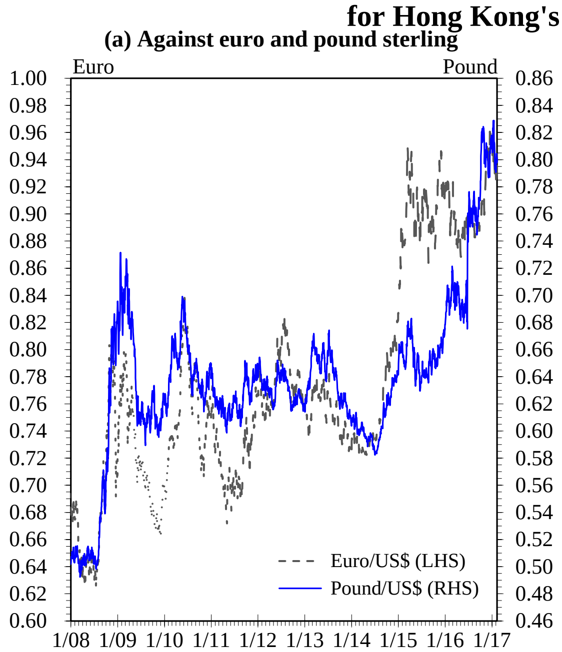
2.11 Furthermore, the Fed's timing and pace of interest rate normalisation, determined by the US economic performance under the new administration, are still uncertain. Any unanticipated move by the Fed to raise interest rates or abrupt changes in the market's risk sentiment could spark unusually large reactions across international financial markets and possibly accelerate capital outflows from emerging market economies, including those in Asia. Those economies with a large accumulation of dollar-denominated external debts, less resilient financial systems, weaker economic fundamentals and asset bubble risks would be more vulnerable. Therefore, the potential disruptive impacts of a rapidly evolving and complicated global monetary landscape should not be taken lightly.

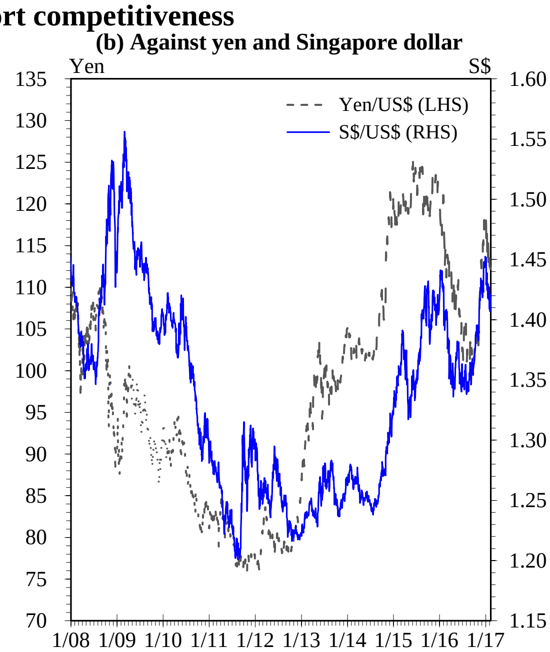
Exchange rates and price competitiveness

2.12 The US dollar rallied strongly against other major currencies since August 2016, as the US regained growth momentum and as the proposed fiscal stimulus under the new US administration raised market expectations for the Fed to further normalise its monetary policy. The appreciations against the Japanese yen and some emerging market currencies were particularly notable. In December 2016, the nominal trade-weighted US dollar index reached a multi-year high, though stabilising somewhat in January 2017. The Hong Kong dollar, which mirrors closely the movements of the US dollar, also strengthened against many other currencies. For 2016 as a whole, the nominal trade-weighted effective exchange rate index of the Hong Kong dollar rose by an average of 3%, after the 6% increase in 2015.

2.13 In 2017, the direction of exchange rate movements will again be subject to a high degree of uncertainty, influenced by a wide-range of factors, particularly the US economic and policy outlook, market expectations of the Fed's future interest rate moves and increasing monetary policy divergence in major economies. In general, a sustained strength in the US dollar and hence the Hong Kong dollar will, to some extent, weigh on the price competitiveness of our exports of goods and services. Yet in overall terms, Hong Kong's export outlook in 2017 should remain largely governed by the strength of the import demand recovery in our major export markets.

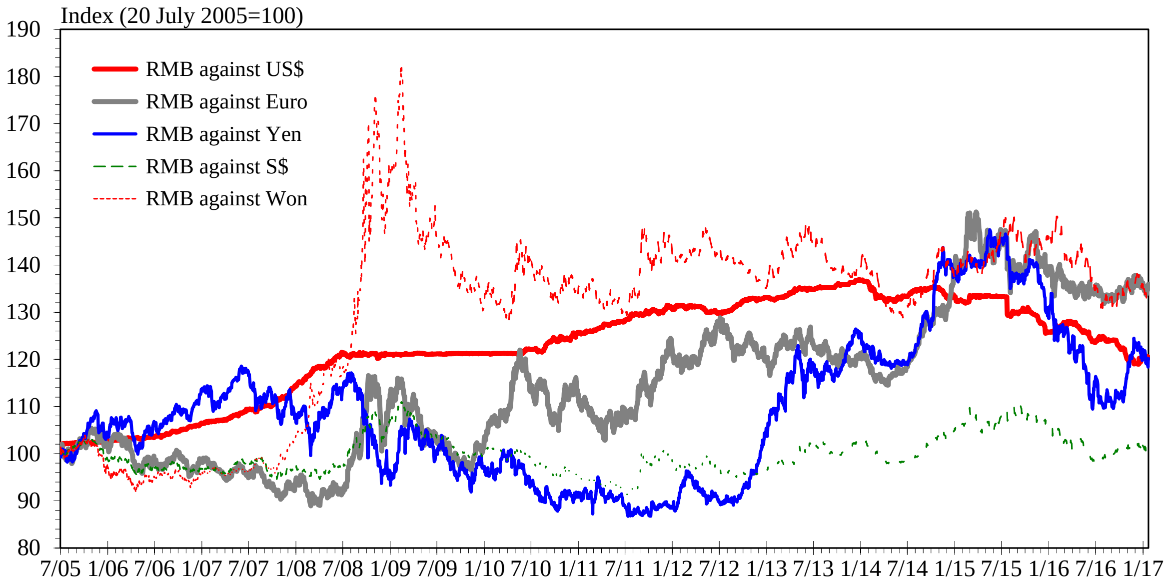
Diagram 2.2 : The sustained strength of the US dollar will not bode well for Hong Kong's export competitiveness





2.14 Given Hong Kong's close economic relations with the Mainland, the movement of the renminbi (RMB) is also an important factor affecting the performance of Hong Kong's external sector. The RMB depreciated moderately by an average of 5% against the Hong Kong dollar during 2016, mainly due to the notable strengthening of the US dollar. But when compared against a basket of major currencies, the RMB actually held broadly stable in the second half of 2016. The Mainland has adopted a more market-determined exchange rate mechanism since mid-August 2015. The inclusion of the RMB into the IMF's Special Drawing Rights basket in October 2016 reflected the progress made in the currency's internationalisation and the Mainland's gradual integration into the global financial system. In addition, a broader basket of foreign currencies was used to benchmark the value of the RMB on entering 2017. All these suggest that the price-setting of the RMB has become more transparent and market-driven, and the Central Government is widely expected to proceed with the exchange rate regime reform in a controlled and gradual manner. Judging from the steady expansion of the Mainland economy, there should be no basis for a protracted depreciation of the RMB in the long run. A relatively stable RMB could help reduce the exchange rate uncertainty facing Hong Kong companies, given the Mainland's important role in regional supply chains and the increasing use of the RMB for settling cross-border trade and investment activities.

Diagram 2.3 : Greater flexibility of the RMB would be conducive to maintaining macroeconomic stability in the Mainland



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

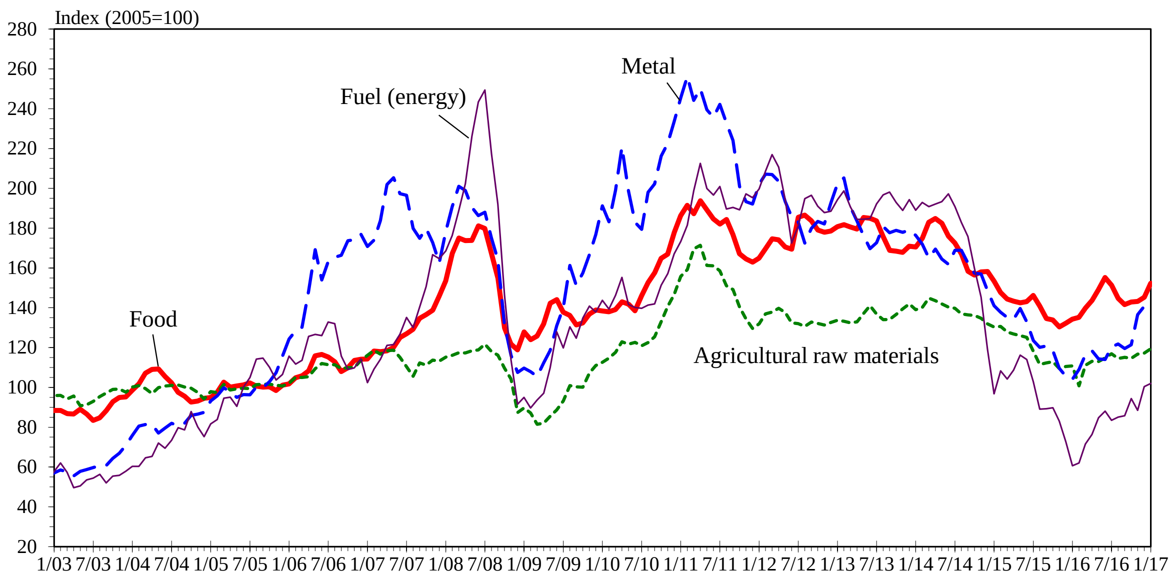
World inflation and global commodity prices

2.15 Global inflationary pressures stayed benign in the past year amid the slow-growing economy and relatively soft international energy and commodity prices. The highly accommodative monetary policies kept by most of the advanced economies likewise mirrored the still-muted underlying price fundamentals and the difficulty in uplifting inflation back to their targets. Overall speaking, under a likely gradual recovery in global demand conditions, world inflation is expected to remain moderate in the near term.

2.16 As one of the factors affecting the global inflation outlook, the prices of oil and many other non-petroleum commodities had already picked up during 2016, albeit remaining relatively low by historical standards. Specifically, oil prices rose visibly from a low of around US$30 per barrel in early 2016, exceeded US$55 per barrel at end-December and drifted higher on entering 2017 amid market anticipation of co-ordinated production cuts to eliminate the global supply glut by members of the Organization of the Petroleum Exporting Countries (OPEC) and some non-OPEC members. Likewise, global food prices rose above their year-ago levels in the second half of 2016, partially reversing the notable declines during 2015, according to the Food and Agriculture Organization of the United Nations. Similarly, the prices of many manufacturing-related commodities, such as agricultural raw materials and metals, resumed year-on-year growth in the fourth quarter of 2016.

2.17 While the downward pressures from earlier declines in international energy and commodity prices on headline inflation will gradually diminish if the aforementioned price recovery firms up, the upsides will be counterbalanced by the generally sub-par economic conditions, slow-closing output gaps and still-weak inflation expectations. Indeed, the core inflation rates of many major economies, which exclude the price effects of energy and major commodities, have remained relatively low, notwithstanding some recent pick-up in their headline inflation rates. Also, the movements of international energy and commodity prices could still be volatile amid the various economic and political uncertainties and possible disruptions to the demand-supply situations. Oil prices may come under pressure again if the earlier pledge to cut production by OPEC members and some other oil-producing countries fails to materialise.

Diagram 2.4 : International commodity prices picked up last year, albeit remaining low by historical standards, and risks of large fluctuations remain



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

Major sources of uncertainty

2.18 The global economic outlook is still surrounded by considerable uncertainties in 2017. *First and foremost*, how well the US economic conditions will hold up under the new administration is the key source of uncertainty, which will have implications for the Fed's timing and pace of interest rate normalisation. Global economic recovery will face some headwinds if the growth in the US is hurt by unconstructive shifts in economic and trade policies, the Fed's interest rate hikes or unfavourable international developments.

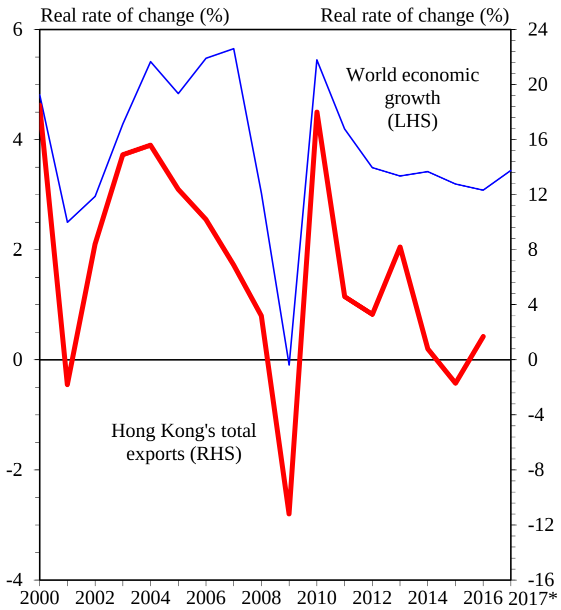
2.19 *Second*, various political uncertainties, in addition to the persisting structural issues and the still rather fragile economic fundamentals of some individual economies, will put the economic recovery in Europe to test. The risks of a hard Brexit cannot be taken lightly, which could have wider implications beyond the UK and the EU. The upcoming general elections in several major European economies may also create new hurdles for economic development in the region. The impaired balance sheets of Italian banks, with their potential negative spill-over effects, are another cause for concern. *Third,* there could be disruptions to global financial markets arising from an increase in the policy divergence among major central banks and other economic and political uncertainties. The resulting capital flow reversals and exchange rate fluctuations could be hugely destabilising for those emerging market economies with weaker fundamentals and large external debts. *Fourth*, intensified geopolitical tensions in many regions of the world and a rise in protectionist and anti-trade sentiments will definitely be harmful for the international trading environment.

2.20 That said, there is also some upside potential to the global economic outlook. If the US growth momentum strengthens more than expected and along a path that supports a more predictable course of policy actions by the Fed, global financial and monetary conditions should hopefully be more stable during the US interest rate upcycle. A reduction in Europe's political uncertainty will be conducive to a steadier economic expansion in the region. Structural reforms in Europe and Japan, if pushed through effectively, would help improve the growth potential for these economies. Also, better-than-expected economic performance of the Mainland and other emerging market economies in Asia will provide a stronger support for regional trade flows, to the benefit of Hong Kong.

Outlook for the Hong Kong economy in 2017

2.21 Given the small and highly externally-oriented nature of our economy, Hong Kong's economic outlook for 2017 will continue to depend predominantly on how global economic and financial conditions will evolve. After a rather weak start in early 2016, Hong Kong's economic growth picked up steadily as the year progressed, alongside a generally stabilising external environment. Regional trade flows have continued to revive amid the relative improvement in external demand, and in tandem, our merchandise export growth staged a visible rebound in the fourth quarter of 2016. Should this positive trend extend into 2017 and barring abrupt negative shocks to the global economic, financial and trading environment, Hong Kong's *exports of goods* will likely see a stronger performance this year, especially if the demand recovery in the advanced markets can gain further traction, rendering firmer support to Asia's production and trading activities. However, a downside factor to watch out is the possibility of a distinct strengthening of the US dollar, which could pose a cap to the upside potential of the current export recovery.

Diagram 2.5 : The outlook for Hong Kong's goods exports should hopefully improve in 2017



Note : (*) Forecast from the IMF World Economic Outlook Update, January 2017.

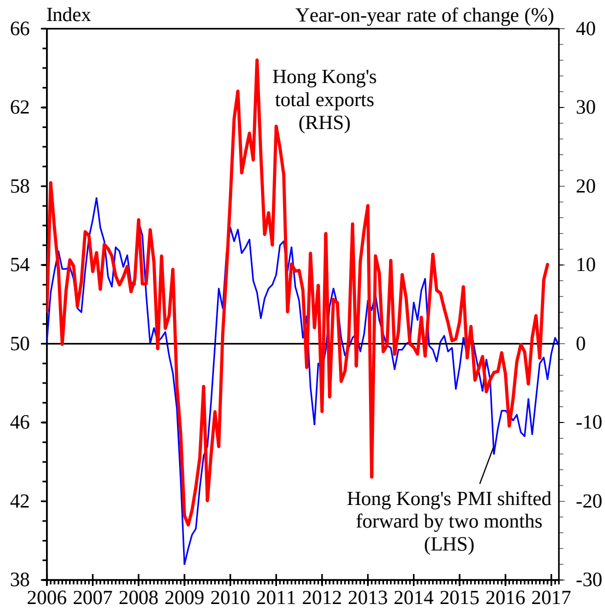
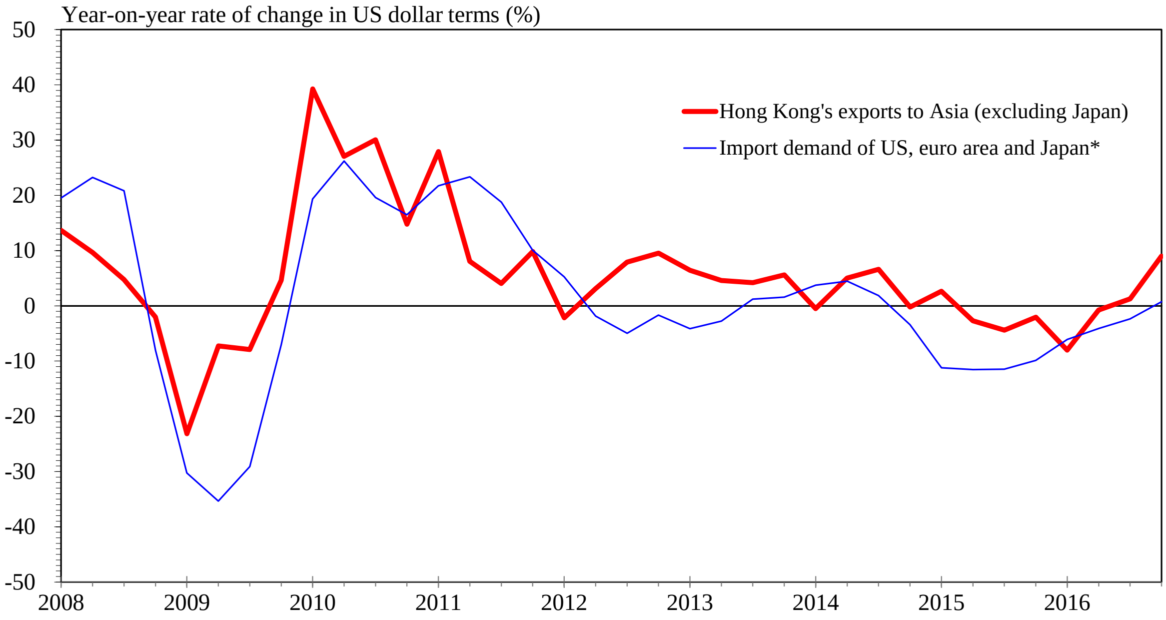


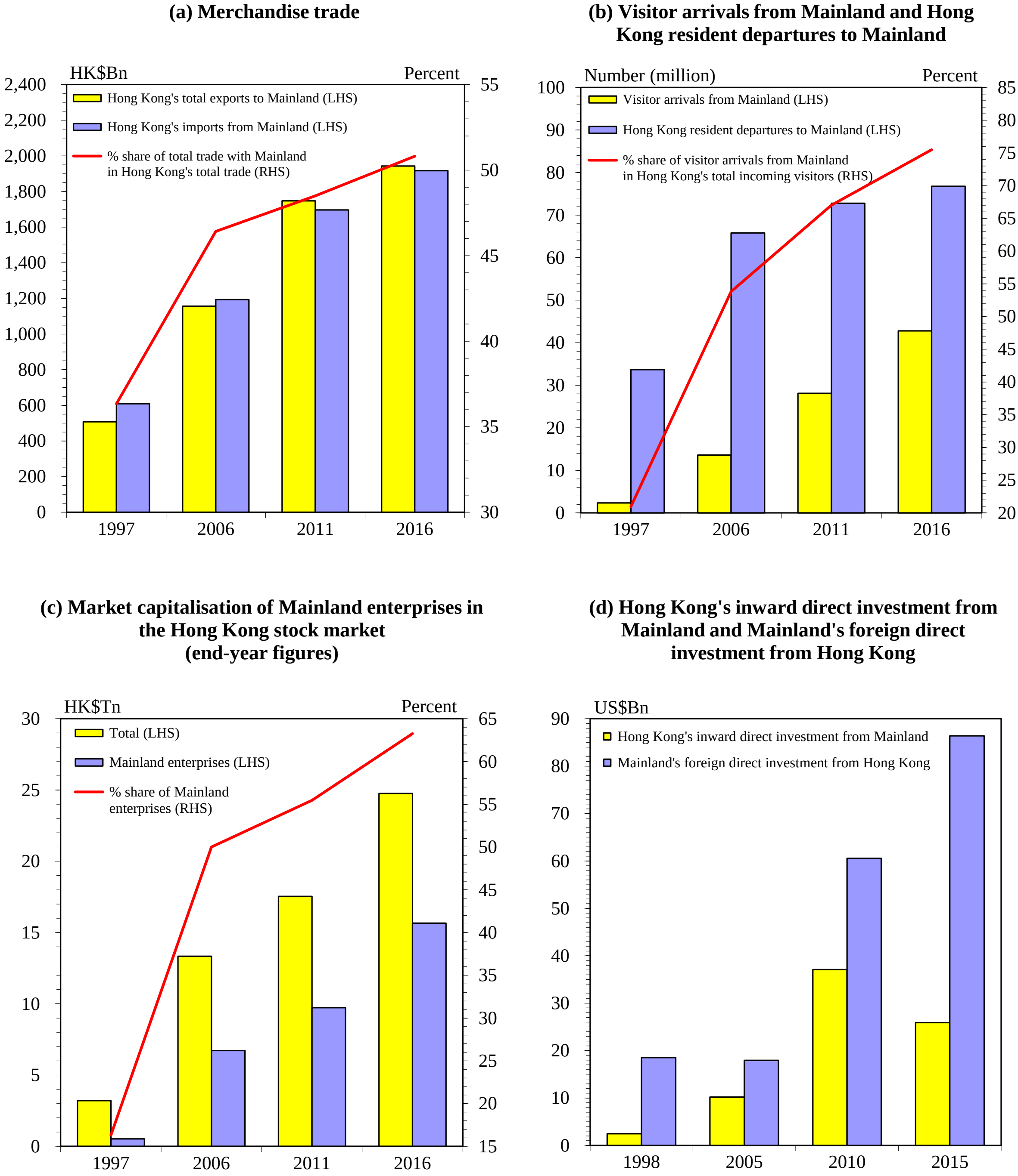
Diagram 2.6 : Regional trade picked up amid the recent recovery in external demand



Note : (*) The latest figure refers to October-November 2016 combined.

2.22 Amid a gradually improving trading environment and lesser drag from inbound tourism over the course of the year, *exports of services* also strengthened up gradually during 2016. By the fourth quarter, services exports returned to a mild year-on-year growth, ending four consecutive quarters of decline. Looking ahead, overall services exports should hopefully improve further this year. The recent rebound in visitor arrivals, if continues, will be one positive factor. On top of this, exports of transport services look set to ride on the expected recovery of regional trade and cargo flows, and more so if the various external uncertainties subside further over the course of 2017. Also, exports of financial services and business and other services will likely benefit from cross-border financing and fund-raising activities, which have great potential to flourish.

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



2.23 Hong Kong's *domestic demand* continued to exhibit much resilience in 2016. Looking ahead, barring any significant negative shocks from the external front, domestic demand should be able to hold up well this year. A stable labour market in a virtually full-employment situation, coupled with steady household income growth, is expected to remain a solid anchor to private consumption expenditure this year, and even more so if asset market conditions are to remain broadly supportive. Investment expenditure is generally sensitive to the vicissitudes of the external environment and the ups and downs of the business cycle. On this, it should be noted that business sentiments of large enterprises have tended to remain stable of late. Ongoing building and construction works are likely to provide a more stable growth impetus to overall investment this year, with expenditure on such activities at a multi-year high last year.

2.24 Local borrowing costs have increased subsequent to the US interest rate hike in December 2016, albeit still at very low levels by historical standards. Given that Hong Kong is not a highly leveraged economy and assuming a gradual normalisation of interest rates by the Fed, the increases in local interest rates in the coming year should be manageable without impinging heavily on the growth momentum of the local economy. That said, various external uncertainties could swing market sentiment. The potential repercussions on asset market conditions and economic sentiment will need to be closely monitored.

Diagram 2.8 : Private consumption looks set to attain further growth in 2017

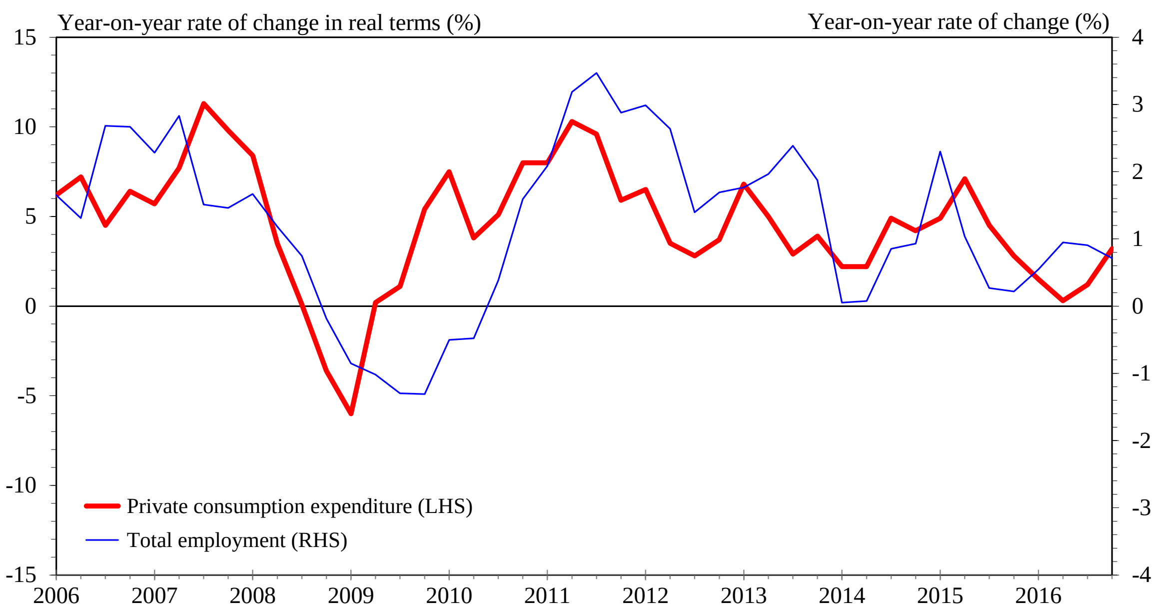
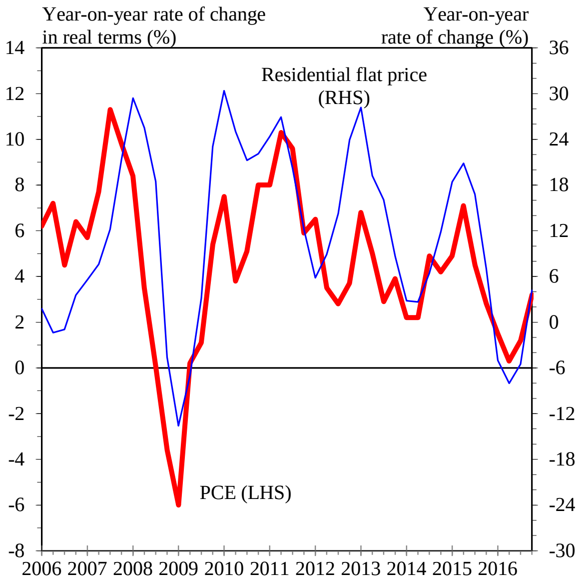


Diagram 2.9 : Consumer sentiment should hold up if asset market conditions remain broadly supportive

(a) Housing wealth



(b) Equity wealth

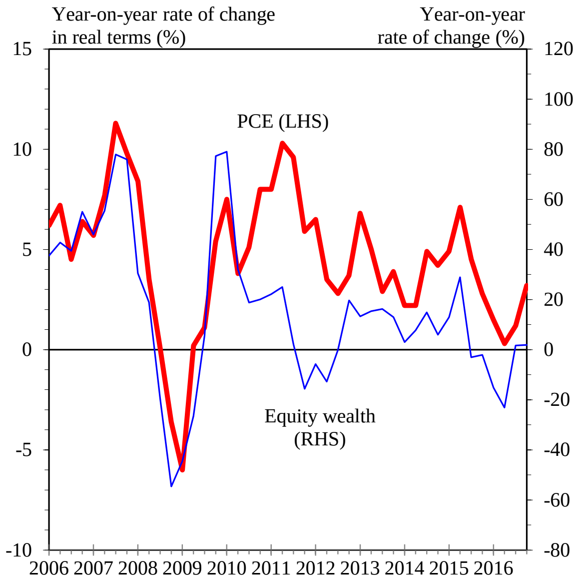
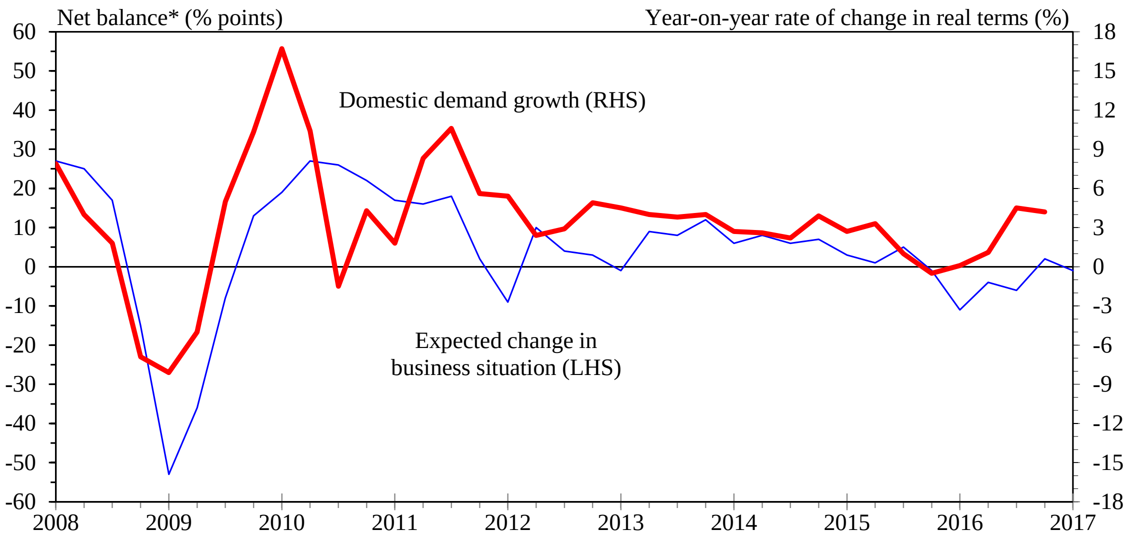
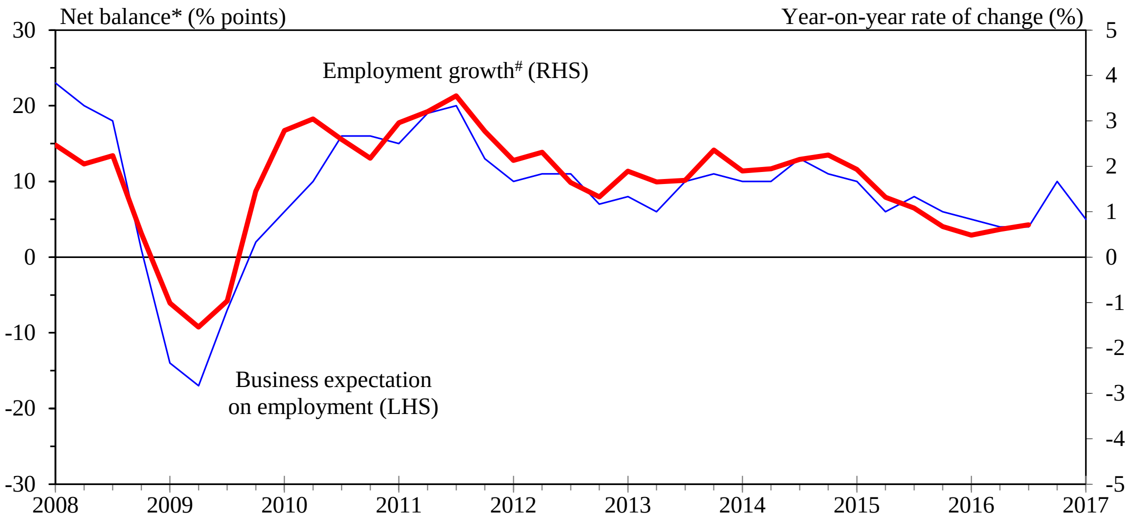


Diagram 2.10 : Business sentiments of large enterprises have tended to remain stable of late



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

Diagram 2.11 : Hiring sentiment held broadly stable

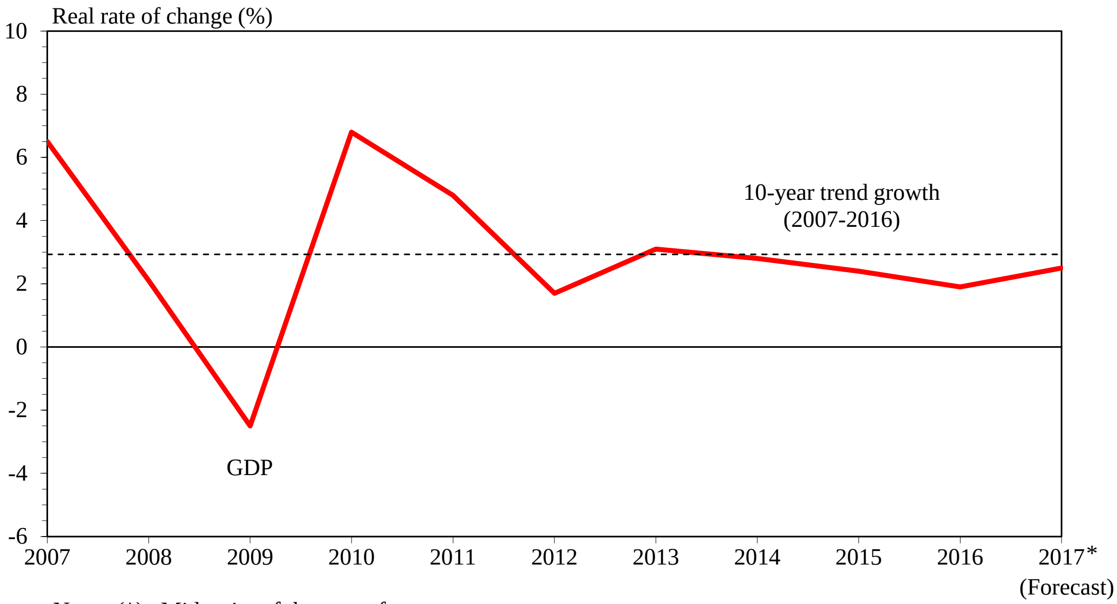


Notes : (*) Net balance indicates the direction of expected change in number of persons engaged versus the preceding quarter. It refers to the difference in percentage points between the proportion of establishments choosing "up" over that choosing "down". A positive sign indicates a likely upward trend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

(#) Employment in the private sector.

2.25 Taking into account a likely further improvement in export performance and continued growth in domestic demand, the Hong Kong economy is projected to grow by 2-3% in 2017, after the 1.9% growth in 2016 and compared to the average annual growth of 2.9% in the past ten years. The forecast is predicated on a slightly faster economic expansion in the US amid a gradual interest rate normalisation by the Fed, modest economic recovery in Europe, no significant disruptions to the global financial environment arising from developments on economic and political fronts, and steady economic performance in the Mainland and other Asian emerging market economies. For comparison, the latest forecasts by private sector analysts for Hong Kong's economic growth in 2017 mostly fall within the range of 1.1-2.1%, averaging around 1.6%, and that by the IMF is 1.9%. Yet, there are downside risks to the forecast if the global economic recovery were to stall again. Abrupt changes in global economic and financial conditions could heighten risk aversion and bring about sudden reversals of capital flows and sharp corrections in asset prices, which would hurt sentiment and derail the current global economic recovery path. On the other hand, there may be some upside potential to the forecast if global economic growth can gain more traction, providing a more favourable support for regional trade flows, to the benefit of Hong Kong. Domestic demand will fare better than expected if financial markets can be more stable and if economic sentiment holds up.

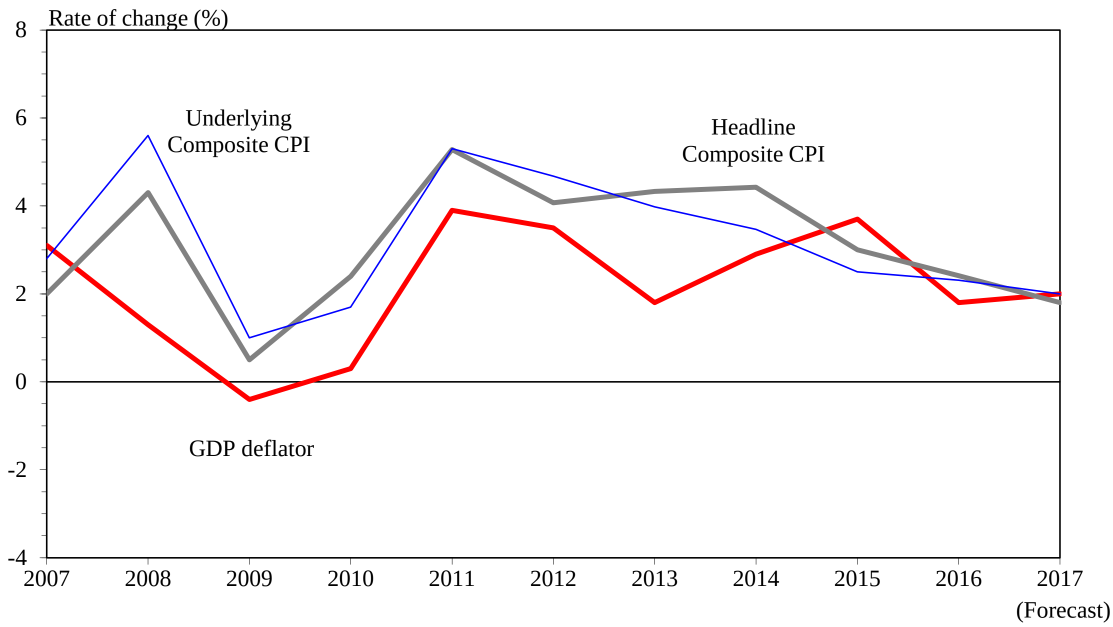
Diagram 2.12 : Hong Kong economy is expected to fare better in 2017, but uncertainties prevail



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

2.26 Underlying inflation in Hong Kong edged down from 2.5% in 2015 to 2.3% in 2016, marking the fifth consecutive year of easing. On the external front, slow growth in the advanced economies and the still-tame inflation outlook for Hong Kong's major trading partners should ease some of the upward pressures from commodity prices and help keep imported inflation in check. On the domestic front, local cost pressures should remain at bay, considering the likely moderate economic growth and the continued feed-through of the earlier softening in rentals. The *underlying Composite CPI* is forecast to increase by 2% for 2017 as a whole, compared to the 2.3% increase in 2016. Taking into account the effects of the Government's one-off measures, the *headline Composite CPI* is forecast to increase by 1.8% in 2017, compared to 2.4% in 2016. The *GDP deflator* is forecast to rise by 2%, in light of the anticipated mild price pressures from both the local and external fronts.

Diagram 2.13 : Inflation will likely remain moderate in 2017



Forecast rate of change in 2017 (%)

Gross Domestic Product (GDP)

Real GDP	**2 to 3**
Nominal GDP	4 to 5
Per capita GDP in real terms	1.2 to 2.2
Per capita GDP at current market prices	HK$349,700 – 353,000 (US$44,800 – 45,300)

Composite Consumer Price Index

Underlying	**2**
Headline	**1.8**

GDP Deflator **2**

Forecast on Hong Kong's real GDP growth in 2017 recently made by other selected parties

	(%)
The University of Hong Kong	1.5 to 2.5
Average forecast by private sector analysts[#]	1.6

Note : (#) Real GDP growth forecasts by private sector analysts mostly fall between 1.1% and 2.1%.

Medium-term outlook for the Hong Kong economy

2.27 Over the medium term, the outlook for the Hong Kong economy remains positive, though external uncertainties still abound on the economic, political and policy fronts. Global economic growth will likely stay modest for an extended period under the “new normal” with unresolved structural issues, while new risks have emerged.

2.28 Among the advanced economies, the US economic outlook is more promising, but will hinge on whether the intended effects of the new US administration’s growth-enhancing policies will be materialised, and how they may affect the Fed’s course of interest rate normalisation and global growth prospects. Meanwhile, many economies in the euro area and Japan are still troubled by lingering structural problems. Apart from the lack of clarity about the trade policy direction of the US, the unfolding of Brexit could also affect future developments in global trade and investment flows. The negotiation process between the UK and the EU is likely to extend beyond 2017. Whether anti-globalisation and protectionist sentiments will spread and result in a change towards more inward-oriented policies in the major economies in the coming years warrant a close watch. Moreover, the potential output growth of many advanced economies beyond the near term looks set to slow amid the absence of a strong demand-side recovery, a protracted period of underinvestment, a slowdown in productivity growth and the intensification of population ageing over time.

2.29 Emerging market economies, in contrast, will remain the main propellers of global economic growth over the medium term. Many emerging market economies have devoted considerable efforts to reduce vulnerabilities and enhance resilience against external shocks, and this should hopefully bear fruit. In particular, Asian economies will likely continue to shine in the global economic arena, underpinned by their stronger economic fundamentals and resilient domestic demand.

2.30 Given Asia’s rising prominence in the global economy, strengthening economic co-operation with the Mainland and our neighbouring economies is vital to Hong Kong’s economic development over the longer run. The Mainland’s economic reorientation towards domestic consumption and the services sector and a further opening up of its market will likely raise the demand for Hong Kong’s higher-end services, especially in the areas of finance and professional services. Closer linkages with the Mainland’s financial markets, the internationalisation of the RMB, the “going-out” of Mainland enterprises, as well as the Belt and Road Initiative, will continue to bring forth extensive opportunities, enabling Hong Kong to serve as a fund-raising and financial management platform, a trade and logistics hub, as well as an investment springboard. CEPA and other co-operation platforms will help deepen our economic integration with the Mainland and consolidate our status as the world's leading offshore RMB business centre and premier asset management hub. Separately, the Government will strive to explore ways to expand trade and investment flows with neighbouring economies and emerging markets that have promising growth prospects.

2.31 In order to make Hong Kong stand out in the midst of the intense global competition, the Government has made continuous efforts to promote Hong Kong's transformation into a high value-added and knowledge-based economy. The Government will further enhance the competitiveness of our pillar industries and promote new growth areas, including riding on the global wave of Fintech and the applications of other innovative technologies. The Government is also committed to raising productivity growth and uplifting our competitiveness through improving the quality of human and physical capital.

2.32 Hong Kong has long been a staunch supporter of free trade, achieving remarkable economic success by leveraging on the opportunities arising from globalisation over the past decades. In face of lingering external uncertainties, the Government will continue to uphold institutional strengths and to make the most out of the free market mechanism, which form the cornerstone of our economy. These include an open market with free movement of goods, capital and people, a low and simple tax regime, a level-playing field for all businesses, the rule of law, an independent judiciary, and the protection of intellectual property rights. All these important institutions will continue to support a favourable business environment for attracting companies, start-ups and entrepreneurs from overseas and the Mainland to invest and expand their business activities in Hong Kong.

2.33 Meanwhile, population ageing, a common phenomenon across advanced economies, has become a more visible challenge to Hong Kong's economic growth, as the labour force could peak as early as in 2018. In response to an ageing population, the Government has adopted a multi-pronged approach by encouraging labour force participation, enhancing the quality of workforce through education and training, attracting talent from outside Hong Kong and creating a family- and age-friendly environment. An ageing society will have profound impacts on public expenses, particularly in the areas of healthcare and social welfare. Yet, the Government will strive to maintain the health of our public finances such that sufficient public resources can be ensured to foster economic development and to build an inclusive society, through tackling the various needs of our economy, including investments in education, training and infrastructure for raising productivity growth, and addressing social issues through different programmes. Taking into account the developments on the external and domestic fronts, the economy is expected to attain a trend growth of 3% per annum in real terms from 2018 to 2021.

2.34 Inflationary pressures are expected to remain moderate over the medium term. Externally, modest global economic growth will likely keep world inflation at a relatively low level. Locally, productivity gains should play a part in alleviating some of the local cost pressures. The Government's incessant efforts to increase land and housing supply will improve the demand-supply situation in the property market, helping to contain rental cost pressures in the years ahead. Taking all these developments into account, the trend rate of change in the underlying Composite CPI in Hong Kong from 2018 to 2021 is forecast at 2.5% per annum. There are, however, upside risks to Hong Kong's inflation outlook, if international food and energy prices accelerate sharply due to adverse supply shocks, or if the global economic recovery is stronger than expected and leads to more rapid increases in inflationary pressures.

Diagram 2.14 : Medium-term trend growth forecast at 3% per annum