CHAPTER 1 : OVERVIEW OF ECONOMIC PERFORMANCE

Summary

- *The Hong Kong economy grew notably by 4.3% in the first quarter of 2017 over a year earlier, sustaining the improving trend that began in the second quarter of last year. External demand continued to strengthen as the global economic environment further improved. Domestic demand also held up well, supported by favourable employment conditions and more positive business sentiment.*

- *On the back of strengthening global demand and continued expansion in regional trading and manufacturing activities, Hong Kong's total exports of goods grew briskly in the first quarter, marking the fastest year-on-year growth since the first quarter of 2013. Exports of services likewise picked up, benefitting from the stronger trade and cargo flows as well as better global economic sentiment. With visitor arrivals resuming growth gradually, exports of travel services also continued to see relative improvement after a prolonged period of setback.*

- *The domestic segment stayed resilient. Private consumption expenditure sustained solid growth, as local consumer sentiment was well underpinned by the favourable job and income conditions and, to some extent, the relatively buoyant asset market performance. Overall investment expenditure increased notably, thanks to the strong expansion of building and construction activity despite the continued fall in machinery and equipment acquisition.*

- *The labour market remained in a state of full employment, with total employment rising to another record high. The seasonally adjusted unemployment rate eased to 3.2% in the first quarter, a low level last seen in the second quarter of 2014, and the underemployment rate also fell to a three-year low of 1.2%. Wages and earnings showed further real improvements on the back of a tight labour market.*

- *The local stock market rallied during the first quarter, alongside the worldwide increase in risk appetite that also fuelled many overseas stock markets. Global investors reacted positively to the improving global outlook despite the interest rate normalisation in the US and the various policy and political uncertainties in the US and Europe. Separately, the residential property market showed some reactivation during the first quarter, with both flat prices and trading activities picking up.*

- *Inflation pressure remained well contained. External cost pressures stayed largely tame, thanks to the low inflation in our major import sources and the strength of the US dollar against many other currencies over the*

past year. Increases in domestic costs were also moderate in the meanwhile.

Overall situation

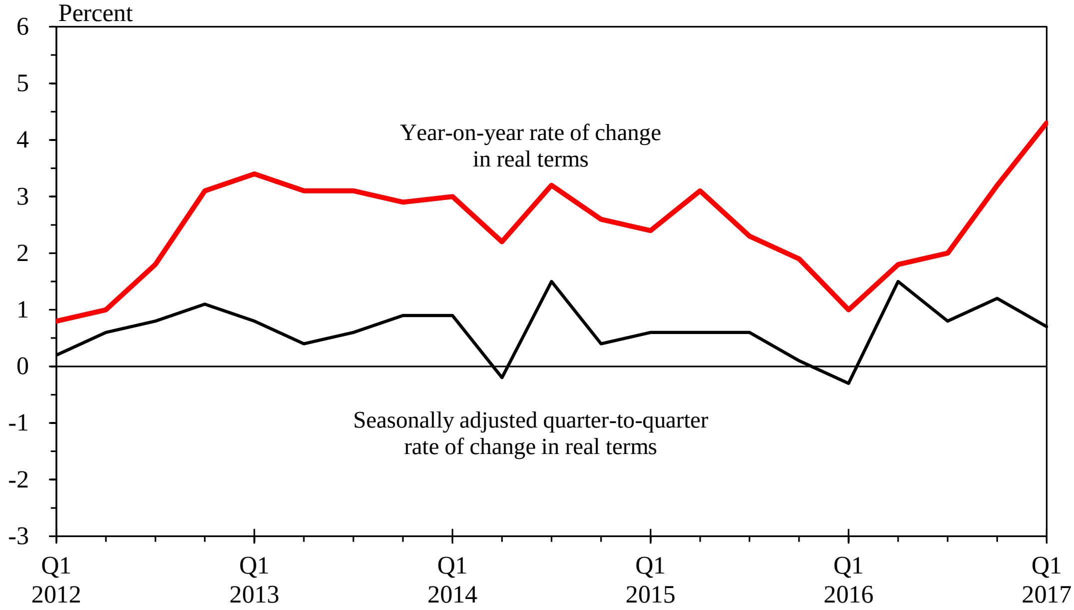
1.1 The Hong Kong economy expanded notably by 4.3% in the first quarter of 2017 over a year earlier, with exports strengthening and domestic demand displaying remarkable resilience. This well sustained the improving trend that started in the second quarter of last year. The strengthening global economic environment helped buttress the performance of Hong Kong's exports of goods and services in the first quarter. The sustained recovery of visitor arrivals also reduced the drag on exports of travel services. Along with an improved economic outlook, local consumer sentiment held firm. Business sentiment, especially among the large enterprises, also improved. Overall investment expenditure saw faster growth, supported by the strong expansion of building and construction activity, despite the continued decline in machinery and equipment acquisition. The labour market was in full employment and turned slightly tighter, with the unemployment rate edging lower. Nevertheless, consumer price inflation remained modest.

1.2 Global economic activity picked up further in the first quarter. The US economy sustained expansion, while the Mainland economy, beating market expectations, accelerated slightly and stayed firmly on track to attain medium-to-high growth. The euro area and Japan both registered further modest economic growth. The Federal Reserve raised interest rates in mid-March, the second time within three months, and indicated more rate hikes to come if the US economic situation remains favourable (see ***Box 1.1*** on US interest rate outlook). Reflecting a brightening global outlook, in April the International Monetary Fund (IMF) projected global economic growth[(1)] to rise from 3.1% in 2016 to 3.5% in 2017, which was 0.1 percentage point higher than the corresponding forecast made three months earlier. However, the IMF points out that binding structural impediments continue to hold back a stronger global recovery and the balance of risks remains tilted to the downside, especially over the medium term. Meanwhile, the concern about the building up of trade tensions between the US and the Mainland was mitigated somewhat, following the successful visit by President Xi to the US in early April.

1.3 Against the background of the continued recovery in global demand, Hong Kong's exports of goods accelerated markedly in growth in the first quarter. Benefitting from the improving trade and cargo flows, more optimistic global economic sentiment and a gradual recovery in inbound tourism, exports of services also picked up. On the domestic front, a more optimistic global outlook was also supportive to both local consumption and investment sentiments. The favourable employment and income conditions underpinned the solid growth in private consumption, whereas the strong expansion of building and construction activities lent strength to overall investment spending despite the still-weak machinery and equipment acquisition. Inflation pressure remained modest in the first quarter amid moderate local cost pressures and muted imported inflation.

1.4 In the first quarter of 2017, *Gross Domestic Product* (GDP)[(2)] grew by 4.3% in real terms over a year earlier, up from the 3.2% growth in the preceding quarter (revised from the earlier estimate of 3.1%). The stronger year-on-year growth of the economy, which was the highest since the second quarter of 2011, also benefitted from the low base of comparison in the first quarter of last year, when economic growth hit a trough amid a disappointing external environment. On a seasonally adjusted quarter-to-quarter comparison[(3)], real GDP grew further by 0.7% in the first quarter, after three consecutive quarters of rapid growth, averaging 1.2% per quarter.

Diagram 1.1 : The Hong Kong economy showed notable year-on-year growth in the first quarter



The external sector

1.5 *Total exports of goods* compiled under the GDP accounting framework showed a notable growth of 9.2% in real terms in the first quarter over a year earlier, up from an increase of 5.1% in the preceding quarter and 1.8% for 2016 as a whole. Analysed by major market, by reference to external merchandise trade statistics, exports to many Asian economies, including the Mainland, registered strong growth in the first quarter, as the intensified trading and manufacturing activities in Asia notably increased the region's intake for raw materials, semi-manufactures and capital goods. Meanwhile, our exports to the major advanced markets also improved by various extents. Exports to Japan picked up amid the revival in the regional trade flows, while those to the US and EU both reverted to moderate growth.

1.6 *Exports of services* also benefitted from the better global economic conditions in the first quarter, up by 2.6% in real terms over a year earlier, compared to the 1.2% growth in the preceding quarter and the 3.2% decline for 2016 as a whole. Exports of transport services sustained brisk growth, amid the stronger regional trade and cargo flows. Exports of financial services reverted to a modest growth and exports of business and other services also grew slightly further, thanks to a more sanguine global economic environment. Exports of travel services also saw some relative improvement, reflecting the continued recovery of visitor arrivals. However, tourist spending had yet to resume growth, probably being constrained by the currency movements and changing tourist spending patterns.

Table 1.1 : Gross Domestic Product, its main expenditure components and the main price indicators (year-on-year rate of change (%))

	2015#	2016#	2016 Q1#	2016 Q2#	2016 Q3#	2016 Q4#	2017 Q1+
Change in real terms of GDP and its main expenditure components (%)							
Private consumption expenditure	4.8	1.8	1.5 (0.2)	0.4 (0.7)	1.6 (1.1)	3.6 (1.5)	3.7 (0.4)
Government consumption expenditure	3.4	3.4	3.2 (0.9)	3.6 (1.0)	3.4 (0.5)	3.4 (0.9)	3.7 (1.2)
Gross domestic fixed capital formation	-3.2	-0.3	-8.7	-5.1	7.2	5.6	6.4
of which :							
Building and construction	2.2	3.9	1.5	2.4	4.3	7.5	9.6
Machinery, equipment and intellectual property products	-7.7	-4.6	-10.8	-10.3	7.6	-4.2	-8.9
Total exports of goods&	-1.7	1.8	-3.5 (-2.5)	2.4 (3.0)	2.5 (0.7)	5.1 (3.9)	9.2 (1.5)
Imports of goods&	-2.7	1.1	-5.6 (-3.8)	0.6 (3.6)	3.1 (1.9)	5.6 (4.0)	9.9 (0.2)
Exports of services&	0.3	-3.2	-5.4 (-1.0)	-6.2 (-0.6)	-2.5 (1.8)	1.2 (1.1)	2.6 (0.5)
Imports of services&	5.0	2.0	4.1 (1.7)	1.2 (-1.1)	0.8 (-0.2)	2.0 (1.6)	0.9 (0.5)
Gross Domestic Product	**2.4**	**2.0**	**1.0** **(-0.3)**	**1.8** **(1.5)**	**2.0** **(0.8)**	**3.2** **(1.2)**	**4.3** **(0.7)**
Change in the main price indicators (%)							
GDP deflator	**3.6**	**1.8**	**2.1** **(0.5)**	**1.7** **(0.5)**	**1.5** **(0.2)**	**1.8** **(0.6)**	**1.9** **(0.6)**
Composite CPI							
Headline	**3.0@**	**2.4**	**2.8** **(0.7)**	**2.6** **(-0.6)**	**3.1** **(0.4)**	**1.2** **(0.7)**	**0.5** **(0.1)**
Underlying^	**2.5@**	**2.3**	**2.8** **(0.7)**	**2.3** **(0.2)**	**2.1** **(0.5)**	**2.1** **(0.7)**	**1.4** **(0.1)**
Change in **nominal GDP** *(%)*	**6.1**	**3.9**	**3.2**	**3.6**	**3.6**	**5.0**	**6.3**

Notes : Figures are subject to revision later on as more data become available. Seasonally adjusted quarter-to-quarter rate of change is not applicable to gross domestic fixed capital formation, as no clear seasonal pattern is found for the category due to the presence of considerable short term fluctuations.

(&) Figures are compiled based on the change of ownership principle in recording goods sent abroad for processing and merchanting under the standards stipulated in the *System of National Accounts 2008*.

(#) Revised figures.

(+) Preliminary figures.

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

(^) After netting out the effects of Government's one-off relief measures.

(@) The year-on-year rates of change of the CPIs from the fourth quarter of 2015 onwards are computed from the new 2014/15-based series, and those before are from the old 2009/10-based series. Splicing has been applied to the indices in order to obtain better estimates of the rates of change for the year 2015.

Box 1.1

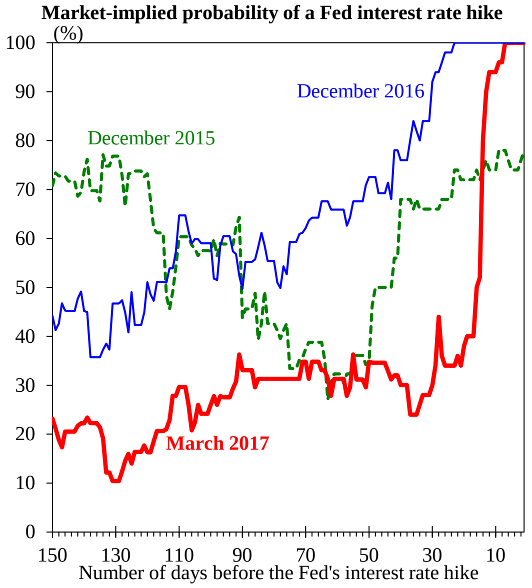
The US interest rate outlook

Following the interest rate hike in December 2016, the US Federal Reserve (Fed) raised the target range for the federal funds rate by another 25 basis points to 0.75-1.00% in March 2017, marking the third increase since December 2015. While the Fed kept the federal funds rate unchanged in its latest Federal Open Market Committee (FOMC) meeting in early May, the interest rate normalisation process in the US is expected to continue in the coming years, though the pace would hinge on the developments of the US economy. Considering that the US interest rate is highly relevant to the Hong Kong economy, this note briefly examines the uncertainties surrounding the US interest rate outlook.

Swings in market perceptions on the Fed's future interest rate actions could bring about significant shifts in the direction of capital flows and heighten volatility in global financial and foreign exchange markets, especially against the backdrop of deepening policy divergence among major central banks. While many regarded the rate hike in March 2017 as widely expected at the time it was announced, market participants only priced in a probability of around 40% for a March rate hike in late February, notwithstanding generally positive incoming economic data. It was after Fed officials had signalled an interest rate hike could come as early as March that the market priced in a considerably higher probability for an upcoming interest rate move (***Chart 1***). Similar observations can be drawn when the same analysis is performed on the two other interest rate hikes earlier on. These showed the potential extent of uncertainty when predicting US interest rate movements as purely deduced from analysing financial market data.

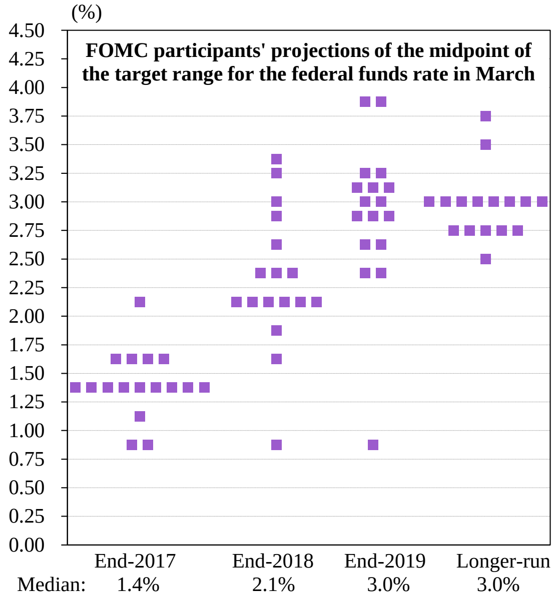
Another perspective to look at the US interest rate outlook is from the projections of the Fed. ***Chart 2*** shows the extent of disparity between the federal funds rate projections of individual FOMC participants in their meeting in March this year. While the median and mode of their projections both pointed to two more interest hikes of 25 basis points each this year, the extent of variability became much larger at end-2018 (from 1.50-1.75% to 3.25%, if removing the extreme values) and at end-2019 (from 2.25-2.50% to 3.25%, if removing the extreme values). On the other hand, it is worth noting that, despite the great variability in the expected interest rate paths of the FOMC participants in the coming two to three years, most of them considered that the US federal funds rate should be around 3.0% in the longer run, i.e. around 2 percentage points higher than the current level.

Chart 1 : Expectations in the financial markets for an interest rate hike only aligned with the Fed shortly before the FOMC decision



Source: Bloomberg's federal funds futures pricing.

Chart 2 : Notable disparity between the expected interest rate paths of the FOMC participants in 2-3 years' time



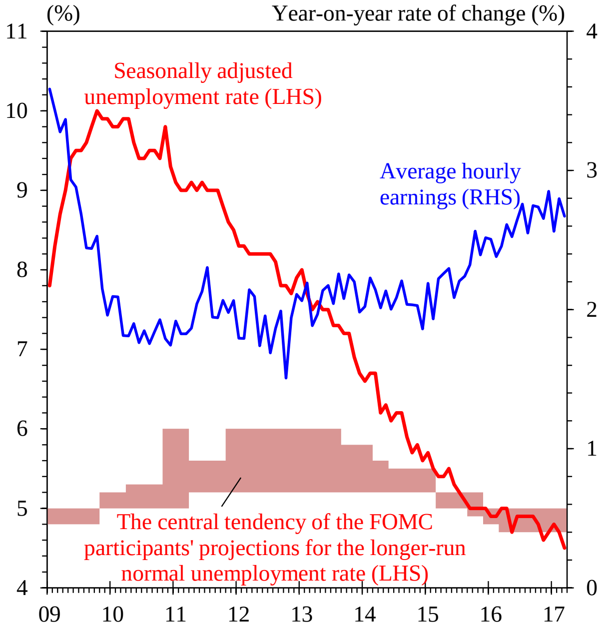
Box 1.1 (Cont'd)

Although there appears to be uncertainty about the pace of interest rate hikes down the road, the US economy's solid progress towards the Fed's dual mandate of maximising employment and maintaining stable prices will provide support for the interest rate normalisation process to continue. In particular, the US labour market has improved significantly and is in the vicinity of fulfilling maximum employment, supported by continued expansion of the US economy. Nonfarm payroll employment gains were solid, averaging 187 000 per month in 2016 and 178 000 per month in the first quarter of 2017. The unemployment rate trended lower to 4.5% in March, slightly below the central tendency of the longer-run normal level projected by the FOMC participants. Alongside a tighter labour market, average hourly earnings growth accelerated gradually from 2.4% year-on-year in the first quarter of 2016 to 2.7% in the first quarter of 2017 (***Chart 3a***).

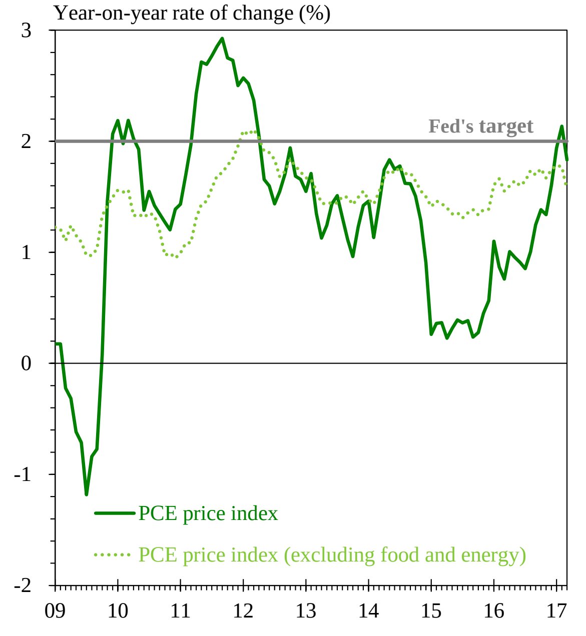
As for prices, personal consumption expenditure (PCE) inflation, the Fed's preferred measure, has moved closer to the Fed's 2% target, picking up progressively from 0.9% in the first quarter of 2016 to 1.4% in the fourth quarter and to 2.0% in the first quarter of 2017, on the back of the oil price recovery, while core PCE inflation averaged 1.7% in the first quarter of 2017 (***Chart 3b***).

Chart 3 : The US economy's solid progress towards the Fed's objectives for monetary policy will provide support for further interest rate normalisation down the road

(a) The labour market continued to improve



(b) PCE inflation has picked up



It is widely expected that the US economy will see slightly faster growth going forward. In April, the IMF projected the US economic growth to be 2.3% in 2017 and 2.5% in 2018, representing a pick-up from the 1.6% growth in 2016. Firmer economic expansion in the US, coupled with a further strengthening in labour market conditions, should help support a sustained pick-up in wage growth, which would in turn exert upward pressures on inflation. Hence the possibility of a faster pace of interest rate increases should not be ruled out.

Box 1.1 (Cont'd)

However, the still-evolving policy developments under the new US administration have complicated the US economic outlook and the Fed's course of monetary policy. On one hand, the proposed tax reforms and infrastructure spending plans, and initiatives to review financial regulations, if implemented in a timely manner, could provide a stronger impetus to US growth. Yet the sustainability of US long-term fiscal position could limit the availability of policy space. On the other hand, there are concerns about a possible rise in protectionist sentiment and the potential adoption of more inward-looking trade policies. The movements of the US dollar will also complicate the inflation picture. How the new administration's set of economic policies will ultimately impact on US growth and inflation, and hence the interest rate outlook, remains to be seen.

Another dimension of the Fed's monetary policy normalisation that deserves a close watch is the eventual scale-back of the Fed's balance sheet. In its May policy statement, the Fed once again indicated that the current reinvestment policy of longer-term asset securities is anticipated to continue until the normalisation of interest rates is well under way to help keep financial conditions accommodative. That said, according to the minutes of March's FOMC meeting, most participants judged that a change to the Fed's current reinvestment policy (implying a scale-back in the Fed's balance sheet) would likely be appropriate later this year, though the timing is still uncertain and would depend on economic and financial conditions. Given the various uncertainties surrounding the issue, market speculations about the Fed's preferred size and composition of its balance sheet as well as the appropriate timing to start its scale-back might affect financial and liquidity conditions in the period ahead.

While there are uncertainties surrounding the Fed's timing and pace of future interest rate hikes and hence risks of increased financial market volatility, Hong Kong is capable of navigating through capricious global financial conditions and of handling massive capital flows, thanks to our strong economic fundamentals and robust financial system. The Government will continue to closely monitor the US economic and monetary policy developments and their possible impacts on the Hong Kong economy.

The domestic sector

1.7 The domestic sector stayed resilient in the first quarter. Local consumption sentiment remained well underpinned by the favourable employment and earning conditions and, to some extent, the positive wealth effect from higher asset prices. *Private consumption expenditure* grew solidly by 3.7% in real terms in the first quarter over a year earlier, similar to the expansion pace in the preceding quarter. *Government consumption expenditure* went up further by 3.7% in the first quarter, broadly similar to the growth pace in recent years.

Table 1.2 : Consumer spending by major component[(a)]
(year-on-year rate of change in real terms (%))

		Total consumer spending in the domestic market[(a)]	*Of which :* Food	Durables	Non-durables	Services	Residents' expenditure abroad	Visitor spending	Private consumption expenditure[(b)]
2016	Annual	-0.2	0.9	-13.3	-0.3	1.9	7.1	-8.1	1.8
	H1	-1.7	0.7	-17.9	-2.5	1.1	9.2	-11.0	1.0
	H2	1.2	1.2	-8.8	1.9	2.8	5.1	-5.3	2.7
	Q1	-2.2	-1.8	-17.8	-3.4	1.8	16.6	-13.0	1.5
	Q2	-1.1	2.7	-18.1	-1.5	0.3	2.4	-8.8	0.4
	Q3	*	0.3	-8.1	-2.9	2.2	4.0	-7.4	1.6
	Q4	2.3	2.0	-9.3	6.1	3.3	6.1	-3.3	3.6
2017	Q1	3.5	3.3	-1.1	4.5	3.9	-0.2	-0.3	3.7

Notes : (a) Consumer spending in the domestic market comprises both local consumer and visitor spending, which are not separable from the survey data.

(b) Private consumption expenditure is obtained by deducting visitor spending from the total consumer spending in the domestic market, and adding back residents' expenditure abroad.

(*) Change within ± 0.05%.

Diagram 1.2 : Private consumption expenditure grew moderately further

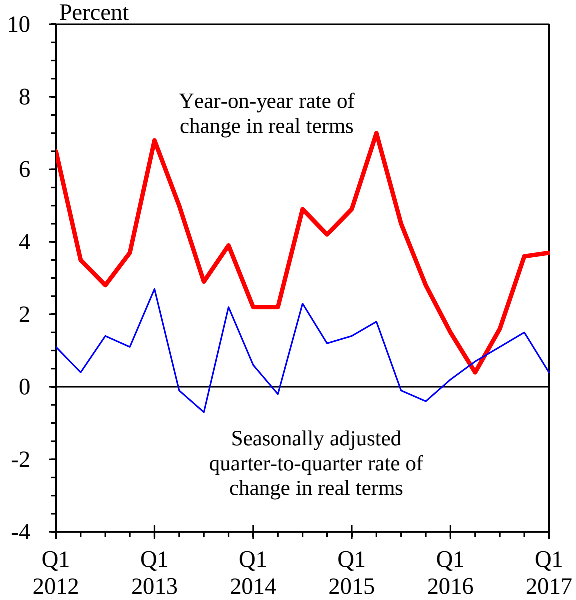
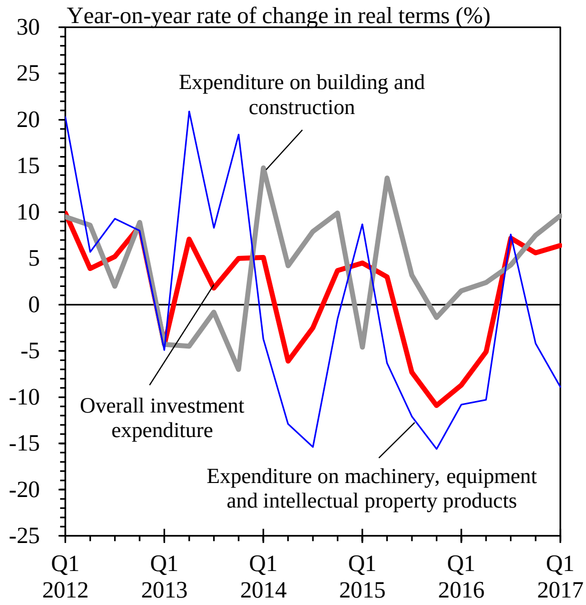


Diagram 1.3 : Investment spending picked up



1.8 Overall investment spending in terms of *gross domestic fixed capital formation* increased notably further by 6.4% year-on-year in real terms in the first quarter, after the visible rebound of 6.3% in the second half of last year. Overall building and construction activity grew strongly further, as buttressed by the double-digit growth in public building and construction works and the visible expansion in private sector building and construction works. However, machinery and equipment acquisition continued to decline, as such spending by the private sector had yet to recover. Conceivably reflecting the more optimistic global economic outlook, the results of the latest Quarterly Business Tendency Survey and the Monthly Survey on the Business Situation of Small and Medium-sized Enterprises (SMEs) (see ***Box 1.2*** for details of business sentiments) suggested that business sentiment turned slightly more positive since entering 2017, particularly so among the large enterprises.

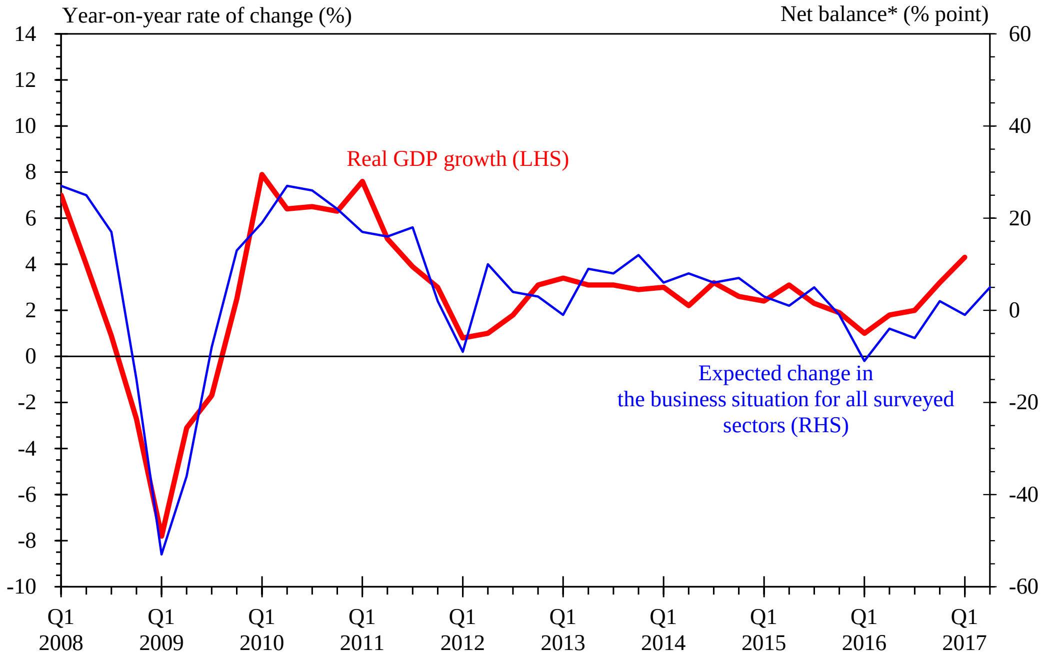
Box 1.2

Business sentiment in Hong Kong

To gain a better understanding of the prevailing business situation and expectations in Hong Kong, the Census and Statistics Department (C&SD) conducts the Quarterly Business Tendency Survey (QBTS) to collect views from over 500 large establishments and the Monthly Survey on the Business Situation of Small and Medium-sized Enterprises (SMEs) to solicit feedbacks from over 500 SMEs[(1)].

According to recent QBTS results, the overall business sentiment of large enterprises in Hong Kong, though still somewhat cautious in some sectors, was generally on an improving trend in the past several quarters. This was largely in line with the re-acceleration of Hong Kong's economic growth since the second quarter of 2016, after a notable slackening in the first quarter of 2016 (***Chart 1***). Based on the latest survey results, in which respondents were asked to exclude seasonal influences in their responses, the proportion of respondents expecting their businesses to fare better in the second quarter of 2017 was slightly higher than that of those expecting a weaker business performance, with large enterprises in such sectors as "information and communications" and "financing and insurance" particularly optimistic about the near-term business outlook. Many other sectors such as "professional and business services", "retail", "import/export trade and wholesale" and "construction" also showed varying degrees of relative improvement (***Table 1***). Meanwhile, hiring sentiment of large enterprises in most sectors remained positive, amid a tight labour market (***Table 2***).

Chart 1 : Sentiments among large enterprises were generally on an improving trend in the past several quarters



Note : (*) Net balance indicates the direction of expected change in the 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.

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(1) SMEs in the sectors covered refer to establishments with fewer than 50 persons engaged.

Box 1.2 (Cont'd)

Table 1 : Large enterprises in some sectors turned more optimistic about the near-term business outlook

QBTS: Expected changes in business situation						
	Net balance* (% point)					
	2016				2017	
	Q1	Q2	Q3	Q4	Q1	Q2
Manufacturing	-10	+12	-2	+2	+18	+14
Construction	-11	-7	-12	-11	-18	-14
Import/export trade and wholesale	-30	-8	-14	-14	-6	-2
Retail	-47	-40	-38	-2	-15	-4
Accommodation and food services	-15	-17	-11	+13	-14	-13
Transportation, storage and courier services	+1	+8	+5	+12	+7	-2
Information and communications	+13	0	+12	+15	0	+19
Financing and insurance	+7	+9	+6	+12	+12	+24
Real estate	-7	-6	-3	+4	-2	0
Professional and business services	0	-11	-14	+9	-8	0

Note: (*) Net balance indicates the direction of expected change in the 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.

Table 2 : Hiring sentiment among large enterprises was mostly positive

QBTS: Expected changes in number of persons engaged						
	Net balance* (% point)					
	2016				2017	
	Q1	Q2	Q3	Q4	Q1	Q2
Manufacturing	-3	+12	+12	+17	+10	-7
Construction	+13	+1	+11	+4	-8	0
Import/export trade and wholesale	-3	-3	-6	-5	0	+2
Retail	+9	-2	-4	+4	+1	+4
Accommodation and food services	+7	+12	+15	+16	+5	+9
Transportation, storage and courier services	+10	+11	+18	+20	+17	+9
Information and communications	+13	+12	+21	+13	+14	+24
Financing and insurance	+7	+7	+10	+10	+15	+16
Real estate	+14	+14	+6	+27	+28	+18
Professional and business services	+5	-4	-7	+15	0	+6

Note: (*) Net balance indicates the direction of expected change in the 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.

As for the SMEs, a set of diffusion indices is compiled by the C&SD based on the monthly survey, to gauge the general directions of change in the respondents' views on business receipts, employment and new orders versus the preceding month. The diffusion indices on business receipts suggested that the overall business situation of the SMEs showed some relative improvement in recent months. The overall index picked up successively from 45.2 in December 2016 to 47.2 in March 2017 and stayed steady at 47.0 in April, albeit still below the boom-bust threshold of 50.0 (***Table 3***). Performances of individual sectors were mixed in terms of business receipts. While the SMEs in the business services sector fared better in April, the readings for those in wholesale trade, real estate, restaurants, and logistics were well below the boom-bust threshold of 50.0. Nevertheless, the SMEs surveyed in general suggested a broadly stable employment situation in recent months (***Table 4***).

For the import/export trade sector in particular, SMEs' views on new orders were sought separately to help gauge the likely export performance in the near term. The diffusion index on new orders hovered below the 50.0 boom-bust threshold in recent months, plausibly reflecting some concerns about lingering external uncertainties (***Table 5***).

The monthly survey on SMEs also indicated that the overall credit situation remained highly accommodative in recent months. In April 2017, 8.0% of SMEs reported current need for credit. Thanks to the generally accommodative monetary conditions and the Government's continued efforts to support SMEs through various loan guarantee and funding schemes, only 0.5% reported tight access to credit (***Table 6***).

While these two surveys have their limitations and the results should be interpreted with care, the latest survey findings seem to suggest that business sentiment in general turned slightly more positive since entering 2017, though some cautiousness lingered on among certain businesses. Although the global economy has been improving gradually since the second quarter of last year, the Government will remain vigilant to various risk factors in the external environment and their possible repercussions on the Hong Kong economy.

Box 1.2 (Cont'd)

Table 3 : Diffusion indices^ on SMEs' business receipts

	2016 Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2017 Jan	Feb	Mar	Apr
Local segments													
Restaurants	44.0	41.4	40.2	49.2	45.0	47.5	44.1	41.9	42.4	45.1	44.4	43.0	43.7
Real estate	46.6	53.4	43.8	50.0	47.4	55.3	42.1	33.3	40.4	45.2	48.0	50.0	42.5
Retail trade	38.8	44.2	37.2	39.7	43.3	45.3	47.9	47.1	43.2	45.2	44.0	43.1	47.6
Wholesale trade	32.4	35.3	38.9	41.7	50.0	47.2	41.7	48.1	41.1	46.4	44.6	40.0	40.0
Business services	50.0	51.8	48.5	45.6	48.5	47.1	47.2	51.2	51.1	51.1	49.0	51.0	54.2
External segments													
Import/export trade	50.9	46.3	41.4	44.0	45.2	45.2	46.9	47.2	47.2	45.2	46.7	50.0	47.0
Logistics	46.7	46.4	37.5	39.5	47.4	50.0	47.1	45.7	38.3	43.5	45.3	44.1	44.1
All the above sectors*	**45.7**	**45.9**	**41.0**	**43.6**	**45.7**	**46.6**	**46.3**	**46.4**	**45.2**	**46.0**	**46.1**	**47.2**	**47.0**

Notes : (^) The diffusion index is computed by adding the percentage of SMEs reporting "up" to one half of the percentage of SMEs reporting "same". A diffusion index reading above 50 indicates that the business condition is generally favourable, whereas an index below 50 indicates otherwise. Respondents were requested to exclude seasonal effects in reporting their views.

(*) Weighted average using total number of SMEs in individual sectors as weights.

Table 4 : Diffusion indices^ on SMEs' employment situation

	2016 Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2017 Jan	Feb	Mar	Apr
Local segments													
Restaurants	50.9	48.3	45.9	50.0	51.7	48.3	51.7	46.3	48.2	50.0	47.5	48.7	46.8
Real estate	50.0	50.0	50.0	46.1	50.0	51.3	51.3	44.8	47.1	47.1	48.0	51.0	50.0
Retail trade	47.4	49.5	48.7	48.3	49.6	49.6	49.6	50.0	49.1	49.4	49.7	49.7	50.0
Wholesale trade	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	48.2	50.0	48.3
Business services	50.0	50.0	48.5	48.5	48.5	48.6	50.0	50.0	50.0	50.0	50.0	51.0	51.0
External segments													
Import/export trade	50.5	49.5	48.8	48.7	49.1	48.2	48.2	50.7	49.1	50.0	50.0	49.1	49.7
Logistics	43.3	50.0	50.0	44.7	50.0	44.4	47.1	52.2	51.7	51.6	50.0	48.5	50.0
All the above sectors*	**49.4**	**49.6**	**48.8**	**48.4**	**49.5**	**48.8**	**49.3**	**49.8**	**49.2**	**49.7**	**49.5**	**49.6**	**49.7**

Notes : (^) The diffusion index is computed by adding the percentage of SMEs reporting "up" to one half of the percentage of SMEs reporting "same". A diffusion index reading above 50 indicates that the employment situation is generally favourable, whereas an index below 50 indicates otherwise. Respondents were requested to exclude seasonal effects in reporting their views.

(*) Weighted average using total number of SMEs in individual sectors as weights.

Table 5 : Diffusion index^ on SMEs' current new orders

	2016 Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2017 Jan	Feb	Mar	Apr
Import/export trade	48.6	47.7	41.4	44.9	46.9	46.5	47.4	48.6	48.1	47.3	46.4	49.1	47.9

Note : (^) The diffusion index is computed by adding the percentage of SMEs reporting "up" to one half of the percentage of SMEs reporting "same". A diffusion index reading above 50 indicates that the new orders condition is generally favourable, whereas an index below 50 indicates otherwise. Respondents were requested to exclude seasonal effects in reporting their views.

Table 6 : Percentage of SMEs with current credit need and reporting tight credit access&

	2016 Jun	Jul	Aug	Sep	Oct	Nov	Dec	2017 Jan	Feb	Mar	Apr
All selected sectors*											
With current credit need	13.0	8.9	8.4	9.3	9.2	9.4	9.8	8.4	8.5	7.8	8.0
Reported tight access to credit	1.2	0.8	0.3	0.9	0.7	0.6	0.5	0.2	0.1	0.7	0.5

Notes : (&) From the June 2016 round onwards, the questions on access to credit have been enhanced for better understanding of the current credit need and credit access situation of SMEs. It should be noted that the assessment of credit access situation might display great fluctuations from month to month given the small number of SMEs involved, as a great majority of SMEs reported "no credit need". Thus the results should be interpreted with caution.

(*) Weighted average using total number of SMEs in individual sectors as weights.

The labour sector

1.9 The labour market, while in a state of full employment, tightened slightly, with the *seasonally adjusted unemployment rate* easing to 3.2% in the first quarter of 2017, a low level last seen in the second quarter of 2014, and the *underemployment rate* edging down to a three-year low of 1.2%. Amid a gradual recovery in labour demand, total employment picked up in growth to reach another record high in the first quarter of 2017. Wages and earnings stayed on the rise in the fourth quarter of 2016 under a resilient and stable labour market.

The asset markets

1.10 The *local stock market* generally trended upwards throughout the first quarter of 2017, as risk aversion continued to recede amid a brightening global economic outlook that also boosted other major stock markets worldwide. The Hang Seng Index closed the first quarter at 24 112, up markedly by 9.6% from end-2016, the best first-quarter performance since 2012. Average daily turnover of the stock market increased to $74.3 billion in the first quarter, from $64.3 billion in the preceding quarter. Credit growth also picked up, with loans for use in Hong Kong at end-March 2017 surging by 11.5% over a year earlier, faster than the 7.3% growth recorded three months earlier.

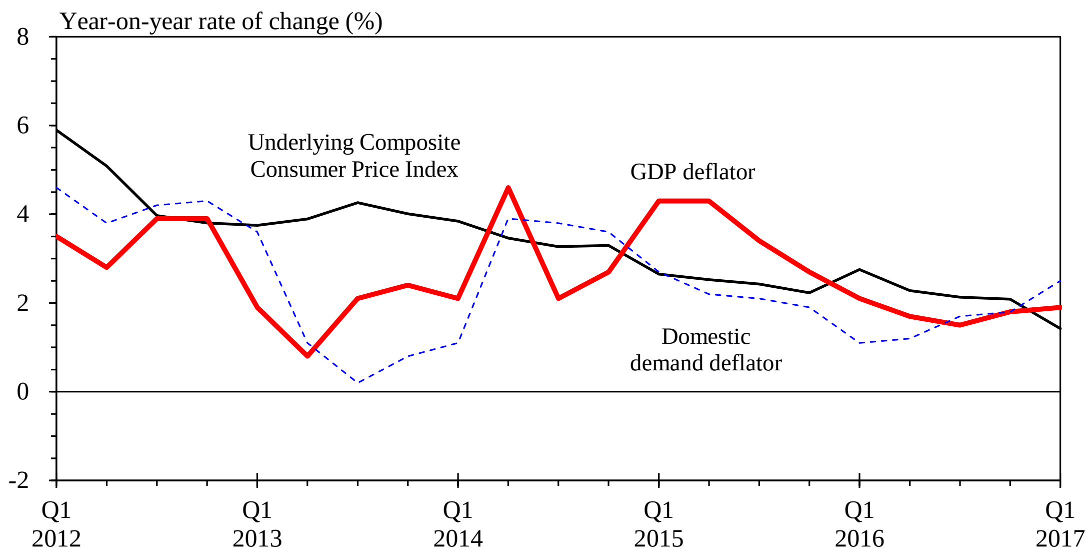
1.11 The *residential property market* showed some reactivation in the first quarter of 2017. Trading volume picked up successively from the low in January, though for the quarter as a whole still down by 22% from the preceding quarter. Residential property prices increased by 4% between December 2016 and March 2017. Overall flat prices in March 2017 exceeded the 1997 peak by 85%, and the housing affordability ratio worsened further to around 66% in the first quarter. Flat rentals rose by 2% during the first quarter. Meanwhile, office and shop rentals both went up by 1%. In early April, the Government announced to tighten up the existing exemption arrangement for Hong Kong permanent residents, regarding the acquisition of more than one residential property under a single instrument, under the New Residential Stamp Duty introduced in November 2016.

Inflation

1.12 Consumer price inflation was modest in the first quarter. External cost pressures stayed largely tame, thanks to the low inflation in our major import sources and the strength of the US dollar against other major currencies over the past year. Locally, rises in labour cost remained steady along with the stable labour market conditions. Rental cost pressures as reflected in consumer price inflation were largely contained, as the slower increases in fresh-letting residential and commercial rentals during 2016 continued to feed through. Besides, the higher base of comparison in the first quarter of last year also contributed to lower consumer price inflation in the first quarter of this year, given the food price spikes early last year due to bad weather conditions, as well as the higher package tour charges in March last year due to the earlier arrival of the Easter holidays. All in all, *headline consumer price inflation* went down to 0.5% in the first quarter, from 1.2% in the preceding quarter. Netting out the effects of the Government's one-off relief measures to more accurately reflect the underlying inflation trend, *underlying consumer price inflation* eased to 1.4% in the first quarter from 2.1% in the preceding quarter.

1.13 The year-on-year rate of increase in the *GDP deflator* picked up slightly to 1.9% in the first quarter from 1.8% in the preceding quarter, reflecting mainly the movement of domestic demand deflator. Meanwhile, the terms of trade deteriorated somewhat as import prices increased slightly faster than export prices.

Diagram 1.4 : Underlying consumer price inflation eased in the first quarter



Note : The year-on-year rates of change of the Composite Consumer Price Index from the fourth quarter of 2015 onwards are computed from the new 2014/15-based series, and those before are from the old 2009/10-based series.

GDP by major economic sector

1.14 The growth in net output of the services sector as a whole picked up to 2.3% in real terms in 2016 from 1.7% in 2015, as the headwinds in the external environment gradually subsided over the course of last year. Specifically, alongside the general recuperation of Asia's trade flows, net output of import and export trade rebounded over the course of 2016, while that of transportation and storage continued to grow moderately. As the primary property market turned more active over the course of 2016, net output of real estate (mainly reflecting activity of private sector developers and property agency) also rebounded in 2016. Net output of financing and insurance sector continued to show notable growth, whereas that of professional and business services grew moderately for the year as a whole. Net output of public administration, social and personal services expanded steadily further. On the other hand, economic activities related to inbound tourism were still weak, as visitor arrivals fell during most of the year. Net output of wholesale and retail trades declined distinctly for the year as a whole, notwithstanding some relative improvement in the fourth quarter of 2016. Net output of accommodation and food services only rose marginally in 2016. As for the secondary sector, net output growth of construction sector slowed in 2016 on a high base of comparison after years of intensive large-scale infrastructure works, yet there was a pick-up in growth over the course of year as the economy regained momentum. Meanwhile, the secular downtrend in net output of manufacturing sector continued.

Table 1.3 : GDP by economic activity[(a)]
(year-on-year rate of change in real terms (%))

	2015	2016	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2	2016 Q3	2016 Q4
Manufacturing	-1.5	-0.4	-1.5	-1.2	-2.1	-1.3	-0.3	-0.4	-0.1	-1.0
Construction	5.4	2.6	-2.2	18.9	6.2	1.2	-1.2	0.8	3.0	7.6
Services[(b)]	1.7	2.3	2.1	1.4	1.7	1.8	1.6	2.7	2.3	2.5
Import/export, wholesale and retail trades	-1.1	0.4	-0.1	-3.9	-0.5	-0.2	-2.1	0.9	0.8	1.7
Import and export trade	-0.9	2.1	0.1	-5.4	-0.3	1.0	0.1	2.8	2.3	2.9
Wholesale and retail trades	-1.6	-6.0	-0.8	1.7	-1.5	-4.8	-10.0	-5.9	-5.9	-2.8
Accommodation[(c)] and food services	-1.9	0.1	-1.3	-1.7	-4.0	-0.6	-0.9	1.0	0.1	0.2
Transportation, storage, postal and courier services	3.3	3.3	3.5	2.6	2.7	4.5	2.6	3.4	3.5	3.8
Transportation and storage	4.0	3.4	4.1	3.1	3.2	5.3	2.8	3.5	3.4	3.8
Postal and courier services	-8.2	2.3	-6.6	-7.1	-9.2	-9.7	-1.4	2.7	5.8	2.5
Information and communications	4.0	3.7	5.0	4.7	3.6	3.0	3.7	4.2	3.7	3.3
Financing and insurance	6.1	4.7	4.8	8.0	5.8	5.7	5.0	4.2	4.7	4.8
Real estate, professional and business services	0.7	3.0	2.9	0.6	0.1	-0.7	1.8	3.7	3.2	3.5
Real estate	-2.3	3.7	0.6	-1.4	-2.5	-5.7	0.6	2.9	5.5	6.0
Professional and business services	3.2	2.5	5.2	2.2	2.1	3.4	2.6	4.4	1.4	1.7
Public administration, social and personal services	2.5	2.7	2.1	1.9	3.3	2.9	2.5	3.3	2.5	2.3

Notes : Figures are subject to revision later on as more data become available.

(a) The GDP figures shown in this table are compiled from the production approach, in parallel with those shown in Table 1.1 which are compiled from the expenditure approach. For details, see Note (2) to this chapter.

(b) In the context of value-added contribution to GDP, the service sectors include ownership of premises as well, which is analytically a service activity.

(c) Accommodation services cover hotels, guesthouses, boarding houses and other establishments providing short term accommodation.

Other economic developments

1.15 President Xi and US President Trump held their first meeting in Florida in early April, pledging to expand mutually beneficial co-operation. A new US-China Comprehensive Dialogue headed by the two Presidents would be established, overseeing diplomatic and security, economic, law enforcement and cybersecurity, and social and culture issues. Notably, a 100-day plan was set up for discussing key trade issues. The developments helped allay the market concern about a possible deterioration of the trade relations between the two largest economies in the world.

1.16 In view of the need to stabilise the economy and support employment amid an uncertain external environment, the 2017-18 Budget (the Budget) proposed a series of tax and relief measures amounting to $35.1 billion. These one-off relief measures, together with other spending initiatives in the Budget, were estimated to have a fiscal stimulus effect of boosting GDP for 2017 by 1.1 percentage points. The Budget also laid out measures to support SMEs and the tourism industry in Hong Kong.

1.17 On top of tax and relief measures, the Budget adopted a forward-looking approach and earmarked some $61 billion of the fiscal surplus to strengthen various policy areas for the future. These included provision of services for the elderly and persons with disabilities, sports and recreation facilities, innovation and technology development, and youth development. To secure our long-term economic growth prospect, the Government would continue to strengthen the competitiveness of pillar industries (viz. trading and logistics industry, financial services industry, business and professional services industry, and tourism industry), and encourage diversified development in innovation and technology, creative industries, and financial technologies.

1.18 Manpower and land were identified in the Budget as two major constraints on our economic growth. On human capital, the Government has been investing heavily to nurture talent, as education has been the largest policy area in the Government's recurrent expenditure. On land supply, the Government would continue its endeavour to increase land supply on all fronts to meet the housing, economic and social development needs of Hong Kong.

1.19 The Financial Secretary in his Budget Speech called for a sound and progressive fiscal policy. The Government will be appropriately proactive in developing the economy and improving people's livelihood, be forward looking and invest continuously for the future of Hong Kong, and make good use of financial resources with a view to building a fair and just society that shares the fruits of economic advancement among people from all walks of life. To make optimal allocation of financial resources, the Government will take into account the source and nature of the fiscal surplus, alongside the prevailing economic situation, the future society needs and the community's expectations. Strict fiscal discipline will also need to be maintained to ensure sustainability in the long run, as well as resilience to withstand short-term economic fluctuations. Separately, the Government pledged to comprehensively examine various tax issues, with a view to fostering development of industries, strengthening Hong Kong's international competitiveness and enhancing our tax regime.

1.20 In late March, the Asian Infrastructure Investment Bank (AIIB) announced that Hong Kong would become a new member upon deposit of first instalment of capital subscription. Hong Kong's participation in the AIIB will create new opportunities for the financial and professional services sector, and reinforce our position as a premier international financial centre.

Notes :

(1) The upward revision in the global economic growth forecasts for 2017 by the IMF in April 2017 mainly consisted of an improved outlook for advanced economies and a more optimistic growth prospect for the Mainland. The table below presents a more detailed comparison between the growth forecasts made by the IMF in April 2017 and those three months ago.

		2017	
	2016 (%)	January round (%)	April round (%)
World (PPP## weighted)	3.1	3.4	3.5
Advanced economies	1.7	1.9	2.0
US	1.6#	2.3	2.3
Euro area	1.8#	1.6	1.7
UK	1.8#	1.5	2.0
Japan	1.0#	0.8	1.2
Emerging market and developing economies	4.1	4.5	4.5
Emerging and developing Asia	6.4	6.4	6.4
Mainland China	6.7#	6.5	6.6
India^	7.1#	7.2	7.2
Middle East and North Africa	3.8	2.9	2.3

Notes : (#) Actual figures.
(^) Fiscal year.
(##) PPP refers to purchasing power parity.

(2) The Gross Domestic Product (GDP) is an overall measure of net output produced within an economy in a specified period, such as a calendar year or a quarter, before deducting the consumption of fixed capital. In accordance with the expenditure approach to its estimation, GDP is compiled as total final expenditures on goods and services (including private consumption expenditure, government consumption expenditure, gross domestic fixed capital formation, changes in inventories, and exports of goods and services), less imports of goods and services.

(3) The seasonally adjusted quarter-to-quarter GDP series, by removing the variations that occur at about the same time and in about the same magnitude each year, provides another perspective for discerning the trend, particularly in regard to turning points. A detailed examination reveals the presence of seasonality in the overall GDP and in some of its main components, including private consumption expenditure, government consumption expenditure, exports of goods, imports of goods, exports of services, and imports of services. However, due to the presence of considerable short-term fluctuations, no clear seasonal pattern is found in gross domestic fixed capital formation. Therefore, the seasonally adjusted series of GDP is compiled separately at the overall level, rather than summing up from its main components.