

## CHAPTER 1 : OVERVIEW OF ECONOMIC PERFORMANCE

### *Summary*

- *The Hong Kong economy sustained above-trend growth in the second quarter of 2017, expanding by 3.8% over a year earlier, following notable growth of 4.3% in the first quarter. The generally benign global economic environment remained supportive to external demand. Domestic demand growth stayed robust, buttressed by favourable labour market conditions and improved economic sentiment.*
- *External demand improved further in the second quarter, with downside risks to the global economic outlook receding. This continued to render support to Asia's regional trading and manufacturing activities. Against this backdrop, Hong Kong's total exports of goods registered visible growth in the second quarter, with exports to Asian markets providing the main growth impetus. Meanwhile, exports of services grew at a steady pace amid reviving regional trade flows and increased cross-border financial activities, notwithstanding the stuttered recovery in inbound tourism.*
- *The domestic sector continued to display strength in the second quarter. Private consumption expenditure grew briskly, underpinned by favourable labour market conditions and stronger wealth effects. Meanwhile, overall investment expenditure strengthened to show sizeable growth, as machinery and equipment acquisition rebounded and building and construction activity sustained its uptrend.*
- *The labour market tightened along with the above-trend pace of economic expansion. Total employment saw further sturdy growth in the second quarter, and the seasonally adjusted unemployment rate went down slightly to a three-year low of 3.1%. Wages and earnings improved further in real terms.*
- *The rally in the local stock market at the beginning of this year extended well into the second quarter. Market sentiment was rather bullish amid the improved global economic outlook that also drove up many major overseas stock markets. The residential property market stayed largely active during the second quarter, though the pace of price gains slowed somewhat over the course of the quarter.*
- *Underlying inflation remained moderate in the second quarter, thanks to limited external price pressure and moderate increase in local costs. As these developments are expected to continue, inflationary pressure in the economy should be contained in the near term.*

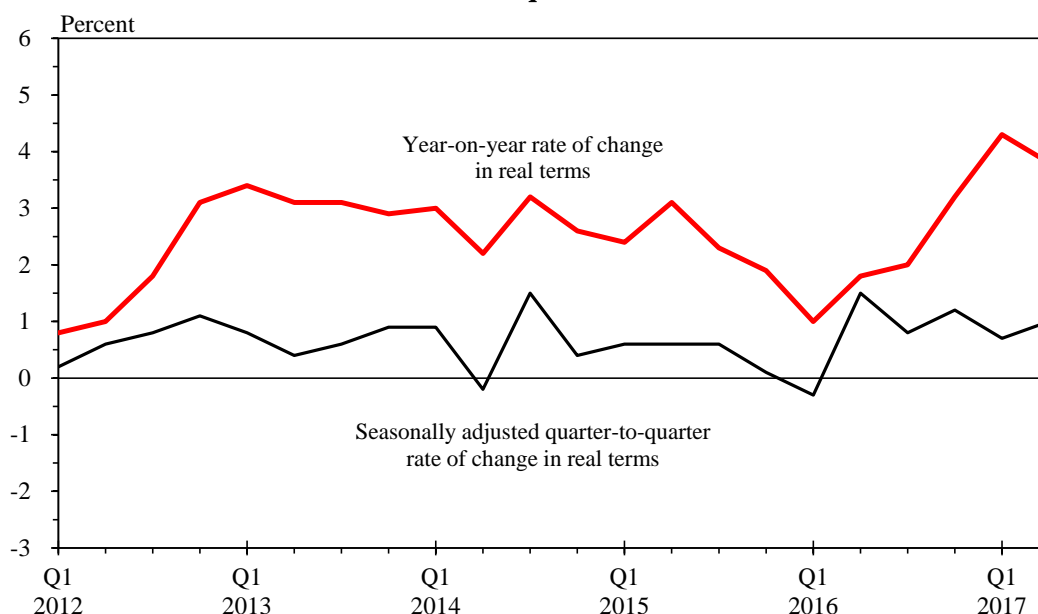
## Overall situation

1.1 The Hong Kong economy grew by 3.8% in the second quarter of 2017 over a year earlier, following notable growth of 4.3% in the first quarter and sustaining another quarter of above-trend growth. Global economic conditions remained largely benign in the second quarter, thereby rendering support to external demand for goods and services. Exports of goods grew visibly in the second quarter following sizeable growth in the first quarter, with Asian markets providing the main impetus. Exports of services grew at a steady pace amid reviving regional trade flows and increased cross-border financial activities, though the recovery in inbound tourism stuttered. The domestic sector continued to display strength. Private consumption expenditure expanded briskly, underpinned by favourable labour market conditions and stronger wealth effects. Overall investment expenditure saw faster growth, supported by a bounce-back in machinery and equipment acquisition, rising building and construction activity and a notable increase in costs of ownership transfer. Overall inflationary pressure stayed moderate.

1.2 The global economy expanded further in the second quarter. The US economy continued to grow moderately, bolstering the Federal Reserve's confidence to raise rates again in mid-June and to reveal a firmer intention to begin scaling back its balance sheet later this year. The economic recovery in the euro area gathered more pace, as the impact from policy and political uncertainties remained relatively limited. Meanwhile, the Mainland economy stayed on the path of medium-high speed growth and picked up slightly from the growth pace last year, buttressed by its resilient domestic demand and strengthening external sector. Economic growth rates in the rest of Asia were in general solid, aided by a continued expansion in regional trading and manufacturing activities. On the whole, downside risks to the near-term global economic outlook receded in the second quarter, though uncertainties continued to prevail, including the future pace of monetary policy normalisation in the US; ongoing Brexit-related negotiations, policy and political developments in the US and Europe; and still-elevated geopolitical tensions in various regions. Against this backdrop, the International Monetary Fund (IMF)<sup>(1)</sup> in July projected that the global economy would grow by 3.5% in 2017. While the overall growth forecast by the IMF for the global economy remained unchanged from its previous assessment in April, the IMF expected a slower growth in the US due to uncertainty over the timing and nature of its future fiscal policy changes, but projected faster growth for several other major economies such as China, the euro area and Japan.

1.3 In the second quarter of 2017, *Gross Domestic Product (GDP)*<sup>(2)</sup> grew by 3.8% in real terms over a year earlier, following notable growth of 4.3% in the preceding quarter (the same as the preliminary estimate). Both were stronger than the trend growth of 2.9% per annum over the past ten years. For the first half of 2017 as a whole, real GDP expanded by 4.0% year-on-year, doubling its 2.0% growth pace in 2016. On a seasonally adjusted quarter-to-quarter basis<sup>(3)</sup>, real GDP picked up to grow by 1.0% in the second quarter of 2017, following the 0.7% growth in the preceding quarter (the same as the preliminary estimate) and representing the fifth consecutive quarter-to-quarter expansion.

**Diagram 1.1 : The Hong Kong economy sustained above-trend growth in the second quarter of 2017**



## **The external sector**

1.4 *Total exports of goods* compiled under the GDP accounting framework grew visibly by 5.6% in real terms in the second quarter over a year earlier, following marked growth of 9.3% in the first quarter when there was a fall-off in external demand a year ago. Among major markets, with reference to external merchandise trade statistics, exports to Asian economies remained the key growth driver of our overall exports in the second quarter as the demand for raw materials, semi-manufactures and capital goods remained robust amid reviving regional trading and manufacturing activities. Specifically, exports to the Mainland sustained solid growth, and those to some emerging Asian economies such as India and Vietnam increased strongly. Exports to Japan also picked up to double-digit growth in the second quarter, thanks to recovery in production activities and relative improvement in consumer sentiment there. In contrast, the US and EU markets rose at a modest pace by comparison.

1.5 *Exports of services* grew modestly by 2.3% year-on-year in real terms in the second quarter, after 2.8% growth in the previous quarter, underpinned by the generally positive global economic environment. Exports of transport services expanded notably, thanks to growth in regional trade and cargo flows. Exports of financial services sustained moderate growth, amid increasing cross-border financial activities. Exports of business and other services also increased marginally. Meanwhile, exports of travel services fell modestly. The relative improvement that was seen in these exports in recent quarters stuttered, as tourist spending still lacked growth and the recovery in visitor arrivals was unsteady in the second quarter.

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

	<u>2015</u> <sup>#</sup>	<u>2016</u> <sup>#</sup>	<u>2016</u>				<u>2017</u>	
			<u>Q1</u> <sup>#</sup>	<u>Q2</u> <sup>#</sup>	<u>Q3</u> <sup>#</sup>	<u>Q4</u> <sup>#</sup>	<u>Q1</u> <sup>#</sup>	<u>Q2</u> <sup>+</sup>
<i>Change in real terms of GDP and its main expenditure components (%)</i>								
Private consumption expenditure	4.8	1.8	1.5 (0.2)	0.4 (0.7)	1.6 (1.1)	3.6 (1.5)	3.9 (0.5)	5.3 (2.0)
Government consumption expenditure	3.4	3.4	3.2 (0.9)	3.6 (1.0)	3.4 (0.5)	3.4 (0.9)	3.1 (0.6)	3.2 (1.1)
Gross domestic fixed capital formation	-3.2	-0.3	-8.7	-5.1	7.2	5.6	5.9	8.0
Building and construction	2.2	3.9	1.5	2.4	4.3	7.5	8.6	4.0
Costs of ownership transfer	-8.3	-2.9	-50.9	-19.2	22.5	63.7	77.3	53.4
Machinery, equipment and intellectual property products	-7.7	-4.6	-10.8	-10.3	7.6	-4.2	-8.6	4.6
Total exports of goods <sup>&amp;</sup>	-1.7	1.8	-3.5 (-2.5)	2.4 (3.0)	2.5 (0.7)	5.1 (3.9)	9.3 (1.6)	5.6 (-0.8)
Imports of goods <sup>&amp;</sup>	-2.7	1.1	-5.6 (-3.8)	0.6 (3.6)	3.1 (1.9)	5.6 (4.0)	10.0 (0.3)	6.2 (-0.2)
Exports of services <sup>&amp;</sup>	0.3	-3.2	-5.4 (-1.0)	-6.2 (-0.6)	-2.5 (1.8)	1.2 (1.1)	2.8 (0.6)	2.3 (-1.3)
Imports of services <sup>&amp;</sup>	5.0	2.0	4.1 (1.7)	1.2 (-1.1)	0.8 (-0.2)	2.0 (1.6)	0.9 (0.5)	3.5 (1.6)
<b>Gross Domestic Product</b>	<b>2.4</b>	<b>2.0</b>	<b>1.0</b> <b>(-0.3)</b>	<b>1.8</b> <b>(1.5)</b>	<b>2.0</b> <b>(0.8)</b>	<b>3.2</b> <b>(1.2)</b>	<b>4.3</b> <b>(0.7)</b>	<b>3.8</b> <b>(1.0)</b>
<i>Change in the main price indicators (%)</i>								
<b>GDP deflator</b>	<b>3.6</b>	<b>1.8</b>	<b>2.1</b> <b>(0.5)</b>	<b>1.7</b> <b>(0.5)</b>	<b>1.5</b> <b>(0.2)</b>	<b>1.8</b> <b>(0.6)</b>	<b>2.1</b> <b>(0.8)</b>	<b>3.1</b> <b>(1.4)</b>
<b>Composite CPI</b>								
<b>Headline</b>	<b>3.0</b> <sup>@</sup>	<b>2.4</b>	<b>2.8</b> <b>(0.7)</b>	<b>2.6</b> <b>(-0.6)</b>	<b>3.1</b> <b>(0.4)</b>	<b>1.2</b> <b>(0.7)</b>	<b>0.5</b> <b>(0.1)</b>	<b>2.0</b> <b>(0.7)</b>
<b>Underlying</b> <sup>^</sup>	<b>2.5</b> <sup>@</sup>	<b>2.3</b>	<b>2.8</b> <b>(0.7)</b>	<b>2.3</b> <b>(0.2)</b>	<b>2.1</b> <b>(0.5)</b>	<b>2.1</b> <b>(0.7)</b>	<b>1.4</b> <b>(0.1)</b>	<b>2.0</b> <b>(0.7)</b>
<b>Change in nominal GDP (%)</b>	<b>6.1</b>	<b>3.9</b>	<b>3.2</b>	<b>3.6</b>	<b>3.6</b>	<b>5.0</b>	<b>6.5</b>	<b>7.0</b>

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

## The domestic sector

1.6 The domestic sector continued to display strength in the second quarter. *Private consumption expenditure* (PCE) grew briskly by 5.3% in real terms in the second quarter over a year earlier, picking up from 3.9% growth in the first quarter. The faster growth in the second quarter mainly reflected robust local consumption demand, which was underpinned by favourable labour market conditions and stronger wealth effects. Also relevant was sizeable growth in residents' expenditure abroad, partly helped by the difference in timing of the Easter holidays in 2016 and 2017, which fell in late March last year but mid-April this year (See **Box 1.1** for an explanation of the discrepancy between the recent performance of PCE and retail sales in Hong Kong). *Government consumption expenditure* maintained steady year-on-year growth of 3.2% in real terms in the second quarter, slightly accelerating from its 3.1% growth in the preceding quarter.

**Table 1.2 : Consumer spending by major component<sup>(a)</sup>**  
(year-on-year rate of change in real terms (%))

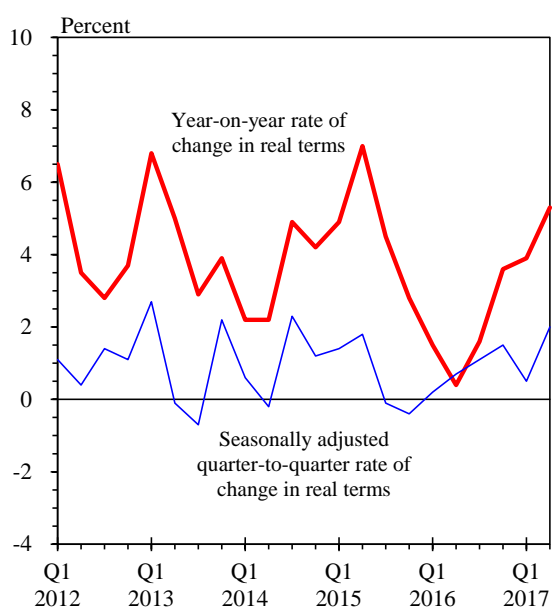
	Total consumer spending in the domestic market <sup>(a)</sup>	<i>Of which :</i>				Residents' expenditure abroad	Visitor spending	Private consumption expenditure <sup>(b)</sup>
		Food	Durables	Non-durables	Services			
2016 Annual	-0.2	0.9	-13.3	-0.3	1.9	7.1	-8.1	1.8
H1	-1.7	0.7	-17.9	-2.5	1.1	9.2	-11.0	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								
H1	3.9	3.3	-0.6	5.7	4.0	4.1	-0.6	4.6
Q1	3.6	3.3	-1.1	4.5	4.2	-0.2	-0.2	3.9
Q2	4.1	3.4	0.2	6.9	3.8	8.7	-1.1	5.3

Notes : (a) Consumer spending in the domestic market comprises both local consumer and visitor spending.

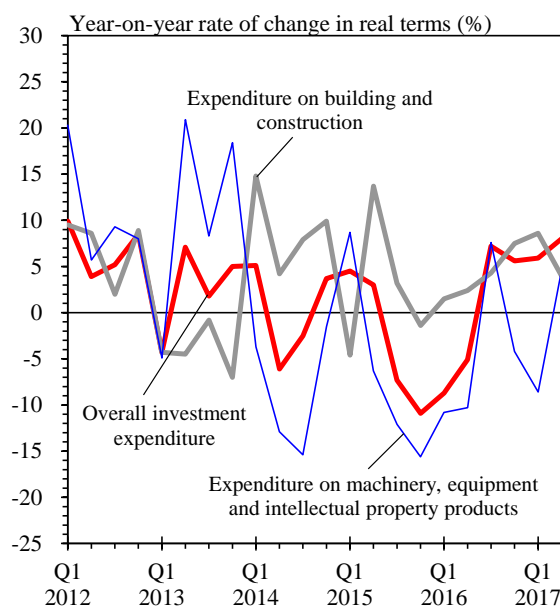
(b) Private consumption expenditure is obtained by deducting visitor spending from total consumer spending in the domestic market, and adding back residents' expenditure abroad.

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

**Diagram 1.2 : Private consumption expenditure grew briskly**



**Diagram 1.3 : Overall investment spending strengthened to show sizeable growth**



1.7 Overall investment spending in terms of *gross domestic fixed capital formation* strengthened to show sizeable growth of 8.0% in real terms in the second quarter over a year earlier, after visible growth of 5.9% in the preceding quarter. Within this, overall building and construction expenditure maintained its uptrend, expanding by 4.0%, as private building and construction activity saw further notable growth and public building and construction expenditure stayed at a high level. Cost of ownership transfer also increased markedly against a low base of comparison last year. Machinery and equipment acquisition rebounded by 4.6% year-on-year, after falling for two consecutive quarters. Indeed, the latest Quarterly Business Tendency Survey and other surveys on business sentiments also indicated that business sentiment in many economic sectors remained broadly optimistic (see **Box 1.2** for more detailed analysis of the results of these surveys on business sentiments), mirroring the improving global economic outlook.

## Box 1.1

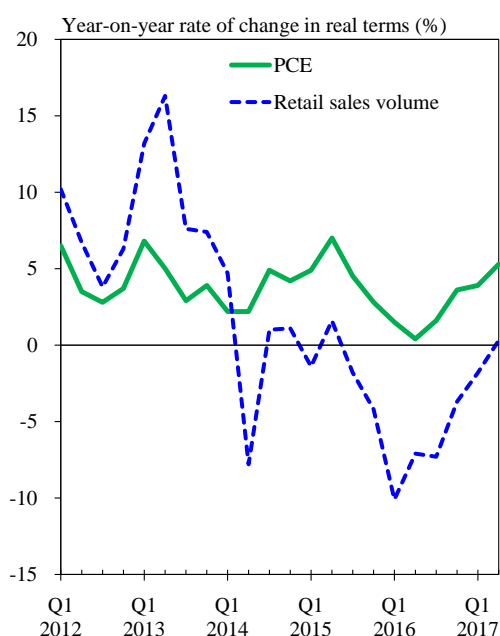
### Discrepancy between the recent performance of PCE and retail sales in Hong Kong

Private consumption expenditure (PCE), which measures the overall consumption expenditure of Hong Kong residents, grew visibly by 4.6% in the first half of 2017 in real terms over a year earlier, an acceleration from the 1.8% growth for 2016 as a whole. While local retail sales volume likewise improved over the same period, its performance was weaker by comparison (*Chart 1*). This box article, by making reference to the coverage of these two indicators, explains the factors behind the differences in their recent performance.

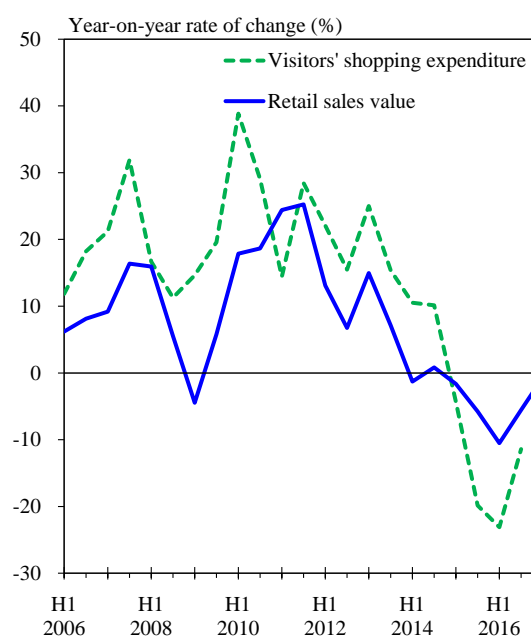
By definition, PCE covers consumer spending on goods (purchased from all channels including retail outlets) and services by Hong Kong residents, both domestically and abroad. Meanwhile, retail sales figures cover the sales receipts of goods sold by local retail outlets to both local residents and foreign visitors. Simply put, PCE has a much broader coverage than retail sales in terms of the types of purchases and geographical locations (as PCE covers residents' expenditure outside Hong Kong). Yet, PCE does not include visitors' shopping expenditure in Hong Kong, which is instead covered in retail sales figures.

Until a year or two ago, inbound tourism witnessed a sustained period of rapid expansion, with visitor arrivals and visitors' shopping expenditure<sup>(1)</sup> surging at an average annual rate of 8.4% and 12.0% respectively over the past ten years, far outpacing the average annual growth of 7.1% in retail sales value over the same period. Thus, tourists spending assumed an increasingly significant role in driving retail sales, with its estimated share in retail sales rising from just 22% in 2006 to around 35% to 40% in recent years. Hence, the performance of retail sales also increasingly reflected the change of visitors' shopping profile, on top of the shopping outlay of local residents. For instance, when the year-on-year decline in visitors' shopping expenditure widened from 4.3% in the first half of 2015 to 23.1% in the first half of 2016, the year-on-year decline in retail sales value also worsened from 1.6% to 10.5% over the same period. Then, as inbound tourism began to bottom out slowly since the second half of 2016, retail sales also improved relatively in tandem (*Chart 2*).

**Chart 1: Retail sales showed a weaker performance than PCE of late**



**Chart 2: Retail sales followed the swings in visitors' shopping expenditure**



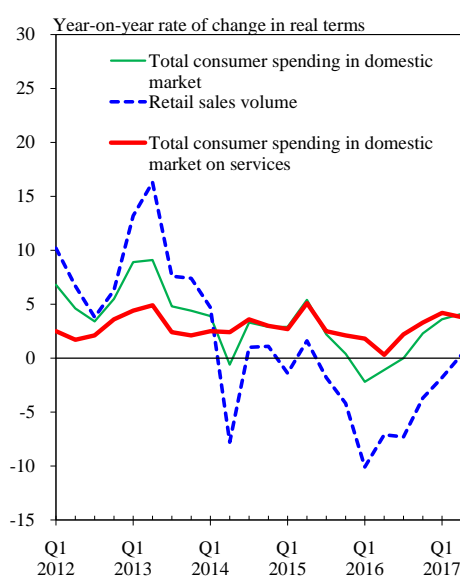
(1) Refers to the shopping expenditure of overnight and same-day-in-town visitors compiled by the Hong Kong Tourism Board. It is used as a proxy of inbound tourism's contribution to retail sales in this article.



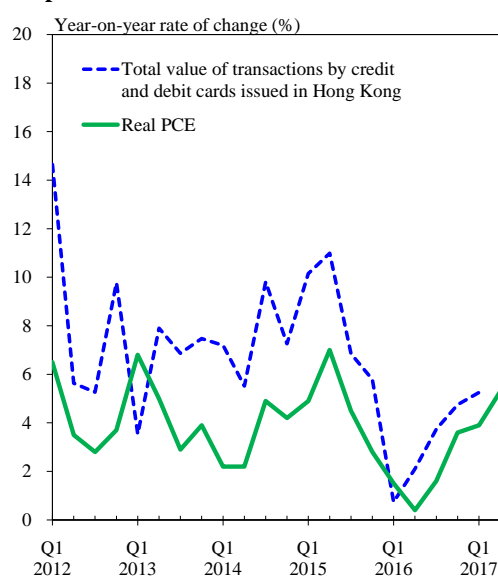
## Box 1.1 (Cont'd)

On the other hand, the performance of PCE hinges on local consumer sentiment, which in turn depends on factors such as conditions in the labour market and asset markets, in addition to the external environment. In recent years, thanks to a sustained period of full employment in the labour market with real growth in wages and earnings, local consumer sentiment generally fared well, though it was somewhat affected by various adversities in the external environment that emerged in individual quarters. For instance, in the first half of 2016, as global economic growth was lacklustre with gyrations in global financial markets, local consumer sentiment worsened correspondingly, dragging the growth in PCE to only 1.0% year-on-year. However, while spendings on both goods and services responded to the change in local consumer sentiment, fluctuations in services outlays have been smaller than those in retail sales over time (*Chart 3*), conceivably due in part to the fact that a significant proportion of services consumption are “necessities” such as housing, transportation, medical services and education services. Considering that services outlays account for over 50% of overall consumer spending, this further explains why PCE exhibits more resilience and a more stable trend than retail sales. As for the more recent period in 2017 so far, with favourable labour market conditions and increases in asset prices, local consumption demand was robust, rendering solid growth in PCE. Furthermore, the state of local consumer sentiment could also be gauged by statistics from the payment side. Specifically, steady growth in the total value of transactions by credit and debit cards issued in Hong Kong<sup>(2)</sup> since the fourth quarter of 2016 was another indication of the prevailing optimistic local consumer sentiment (*Chart 4*).

**Chart 3: Growth in services spending tended to be more stable**



**Chart 4: Payment side indicator likewise pointed to robust local consumer sentiment**



In sum, PCE is a more appropriate and comprehensive measure of the state of local private consumption than retail sales. Looking ahead, while various sources of external uncertainties remain at play, especially the uncertain pace of US monetary policy normalisation, near-term local consumer sentiment is likely to remain sanguine on the back of favourable labour market conditions, thereby rendering further impetus to PCE growth going forward. As for the outlook for retail sales, while the prevailing positive local consumer sentiment would be a supportive factor, its performance would unavoidably hinge on the recovery pace of inbound tourism. Considering the importance of private consumption in the local economy, and the role of the retail sector as a key employment generator, we will closely monitor local consumption demand and the retail sector in the period ahead.

(2) Sourced from statistics of payment cards issued in Hong Kong as published by the HKMA. Credit card transactions in this article refer to credit card transactions on retail sales as defined by the HKMA. HKMA's definition of retail sales is different from that of the Census and Statistics Department.

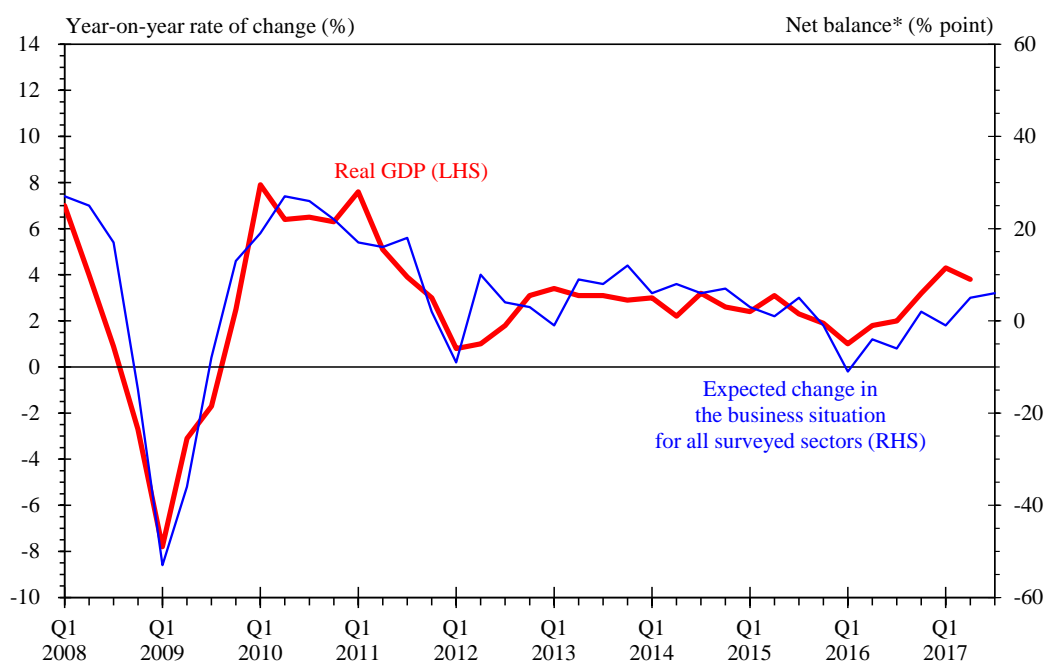
## Box 1.2

### Business sentiment in Hong Kong

This box article intends to give a general overview on the prevailing business sentiment in Hong Kong, based on results from various surveys that are available in the public domain.

According to the latest results from the Census and Statistics Department (C&SD)'s Quarterly Business Tendency Survey (QBTS)<sup>(1)</sup>, large enterprises in Hong Kong have turned somewhat more sanguine about their near-term business prospects alongside the above-trend growth of the Hong Kong economy in the first half of 2017 (*Chart 1*). In particular, the proportion of large enterprises surveyed in early June till mid-July 2017 expecting their business situation to be better in the third quarter of 2017 outweighed that of those expecting a weaker business performance by 6 percentage points (i.e. a net balance of +6), up from a net balance of +5 in the preceding quarter. Among the various sectors, large enterprises in “financing and insurance”, “information and communications”, and “manufacturing” remained highly optimistic. “Real estate” and “transportation, storage and courier services” returned to a positive net balance, while some other sectors such as “construction”, “import/export trade and wholesale” and “accommodation and food services” also saw some relative improvements (*Table 1*). Hiring sentiment of large enterprises in most sectors remained positive, broadly in line with the prevailing sturdy growth in employment (*Table 2*).

**Chart 1 : Large enterprises in Hong Kong generally remained positive about their near-term business prospects**



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.

(1) The Quarterly Business Tendency Survey collected views from around 500 large establishments on their near-term business outlook. Respondents were asked to exclude seasonal influences in their responses.

## Box 1.2 (Cont'd)

**Table 1 : Large enterprises in general turned more sanguine about the near-term business outlook**

QBTS: Expected changes in business situation						
	Net balance* (% point)					
	2016			2017		
	Q2	Q3	Q4	Q1	Q2	Q3
Manufacturing	+12	-2	+2	+18	+14	+18
Construction	-7	-12	-11	-18	-14	-9
Import/export trade and wholesale	-8	-14	-14	-6	-2	0
Retail	-40	-38	-2	-15	-4	-4
Accommodation and food services	-17	-11	+13	-14	-13	-2
Transportation, storage and courier services	+8	+5	+12	+7	-2	+2
Information and communications	0	+12	+15	0	+19	+17
Financing and insurance	+9	+6	+12	+12	+24	+19
Real estate	-6	-3	+4	-2	0	+6
Professional and business services	-11	-14	+9	-8	0	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		
	Q2	Q3	Q4	Q1	Q2	Q3
Manufacturing	+12	+12	+17	+10	-7	+21
Construction	+1	+11	+4	-8	0	+2
Import/export trade and wholesale	-3	-6	-5	0	+2	-1
Retail	-2	-4	+4	+1	+4	-3
Accommodation and food services	+12	+15	+16	+5	+9	+20
Transportation, storage and courier services	+11	+18	+20	+17	+9	+7
Information and communications	+12	+21	+13	+14	+24	+9
Financing and insurance	+7	+10	+10	+15	+16	+16
Real estate	+14	+6	+27	+28	+18	+14
Professional and business services	-4	-7	+15	0	+6	-3

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.

Separately, the C&SD also compiled a set of diffusion indices on a monthly basis<sup>(2)</sup> to gauge the general directions of change in the views of small and medium-sized enterprises (SMEs) on their business situation versus the preceding month. While the overall index on business receipts was still below the divide of 50.0, the readings since March 2017 were somewhat higher than those in the second half of 2016 and early 2017. Also, the feedbacks from SMEs surveyed continued to point to a broadly stable employment situation and highly accommodative credit situation in recent months (*Table 3*).

**Table 3 : Selected results from C&SD's Report on Monthly Survey on the Business Situation of SMEs**

	2016						2017						
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul
Diffusion indices <sup>^</sup> for all selected sectors*													
Business receipts	43.6	45.7	46.6	46.3	46.4	45.2	46.0	46.1	47.2	47.0	47.0	46.5	47.8
Employment	48.4	49.5	48.8	49.3	49.8	49.2	49.7	49.5	49.6	49.7	50.0	49.2	49.0
Percentage of SMEs in all selected sectors*													
with current credit need	8.9	8.4	9.3	9.2	9.4	9.8	8.4	8.5	7.8	8.0	8.1	7.9	7.1
reported tight access to credit <sup>&amp;</sup>	0.8	0.3	0.9	0.7	0.6	0.5	0.2	0.1	0.7	0.5	0.1	0.2	0.6

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 / 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.

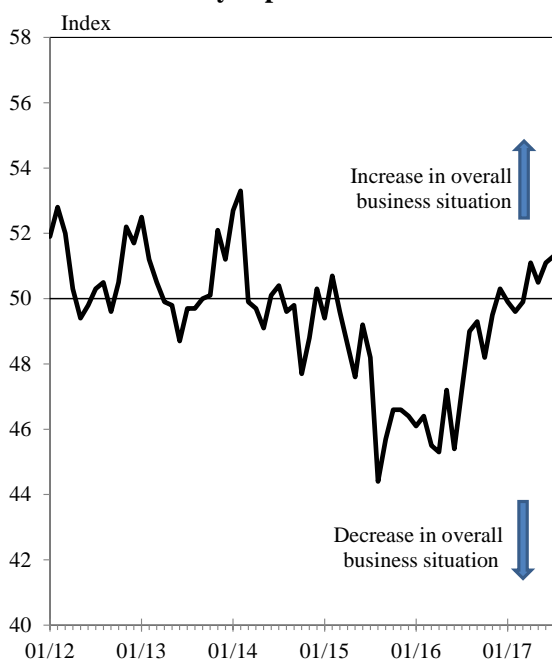
(&) It should be noted that the assessment of credit access situation might display great fluctuations from month to month given the small number of SMEs involved, as a great majority of SMEs reported "no credit need". Thus the results should be interpreted with caution.

(2) It refers to the results from the Monthly Survey on the Business Situation of SMEs that solicits feedbacks from a panel sample of around 600 SMEs each month.

## Box 1.2 (Cont'd)

There are also other surveys in the public domain that help shed some light on the prevailing business sentiment. The Nikkei Purchasing Managers' Index (PMI) of Hong Kong<sup>(3)</sup>, which gauges the performance of the private sector's business activity, showed a general trend of improvement since mid-2016 as the Hong Kong economy regained growth momentum over the course of 2016. It rose above the 50.0 divide in April 2017 and pointed to continued activity expansion in the subsequent three months, largely in line with the more sanguine economic environment in 2017 so far (*Chart 2*). Separately, business sentiment of Hong Kong's exporters, as measured by the Hong Kong Trade Development Council (HKTDC)'s Export Index<sup>(4)</sup>, rose visibly to a 16-quarter high of 50.1 in the second quarter of 2017, from 47.1 in the first quarter, broadly in line with the sustained improvement in external demand and reviving regional trade flows during the quarter (*Table 4*).

**Chart 2 : Nikkei Hong Kong PMI pointed to continued activity expansion in recent months**



Source: Nikkei; IHS Markit.

Note: A reading above 50 indicates an increase in the overall business situation, whereas a reading below 50 indicates a decrease in the overall business situation. The index has been adjusted for seasonality.

**Table 4 : HKTDC's Export Index improved visibly in the second quarter of 2017**

2015	Q1	44.9
	Q2	46.8
	Q3	37.1
	Q4	31.4
2016	Q1	37.3
	Q2	37.2
	Q3	38.8
	Q4	33.7
2017	Q1	47.1
	Q2	50.1

Source: HKTDC.

Note: A reading above 50 indicates that more than half of the surveyed traders incline towards the upside, which can be interpreted as an upward trend and an increase in confidence, and vice versa for a reading below 50.

It is worthwhile to point out that these surveys are essentially opinion-based, thereby unavoidably subject to various limitations (e.g. results are not directly comparable) and hence the results should be interpreted with care. Nonetheless, the latest survey findings seem to suggest that business sentiment in Hong Kong has generally remained positive of late, as the global economy sustained its growth momentum. While downside risks in the global macroeconomic environment have receded thus far this year, the Government will stay vigilant to various developments on the external front and their possible repercussions on the Hong Kong economy.

- (3) According to the press release jointly released by Nikkei and IHS Markit, the Nikkei Hong Kong PMI is compiled according to monthly replies to questionnaires sent to purchasing executives in over 300 companies. It is a composite index based on five individual indices with the following weights: New Orders (0.3); Output (0.25); Employment (0.2); Suppliers' Delivery Times (0.15); and Stock of Items Purchased (0.1), with the Delivery Times index inverted so that it moves in a comparable direction. Survey responses reflect the change, if any, in the prevailing month compared to the previous month.
- (4) The HKTDC Export Index is compiled based on a quarterly survey to collect views from 500 traders concerning their export performances in the prevailing quarter as well as their outlook for the subsequent quarter and covers six major industries – electronics, clothing, jewellery, timepieces, toys and machinery.

## **The labour sector**

1.8 Overall labour market conditions remained favourable and tightened somewhat, with the *seasonally adjusted unemployment rate* going down slightly to a three-year low of 3.1% in the second quarter. The *underemployment rate* held steady at 1.2% in the same quarter. Total employment sustained sturdy year-on-year growth in the second quarter. Wages and earnings stayed on the rise in real terms. Partly benefitting from the upward adjustment of the Statutory Minimum Wage rate since May 2017, the average monthly employment earnings of full-time employees (excluding foreign domestic helpers) engaged in elementary occupations continued to increase, up by 3.4% year-on-year in real terms in the second quarter.

## **The asset markets**

1.9 The *local stock market* sustained a general uptrend in the second quarter, similar to the gains in many overseas stock markets. Such favourable developments largely reflected upbeat investor sentiment amid a benign global economic outlook, notwithstanding the uncertainties surrounding the future path of monetary policy normalisation among major central banks and the complications in Brexit negotiations after the UK general election. The Hang Seng Index closed the second quarter at 25 765, up by 6.9% from three months earlier. Average daily turnover edged up to \$77.8 billion in the second quarter, from \$74.3 billion in the preceding quarter. Credit growth remained strong, with loans for use in Hong Kong at end-June increasing by 13.8% over a year earlier, following corresponding growth of 11.5% three months earlier.

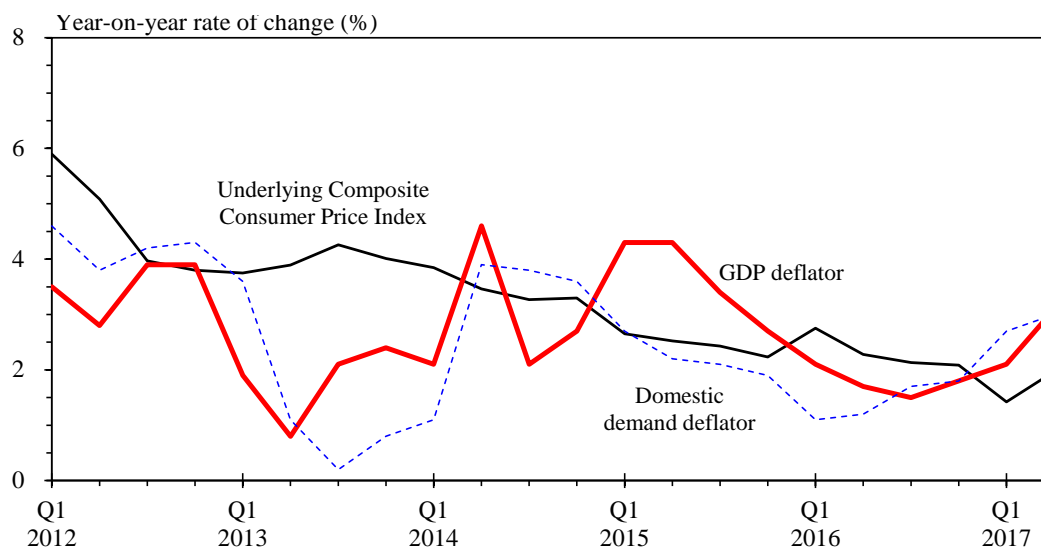
1.10 The *residential property market* stayed active in the second quarter. Trading activities picked up, with the number of residential property transactions increasing from 13 200 in the first quarter to 18 900 in the second quarter. Residential property prices rose by 5% between March and June. Compared to the 1997 peak, overall flat prices in June were 94% higher. Meanwhile, the housing affordability ratio worsened to around 67% in the second quarter. During the second quarter, flat rentals went up by 3%, while shop and office rentals rose by 2% and 1% respectively. To strengthen banks' risk management and resilience, the Hong Kong Monetary Authority in mid-May introduced the eighth round of macro-prudential measures for property mortgage loans.

## Inflation

1.11 Consumer price inflation remained moderate in the second quarter. External price pressures were muted, thanks to low inflation in our major import partners and the appreciation of the Hong Kong dollar alongside its US counterpart against many other currencies on a year-on-year basis. Locally, increases in labour costs stayed largely moderate. Slower rises in fresh-letting residential and commercial rentals in 2016 continued to feed through into the Composite CPI, notwithstanding the more visible pick-ups in fresh-letting residential rentals in recent months. Yet, as the temporary effect from the high base of comparison due to the weather-induced spikes in food prices in the early months last year dissipated, consumer price inflation in the second quarter returned to levels that were more in line with the prevailing moderate price pressures in the economy. In sum, netting out the effects of the Government's one-off relief measures to more accurately reflect the underlying inflation trend, *underlying composite consumer price inflation* was 2.0% in the second quarter, up from 1.4% in the first quarter. Meanwhile, *headline consumer price inflation* also ticked up to 2.0% from 0.5%. Headline consumer price inflation showed a larger up-tick in the second quarter, as the dampening effect of the rates concession on the headline rate in the first quarter largely dissipated.

1.12 The year-on-year rate of increase in the *GDP deflator* also picked up to 3.1% in the second quarter, from the 2.1% increase in the first quarter. Analysed by its major components, the domestic demand deflator showed a slightly larger year-on-year increase, while the terms of trade held virtually unchanged year-on-year.

**Diagram 1.4 : Underlying consumer price inflation remained moderate in the second 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**

1.13 The net output of the services sector as a whole expanded by 3.5% in real terms in the first quarter of 2017 over a year earlier. This was higher than its 2.5% growth in the fourth quarter of 2016, largely mirroring the stronger year-on-year growth of the overall economy. Among the key services industries, the net output of import and export trade, as well as transportation and storage, grew more visibly in the first quarter, amid strengthening trade flows. The net output of wholesale and retail trades showed further relative improvement, and that of accommodation and food services grew at a faster year-on-year pace than in previous quarters, as visitor arrivals resumed growth gradually. The net output of real estate, which mainly reflects activity of private sector developers and property agencies, increased visibly as the residential property market revived in the first quarter over a very low base of comparison a year earlier. Financing and insurance, and information and communications all saw faster expansion in the first quarter, whereas professional and business services registered slower growth. As for the secondary sector, construction activity expanded apace in the first quarter, driven by visible growth in both the public and the private sectors. Meanwhile, the net manufacturing output increased marginally.

**Table 1.3 : GDP by economic activity<sup>(a)</sup>  
(year-on-year rate of change in real terms (%))**

	<u>2016</u>	<u>2016</u>				<u>2017</u>
		<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>	<u>Q1</u>
Manufacturing	-0.4	-0.3	-0.4	-0.1	-1.0	0.2
Construction	2.6	-1.2	0.8	3.0	7.6	8.6
Services <sup>(b)</sup>	2.3	1.6	2.7	2.3	2.5	3.5
Import/export, wholesale and retail trades	0.4	-2.1	0.9	0.8	1.7	3.9
Import and export trade	2.1	0.1	2.8	2.3	2.9	5.1
Wholesale and retail trades	-6.0	-10.0	-5.9	-5.9	-2.8	-0.8
Accommodation <sup>(c)</sup> and food services	0.1	-0.9	1.0	0.1	0.2	1.6
Transportation, storage, postal and courier services	3.3	2.6	3.4	3.5	3.8	4.7
Transportation and storage	3.4	2.8	3.5	3.4	3.8	4.5
Postal and courier services	2.3	-1.4	2.7	5.8	2.5	9.0
Information and communications	3.7	3.7	4.2	3.7	3.3	3.8
Financing and insurance	4.7	5.0	4.2	4.7	4.8	5.2
Real estate, professional and business services	3.0	1.8	3.7	3.2	3.5	4.4
Real estate	3.7	0.6	2.9	5.5	6.0	8.5
Professional and business services	2.5	2.6	4.4	1.4	1.7	0.6
Public administration, social and personal services	2.7	2.5	3.3	2.5	2.3	2.5

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, while those shown in Table 1.1 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

1.14 Hong Kong was named as the world's most competitive economy for the second consecutive year in the International Institute for Management Development World Competitiveness Yearbook 2017. In particular, Hong Kong remained on top in terms of government efficiency and business efficiency, a clear recognition of the Government's commitment to building a favourable business environment and a robust financial system. In light of the fierce competition in the global economic arena, the Government will strive to uphold our prevailing competitive edges, including the open and free market principle, the rule of law, an efficient public sector and a robust institutional framework. These competitive strengths enabled us to make significant progress in economic development in the past two decades after returning to the Motherland (See **Box 1.3** for a detailed review).

1.15 To further enhance Hong Kong's economic integration with the Mainland, the Framework Agreement on Deepening Guangdong-Hong Kong-Macao Cooperation in the Development of the Bay Area was signed in Hong Kong on 1 July by the National Development and Reform Commission, the Hong Kong SAR Government, the People's Government of Guangdong Province and the Macao SAR Government. The Framework Agreement provides that the objective of cooperation is to implement the principle of "one country, two systems" fully and accurately, improve and innovate on the cooperation mechanism, establish a mutually complementary cooperation relationship, and jointly take forward the development of the Guangdong-Hong Kong-Macao Bay Area. In addition, the Framework Agreement establishes the key cooperation areas in the development of the Bay Area, which include, among others, promoting infrastructure connectivity, enhancing the level of market integration, and building a global technology and innovation hub.

1.16 Furthermore, under the framework of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), the Investment Agreement and Agreement on Economic and Technical Cooperation were signed in June. With these two new Agreements, CEPA becomes a comprehensive modern free trade agreement covering the four important pillars of trade in goods, trade in services, investment, and economic and technical cooperation.

1.17 On financial development, the People's Bank of China and the Hong Kong Monetary Authority made a joint announcement in May on their approval for establishing mutual bond market access between Hong Kong and the Mainland (Bond Connect). Qualified overseas investors can buy bonds in the Mainland interbank bond market with either Renminbi (RMB) or foreign

currencies. Bond Connect will facilitate investors' participation in the bond markets, improve the connectivity between market infrastructures and promote healthy development of the bond markets, thereby enhancing Hong Kong's status as an international financial centre and the global offshore RMB business hub. Separately, Hong Kong became a new member of the Asian Infrastructure Investment Bank (AIIB) and participated in AIIB's June meeting.

1.18 The Chief Executive laid out a package of priority measures to support quality education at the Legislative Council on 5 July. Specific measures included, among others, providing a non-means-tested annual subsidy of \$30,000 for eligible students pursuing full-time locally accredited local and non-local self-financing undergraduate (including top-up degree) programmes, increasing the teacher-to-class ratio for public primary and secondary schools by 0.1 across-the-board, providing additional resources to enhance support for students in special schools, and providing for annual adjustment of the portion for teachers' salary in the subsidies under the Free Quality Kindergarten Education Policy in line with the annual civil service pay adjustment. This package marked the first step of the fifth-term Government in improving education for our next generation.

## Box 1.3

### Twenty years after returning to the Motherland : a review

Since returning to the Motherland, Hong Kong has gone through many significant challenges over the past two decades, including the Asian Financial Crisis, the bursting of the IT bubble, the outbreak of SARS, and the Global Financial Crisis. Each time, the economy was able to recover swiftly and move from strength to strength, making progress in economic development and embodying the successful implementation of “one country, two systems”.

#### Notable economic growth over the past two decades

Hong Kong economy has grown remarkably since China resumed the exercise of sovereignty over Hong Kong. The size of the economy in 2016 was 1.8 times that of 1997. Real GDP growth averaged 3.2% per annum during the period, exceeding that of advanced economies at 2.0% per annum. Per capita nominal GDP reached US\$43,700 in 2016, surpassing many advanced economies<sup>(1)</sup>.

#### Sound fundamentals; highly internationalised city

Hong Kong’s friendly business environment is well recognised worldwide. The number of overseas and Mainland companies which chose to locate their regional headquarters or regional offices here increased sizably, up from some 2 500 in 1997 to over 3 700 in 2016. The total position of direct investment liabilities in Hong Kong surged from \$1,914 billion in 1998<sup>(2)</sup> to \$13,845 billion in 2016, or 556% of GDP in 2016, underscoring Hong Kong’s important role as an international business hub.

Hong Kong’s economic development has been underpinned by strong competitive advantages. Its simple and low tax system, free and open trade, rule of law, level playing field, robust regulatory regimes, and fully convertible currency altogether provide an attractive economic environment. In addition, the world-class financial system, superb transport and communications infrastructure, and efficient government are also essential elements of Hong Kong’s success. These competitive strengths have won us successive international accolades from prestigious research institutions worldwide (**Table 1**).

**Table 1: Hong Kong ranks among the top in the global league**

<b>Economic Freedom</b>	
Heritage Foundation	1st for 23 consecutive years
Fraser Institute	1st every year since the report first came out in 1996
<b>Ease of Doing Business</b>	
The World Bank	4th in 2017; persistently top five in the past ten years
<b>Competitiveness</b>	
International Institute for Management Development	1st in 2016 and 2017; top three in nine out of the past ten years

Hong Kong’s economic fundamentals have also gone from strength to strength, empowering the economy to weather global challenges. Hong Kong’s current account stayed in healthy surplus, averaging 2.6% of GDP in the past five years. Public finance has been sound, with successive years of fiscal surpluses since the fiscal year 2004/05 yielding a huge fiscal reserve of \$953.7 billion, equivalent to 25 months of government expenditure. In terms of international investment position, Hong Kong has all along been a net creditor, with net external financial assets reaching 368% of GDP in 2016. Official foreign currency reserve assets increased from US\$92.8 billion at end-December 1997 to US\$408.0 billion at end-June

(1) According to the IMF’s World Economic Outlook Database in April 2017, the per capita GDPs of Germany, the UK and Japan were US\$41,900, US\$40,100 and US\$38,900 respectively in 2016.

(2) Earliest figure available at 1998.

### **Box 1.3 (Cont'd)**

2017 and are now the seventh largest in the world. The banking sector maintained a strong capital position, sound asset quality and favourable liquidity conditions<sup>(3)</sup>. Strong economic fundamentals provided a buffer against external shocks, which helped Hong Kong going through the global financial turmoil. The hard-won reputation as an international financial centre has been firmly built.

#### **Visible gains in jobs, labour income and productivity**

Sustained economic growth has brought about continued job creation. Between 1997 and 2016, total employment increased by 624 000 to a record annual high of 3.79 million. Indeed, the labour market held in a state of full employment in recent years, with the unemployment rate hovering at 3.1% – 3.5% since the second half of 2011<sup>(4)</sup>, lending strength to our private consumption.

The vibrant labour market also gave rise to some visible improvement in labour income. Between 1997 and 2016, average employment earnings of full-time employees (excluding foreign domestic workers) increased by 36.1% in real terms. With the implementation of Statutory Minimum Wage in 2011 and solid labour demand, the lower-paid full-time workers enjoyed a comparatively more notable increase in earnings in recent years, with average employment earnings in the lowest income decile group (excluding foreign domestic workers) up 14.4% in real terms between 2010 and 2016, higher than the overall average of 9.0%.

The increases in labour earnings were supported by remarkable labour productivity growth that averaged 2.2% per annum since 1997, which in turn drove economic growth. Important industries, such as import and export trade, financing and insurance, and wholesale and retail trades, saw spectacular growth in labour productivity<sup>(5)</sup>. Furthermore, quality talents are vital in driving productivity growth. The share of labour force with tertiary education almost doubled to 38.9% in 2016 as compared to that in 1997. The increasing supply of higher-skilled workers has enabled the economy to climb up the value chain amidst keen global competition.

#### **Closer economic ties to the Mainland**

The Mainland's continued economic reforms and opening-up have provided considerable opportunities to Hong Kong. Through realising these opportunities, the economic ties between the two places get ever closer. With a flexible economy, Hong Kong also adapted to the Mainland's economic transformation and played different significant roles in the past two decades. For the trading sector, China's accession to the World Trade Organization (WTO) in 2001 rendered abundant opportunities. Merchandise trade with the Mainland in 2016 was over three times that in 1997. Indeed, in 2016, close to 90% of re-exports routed through Hong Kong involved the Mainland either as a source or as a destination. The continued economic transformation in the Mainland has not only propelled it to become the world's second largest economy, but also created tremendous opportunities for a wide range of services activities in and outside the Mainland. The implementation of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) in 2003 and its supplements thereafter opened up huge markets, further deepening economic integration between the two places. Under CEPA, the Mainland offers preferential access opportunities for Hong Kong's

(3) According to statistics compiled by the Hong Kong Monetary Authority, the consolidated capital adequacy ratio of locally incorporated authorized institutions was 19.2% at end-2016, well above the international minimum requirement of 8%. Retail banks' classified loan ratio was 0.72% at end-2016, well below the long-run historical average of 2.4% since 2000. The average liquidity coverage ratio of category 1 institutions was 156.3% in the fourth quarter of 2016, well above the 70% statutory minimum requirement applicable for 2016.

(4) The seasonally adjusted unemployment rate was 3.1% in the second quarter of 2017.

(5) Based on sectoral figures which can be dated back to 2000 the earliest, the import and export trade, financing and insurance, and wholesale and retail trades sectors saw spectacular growth in labour productivity at average rates of 5.7%, 4.6% and 4.0% per annum respectively between 2000 and 2016.

### **Box 1.3 (Cont'd)**

products and services, ahead of and beyond its commitments to WTO members. Nowadays, Hong Kong has become an important service hub linking the Mainland and the rest of the world, catalysing the nation's rebalancing of growth towards services and consumption, and benefitting from the process.

#### **China's global financial centre**

As an international financial centre, Hong Kong has a long history serving the financial services needs of Mainland enterprises. It has been an important gateway for investment between the Mainland and the rest of the world. Due to its status as a leading equity fund raiser, the number of Mainland enterprises listed in Hong Kong surged from 101 in 1997 to 1 002 in 2016, accounting for over 60% of stock market capitalisation in 2016. Hong Kong has long been the top external direct investor in the Mainland, with Hong Kong's stock of outward direct investment in the Mainland amounting to \$4,702 billion in 2015. In more recent years, Hong Kong serves as an ideal platform for Mainland entities as they "go global". The stock of inward direct investment from the Mainland to Hong Kong amounted to \$3,270 billion in 2015, 16 times that in 1998.

Hong Kong's financial industry also plays an important role as a testing ground for the Mainland's financial market liberalisation and the opening of its capital account. Notable examples in recent years were the Shanghai- and Shenzhen- Hong Kong Stock Connect, the mutual recognition of funds arrangement with the Mainland and the Bond Connect. With continued support from the Central Government, Hong Kong has become the primary offshore RMB business hub, possessing the world's largest pool of offshore RMB funds that engage in a wide and expanding range of businesses. Buttressed by the Mainland's support and its own competitive strengths, Hong Kong's financial services sector has prospered, causing its contribution to the overall economy to leap by 7 percentage points from 1997 to 17.6% of GDP in 2015.

#### **Economic collaboration with other places**

As a cosmopolitan city, Hong Kong has been making good progress in advancing cooperation with other economic partners in trade and investment over the past two decades. Apart from CEPA, Hong Kong has signed free trade agreements with other trading partners, including New Zealand, the Member States of the European Free Trade Association and Chile. For years, Hong Kong has also invested heavily in infrastructure to boost connectivity with other parts of the world so as to facilitate people and cargo flows. In 2016, Hong Kong International Airport was the world's busiest cargo gateway and third busiest international passenger airport. The construction of a third runway commenced in August 2016. When completed, Hong Kong's capacity in handling air passengers and cargo flows would be further enhanced.

#### **Tremendous opportunities ahead**

The Government will continue to strengthen Hong Kong's role as the principal gateway between the Mainland and the world, being an international financial, transportation and trade centre. Hong Kong will leverage its unique positioning as set out in the Dedicated Chapter on Hong Kong and Macao of the Outline of the National 13th Five-Year Plan. In particular, the development of Guangdong-Hong Kong-Macao Bay Area and the Belt and Road Initiative will certainly provide vast opportunities for Hong Kong in the years to come. The facilitation of factors of production flows in the Bay Area will enhance the complementarity between places in the region and unleash growth potential, while the Belt and Road Initiative will boost demand for high value-added services in Hong Kong as a platform in financing, trading and logistics, and professional services, to name just a few. All in all, given Asia's increasing importance in the world economy amid notable economic growth in the Mainland, Hong Kong's long-term economic outlook is essentially bright. The Government will continue to facilitate economic development, striving for sustainability and thereby creating the necessary resources to improve people's livelihood.

## Notes :

- (1) The table below presents a more detailed comparison between the growth forecasts made by the IMF in July 2017 and those made three months ago.

	<u>2016</u>	<u>2017</u>	<u>2017</u>
	(%)	April round (%)	July round (%)
World (PPP <sup>##</sup> weighted)	3.2	3.5	3.5
Advanced economies	1.7	2.0	2.0
US	1.5 <sup>#</sup>	2.3	2.1
Euro area	1.8 <sup>#</sup>	1.7	1.9
UK	1.8 <sup>#</sup>	2.0	1.7
Japan	1.0 <sup>#</sup>	1.2	1.3
Emerging market and developing economies	4.3	4.5	4.6
Emerging and developing Asia	6.4	6.4	6.5
Mainland China	6.7 <sup>#</sup>	6.6	6.7
India <sup>^</sup>	7.1 <sup>#</sup>	7.2	7.2

- 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 by summing up its main components.