CHAPTER 2 : THE EXTERNAL SECTOR

Summary

- *Global economic activities continued to expand in the second quarter of 2017. The US economy sustained moderate growth. The economic recovery in the euro area became more entrenched, as the impacts of Brexit and other political developments so far had been limited. The Mainland economy continued to grow at a notable pace. As downside risks in the global economy receded, financial markets worldwide were generally buoyant during the quarter. With the supportive global economic environment and the ensuing regional economic upturn, Hong Kong's exports of goods and services made further growth in the second quarter.*

- *Hong Kong's merchandise exports grew visibly year-on-year in real terms(1) in the second quarter. Exports to Asian markets remained the key growth propeller, with further solid expansion in the Mainland market and strong growth in some emerging markets in the region such as India, Vietnam, Thailand and Indonesia. Exports to US and Europe also rose further, though only at a modest rate by comparison.*

- *Exports of services grew steadily year-on-year in the second quarter, thanks to reviving regional trade flows and increased cross-border financial transactions amid a benign global economic environment. Exports of transport services saw further notable growth, and exports of financial services sustained moderate growth. Exports of business and other services increased marginally. On the other hand, exports of travel services dipped slightly, as visitor arrivals grew at a slower pace and tourist spending had yet to resume growth.*

- *Hong Kong continued to strengthen economic ties with its trading and investment partners. In May, Hong Kong and Australia officially launched the Free Trade Agreement (FTA) negotiation. In June, two agreements under the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) framework were signed, broadening the CEPA's scope to become a comprehensive modern free trade agreement covering trade in goods, trade in services, investment, and economic and technical cooperation. This marked another milestone of CEPA's development.*

Goods trade

Total exports of goods

2.1 Alongside the sustained expansion in global economic activities, trading and manufacturing activities in Asia remained on the rise in the second quarter of 2017. Exports of many major Asian economies showed further solid year-on-year growth in the second quarter, notwithstanding the receding low base effects seen in the first quarter. Against this backdrop, Hong Kong's *merchandise exports* (comprising re-exports and domestic exports) grew visibly by 5.8% year-on-year in real terms in the second quarter, after marked growth of 8.8% in the preceding quarter.

2.2 The global economy continued to display solid performance in the second quarter. The US economy grew at a moderate pace, with visible job gains, prompting the Federal Reserve to raise interest rates again in June and unveil plans to start scaling back the balance sheet this year (see ***Box 2.1*** for details). In the euro area, economic sentiment strengthened, as Brexit and other political developments so far had limited impacts. The entrenched economic recovery has raised market's expectation about the possibility of European Central Bank's trimming of monetary stimuli in the period ahead. In Asia, the Mainland economy registered notable growth so far this year, actually representing a slight pick-up from that of last year. Its favourable outlook towards medium-to-high growth is also vindicated by the latest upward revisions by the International Monetary Fund (IMF)[(2)]. Japan's economy also registered relative improvement, while most emerging ASEAN economies showed further solid growth. With the downside risks in the global economy receding, financial markets worldwide were generally buoyant during the quarter.

2.3 The recovery in final demand from major advanced economies in recent quarters added vigour to Asia's manufacturing activity. As goods are generally produced via geographically-fragmented production chains in Asia, the manufacturing expansion in the region is usually manifested by an enlarged growth in intra-regional trade flows involving raw materials, semi-manufactures and capital goods. Regional trade flows of this nature were a key growth engine in Asian exports in recent quarters. As a regional trading and logistics hub, Hong Kong's goods exports benefited considerably from such a development.

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

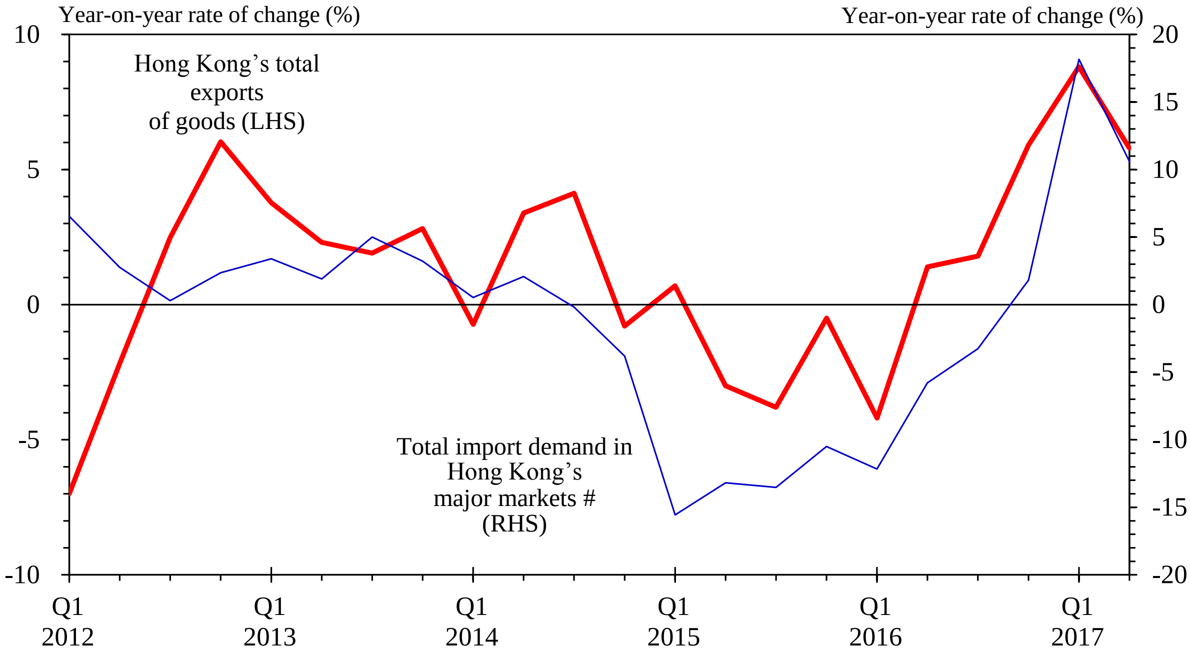
		Total exports of goods				Re-exports				Domestic exports			
		In value terms	In real terms[a]		Change in prices	In value terms	In real terms[a]		Change in prices	In value terms	In real terms[a]		Change in prices
2016	Annual	-0.5	1.4		-1.7	-0.4	1.5		-1.7	-8.5	-7.0		-1.4
	Q1	-6.8	-4.2	(-4.7)	-2.6	-6.7	-4.0	(-4.7)	-2.6	-15.2	-12.1	(-2.4)	-3.2
	Q2	-1.2	1.4	(6.1)	-2.2	-0.9	1.6	(6.3)	-2.2	-16.8	-14.7	(-2.7)	-2.1
	Q3	-0.2	1.8	(1.0)	-1.6	-0.2	1.8	(0.9)	-1.6	-2.0	-0.1	(8.2)	-1.1
	Q4	5.5	5.9	(3.8)	-0.5	5.6	6.0	(3.9)	-0.5	0.9	-0.7	(-3.8)	0.9
2017	Q1	10.3	8.8	(-0.4)	1.6	10.4	8.8	(-0.4)	1.6	4.9	1.8	(1.9)	3.0
	Q2	7.4	5.8	(1.0)	1.6	7.5	5.9	(1.1)	1.6	1.7	-0.6	(-6.3)	2.2

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

(a) The growth rates here are not strictly comparable with those in the GDP accounts in Table 1.1. Figures in Table 1.1 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*.

2.4 *Re-exports*[3], the mainstay of overall merchandise exports and accounting for 98.9% of total exports by value, grew briskly by 5.9% year-on-year in real terms in the second quarter, after 8.8% growth in the preceding quarter. In contrast, *domestic exports*, constituting the remaining 1.1% of total exports, fell slightly by 0.6% in real terms from a year earlier in the second quarter, after 1.8% rise in the first quarter.

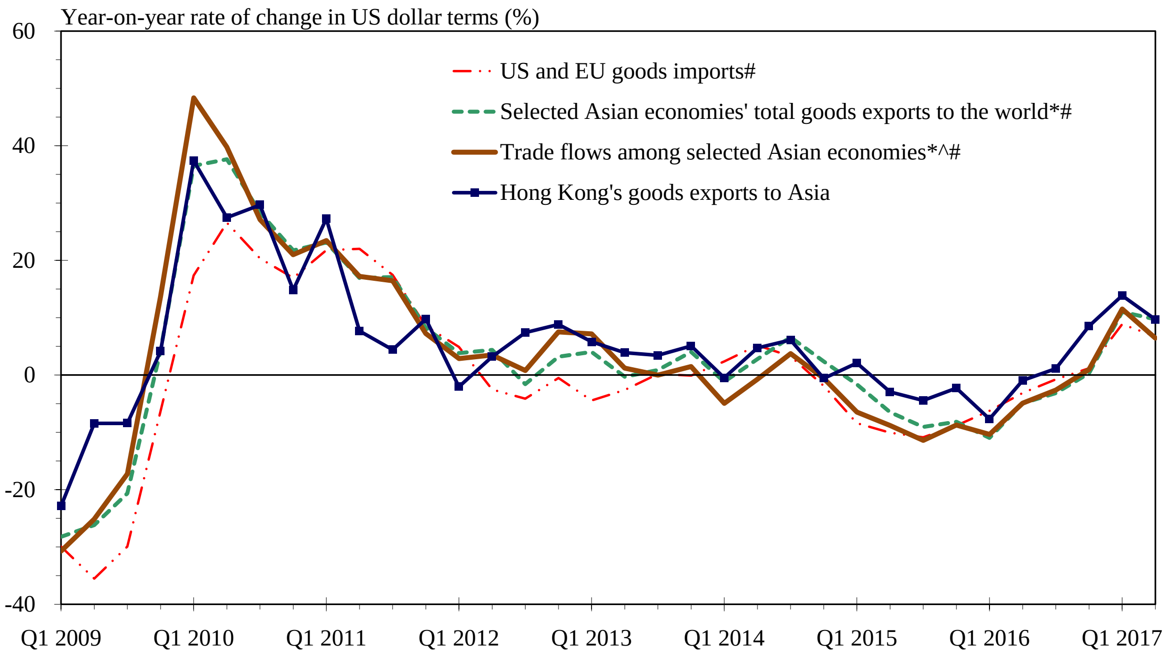
Diagram 2.1 : Merchandise exports grew visibly in the second quarter of 2017



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

(#) Import demand figure for the second quarter of 2017 is based on statistics for April and May 2017.

Diagram 2.2: Intra-regional trade remained on the rise amid revival of import demand from US and EU in recent quarters

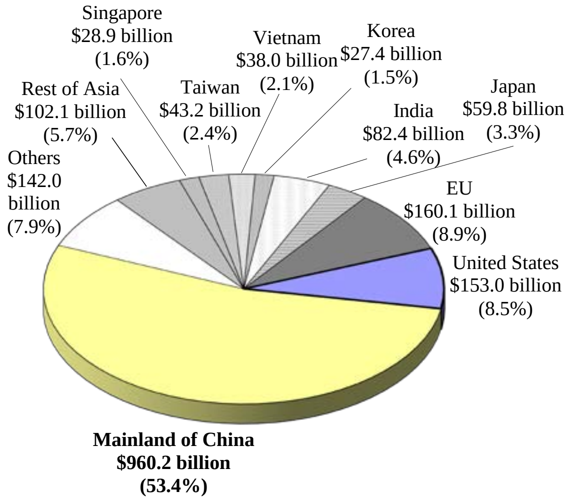


Notes : (*) "Selected Asian economies" include the Mainland of China, Hong Kong, Singapore, Korea, Taiwan, Japan, Indonesia, Malaysia, Thailand and the Philippines.

(^) The trade flows were measured by the sum of the individual economies' exports of goods to the other nine economies within the "selected Asian economies".

(#) Trade figures for the United States, the European Union and "selected Asian economies" for the second quarter of 2017 are based on the information available as of early August 2017.

Diagram 2.3 : Exports to Asia remained the key growth propeller of overall merchandise exports



Total exports of goods in the first half of 2017: $1,796.9 billion

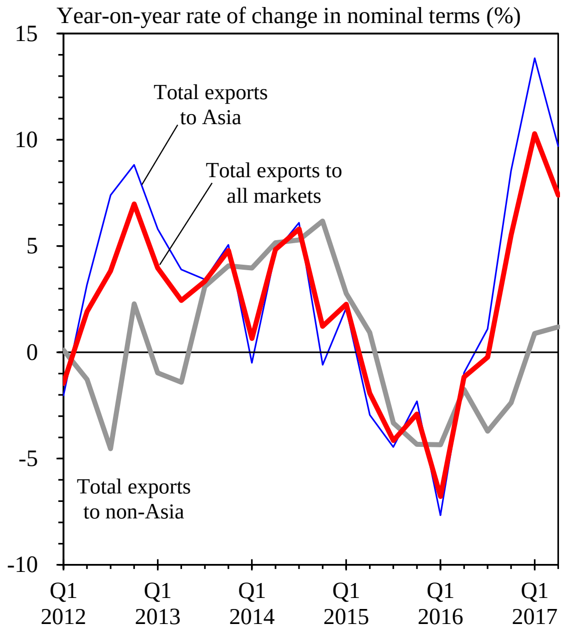


Table 2.2 : Total exports of goods by major market (year-on-year rate of change in real terms (%))

	2016					2017	
	Annual	Q1	Q2	Q3	Q4	Q1	Q2
Mainland of China	2.2	-5.6	2.0	2.7	8.5	9.3	3.9
United States	-1.9	-4.8	-1.4	0.2	-1.9	3.4	1.1
European Union	-0.7	-2.6	3.8	-0.4	-3.2	3.0	1.3
Japan	-2.3	-3.3	-6.6	-1.1	1.7	7.5	12.0
India	17.6	15.8	28.0	15.8	12.1	40.1	53.8
Vietnam	-4.8	-2.1	-8.0	-9.8	0.7	10.8	11.9
Taiwan	19.0	-2.9	17.1	27.5	31.5	44.3	23.0
Singapore	5.9	-0.4	-1.6	7.7	18.3	-1.2	3.9
Korea	1.5	-14.0	3.2	6.7	11.2	15.3	-2.8
Overall*	1.4	-4.2	1.4	1.8	5.9	8.8	5.8

Note : (*) The growth rates here are not strictly comparable with those in the GDP accounts in Table 1.1. Figures in Table 1.1 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*.

2.5 Analysed by major market on a year-on-year comparison in real terms, exports to the Mainland sustained solid growth in the second quarter. Exports to some emerging markets in the region grew robustly, with particularly sizeable growth in such markets as India and Vietnam. Exports of raw materials, semi-manufactures and capital goods to Asia continued to be the key growth driver of overall merchandise exports in Hong Kong. The performances of exports to the higher-income Asian markets were mixed. Exports to Taiwan once again grew briskly and those to Singapore improved to show a moderate rebound, yet those to Korea weakened. Exports to Japan gathered momentum to show double-digit growth from a low base last year, thanks to the recovery in production activities and relative improvement in consumer sentiment there.

2.6 Exports to the US and Europe also rose further in the second quarter, though at a modest pace by comparison. Exports to the US market rose somewhat amid continued moderate economic expansion there. Likewise, exports to the EU grew modestly as the recovery there continued to make progress.

Diagram 2.4 : Exports to the Mainland grew solidly

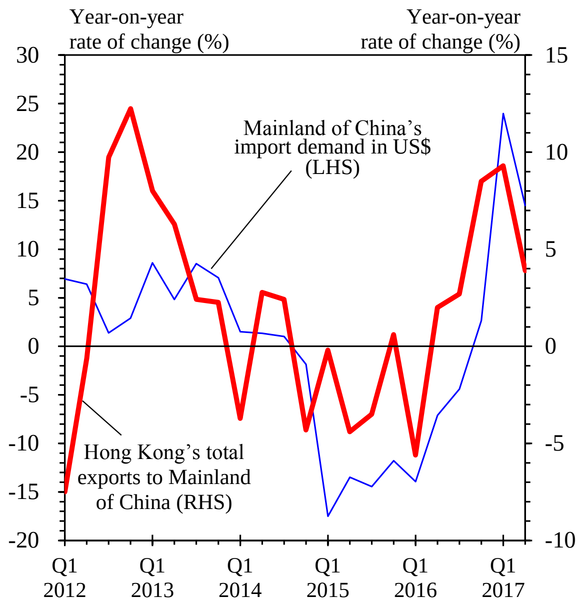


Diagram 2.5 : Exports to the EU grew modestly

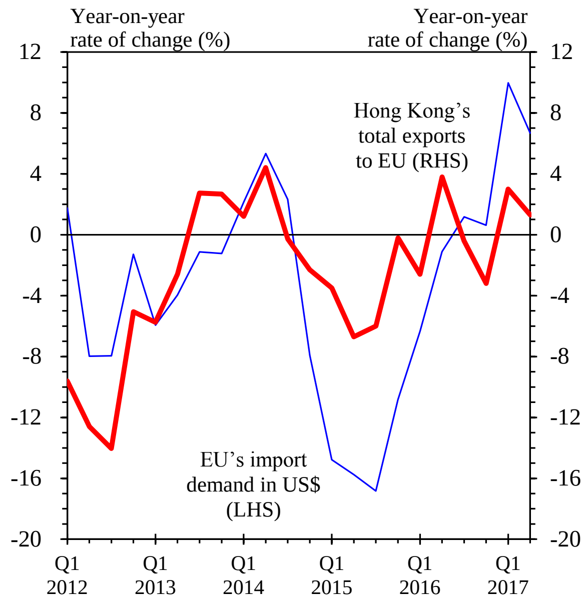


Diagram 2.6 : Exports to the US rose somewhat

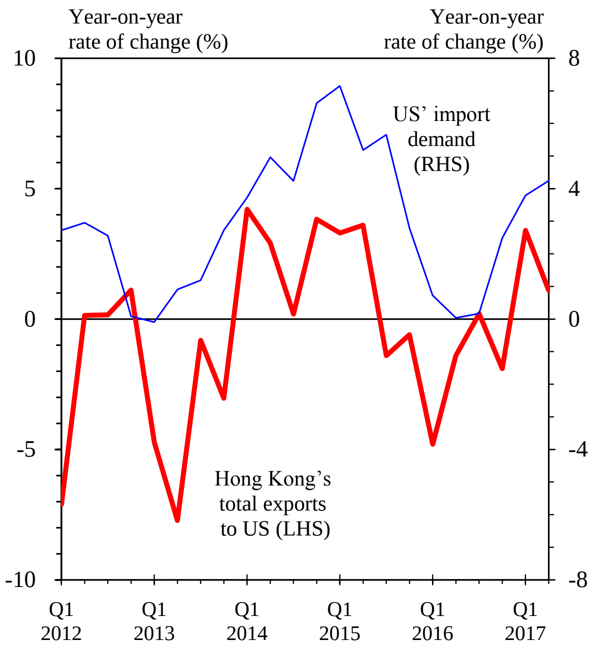


Diagram 2.7 : Exports to Japan gathered momentum to show double-digit growth

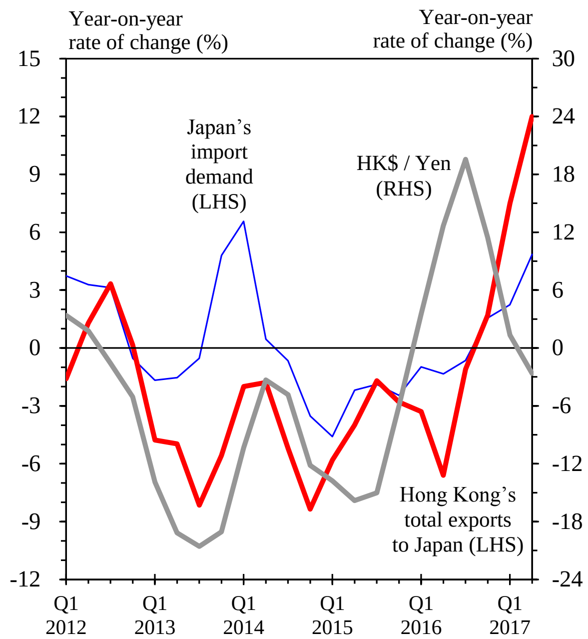


Diagram 2.8 : Exports to India surged

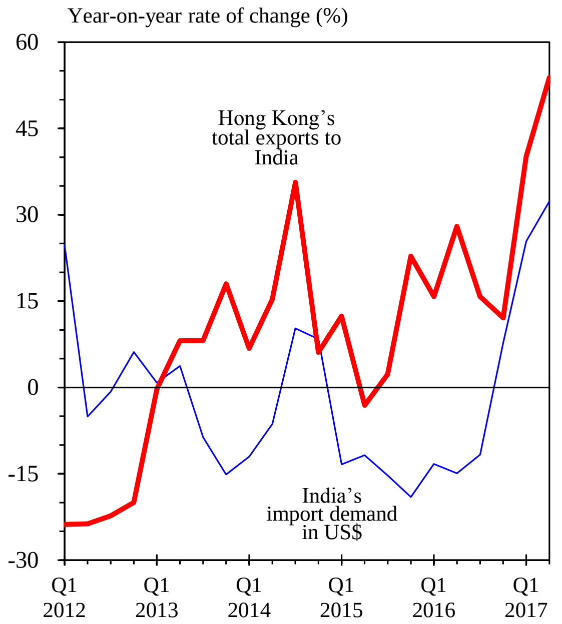


Diagram 2.9 : Exports to Taiwan grew briskly

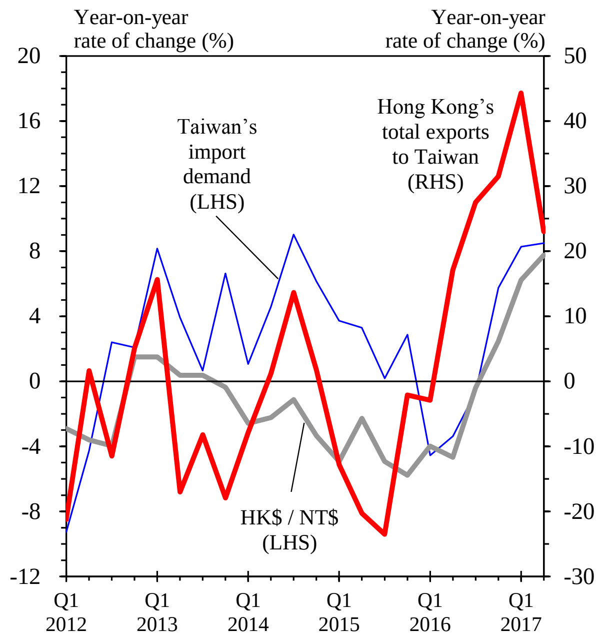


Diagram 2.10 : Exports to Korea weakened

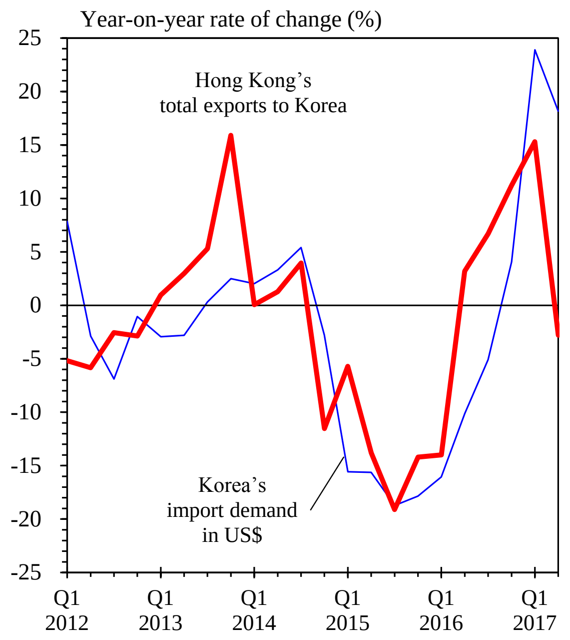
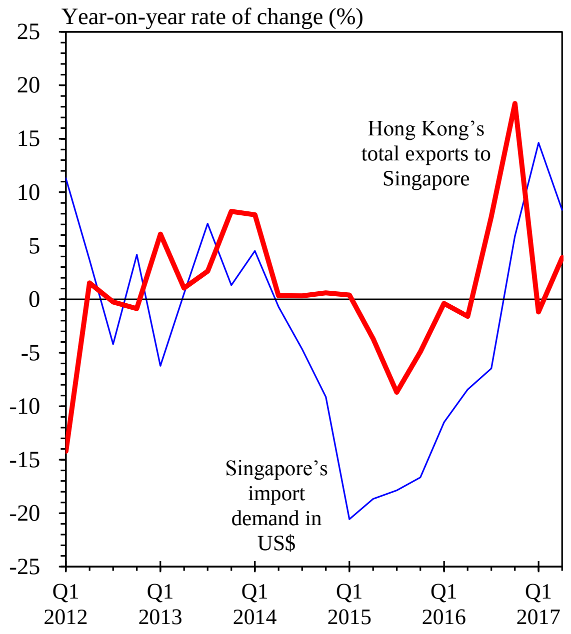


Diagram 2.11 : Exports to Singapore improved to show a moderate rebound



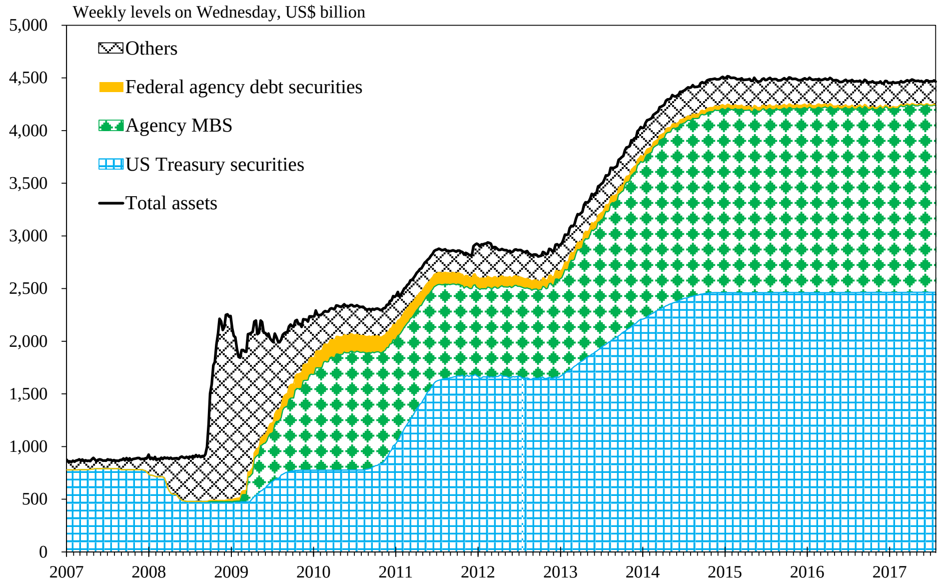
Box 2.1

The US Federal Reserve's balance sheet normalisation

In June 2017, on top of announcing the fourth interest rate hike since December 2015, the US Federal Reserve (Fed) unveiled a plan on normalising its balance sheet, which was expected to start relatively soon according to its statement following the latest Federal Open Market Committee (FOMC) meeting in late July. As reducing the size of the Fed's balance sheet is one of the key aspects of the ongoing monetary policy normalisation in the US, this note intends to examine the Fed's plan and explore its possible implications.

The Fed conducted a series of large-scale asset purchases under its quantitative easing programmes in the wake of the global financial crisis of 2008 (GFC) to ease overall financial conditions and stimulate economic activity in the US. Since then, the Fed has kept its securities holdings at unprecedented levels by reinvesting principal payments received from maturing US Treasury securities, federal agency debt securities and agency mortgage-backed securities (MBS). The amount of assets held by the Fed hovered around US$4.5 trillion since its asset purchase programmes ended in late 2014, representing a significant increase from the pre-crisis level of around US$900 billion (***Chart 1***). Within this, US Treasury securities and agency MBS comprised 55% and 40% of the Fed's total assets respectively.

Chart 1 : The Fed's total assets surged to unprecedented levels after the GFC



Source: Federal Reserve Bank of New York.
Note: Latest position as of 26 July 2017.

Table 1 shows the maturity distribution of the Fed's securities holdings as of 26 July 2017. More than half of the Fed's US Treasury securities will mature by end-2021, while less than 1% of agency MBS will mature within the coming five years. As for federal agency debt securities, the majority will reach maturity by end-2018 and will be reinvested into agency MBS under the Fed's current reinvestment policy.

Table 1 : The maturity distribution of the Fed's securities holdings as of 26 July 2017

Maturity date		Rest of 2017	2018	2019	2020	2021	2022	Beyond 2022	**All**
US Treasury securities*	US$ billion^	90	426	370	232	239	201	889	**2,447**
	% of total	4	17	15	10	10	8	36	**100**
Agency MBS	US$ billion#	&	&	&	0.2	0.4	0.1	1,768	**1,769**
	% of total	&	&	&	0.01	0.02	0.01	99.95	**100**
Federal agency debt securities	US$ billion^	4	2	0.1	-	-	-	2	**8**
	% of total	46	24	0.8	-	-	-	29	**100**

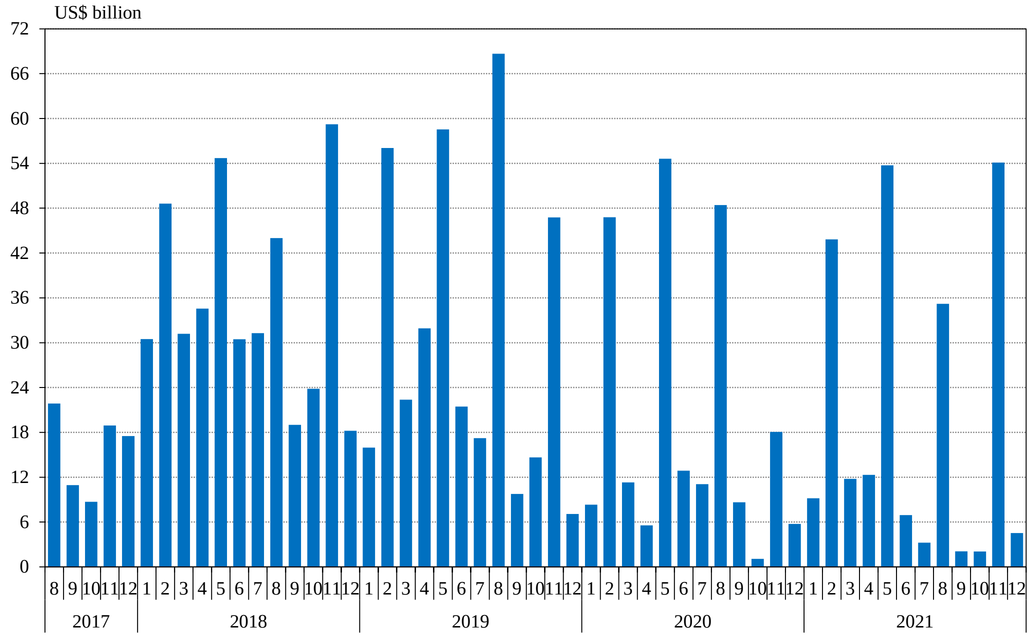
Notes: Compiled based on data from the Federal Reserve Bank of New York.
* Does not include the compensation that adjusts for the effect of inflation on the original face value of inflation-indexed securities, which amounted to US$19 billion as of 26 July 2017.
^ Face value.
\# Remaining principal balance of the securities.
& Less than US$5 million and 0.005%.

Box 2.1 (Cont'd)

To unwind its balance sheet, the Fed plans to gradually scale back reinvestments of its securities holdings by setting monthly caps[(1)], such that only the amount exceeding these caps will be reinvested each month. According to this plan, the scale of the Fed's balance sheet reduction is relatively small when compared to its prevailing securities holdings. The amount of securities that would be rolled off over the first twelve months is capped at US$300 billion, equivalent to 7% of the Fed's current total securities holdings. Provided that the monthly caps as announced are to remain in place, the decline in the Fed's balance sheet over each subsequent twelve-month period would be limited to US$600 billion or 14% of its current total securities holdings.

These monthly caps, however, may not be binding. As an illustration, ***Chart 2*** shows that the monthly face value of maturing US Treasury securities ranges from less than US$6 billion to over US$65 billion. Hence the amount of maturing US Treasury securities in a particular month can be lower than the corresponding monthly cap in many occasions. As for agency MBS, while most of the Fed's holdings have a rather long period of maturity (over 10 years), the amount of principal payments received from these holdings is more difficult to determine in advance, as it consists of scheduled mortgage repayments and homeowners' mortgage prepayments of part or all of their remaining principal balance prior to the maturity date. The latter of which does not follow a pre-set schedule and depends on a range of factors, including the interest rate outlook, changes in house prices and credit conditions. Nonetheless, generally speaking, considering the maturity patterns of the Fed's Treasury securities and agency MBS holdings, the Fed's pace of scaling back its balance sheet could be slower than that suggested by its intended monthly caps.

Chart 2 : The monthly face value of the Fed's maturing US Treasury securities varies greatly



Source: Federal Reserve Bank of New York.
Note: Data as of 26 July 2017.

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(1) Based on the Addendum to the Policy Normalization Principles and Plans released on 14 June 2017, the caps will be set at US$6 billion per month for US Treasury securities and US$4 billion per month for federal agency debt securities and agency MBS. These caps will be raised once every three months by US$6 billion and US$4 billion per month respectively until they reach US$30 billion and US$20 billion per month in a year's time. The caps are anticipated to remain in place until the FOMC judges that the Fed is holding no more securities than necessary for efficient and effective monetary policy implementation.

Box 2.1 (Cont'd)

While the process of the Fed's balance sheet normalisation is expected to be gradual, its scale-down would presumably reverse some of the stimulating effects achieved by previous quantitative easing programmes. Large-scale asset purchases and subsequent reinvestments by the Fed have not only provided abundant liquidity to the financial system after the GFC, but have also lowered longer-term interest rates, thus holding down borrowing costs for households and firms and rendering support to the overall US economy. By means of its asset purchases that began in the wake of the GFC and ended as recently as in late 2014, the Fed had sent a signal of intent to the financial markets on its resolve to maintain an exceptionally accommodative monetary policy stance for a prolonged period of time. The successive asset purchases had effectively lowered market expectations for the future path of policy rates and posed downward pressures on longer-term interest rates. Besides, through the portfolio balance channel, the substantial increase in the Fed's longer-term securities holdings had reduced the amount of these assets available in the market, not only raising the prices of these assets and lowering their yields, but also raising the prices and lowering the yields of other assets with similar risk and return characteristics (e.g. longer-term and high quality corporate bonds) as well.

From the perspective of assessing the uncertainty ahead in the effect of unwinding some of the stimulus measures previously introduced by the Fed (in this case through gradually winding down its balance sheet), it is important to note that the Fed's prior quantitative easing programmes were unconventional measures and there is still yet to be a broadly agreed conclusion on the transmission channels through which they may have an effect on interest rates and macroeconomic variables, such as output, employment and inflation. Indeed, with factors such as investor expectations, economic policies and international economic, monetary and policy developments, intertwining with each other and affecting broader economic and financial conditions at the same time, it is challenging to quantify the standalone impact of the Fed's large-scale asset purchases. In a similar vein, there is no historical guidance for gauging the macroeconomic effects of the Fed's balance sheet normalisation, though the gradual unwinding of the Fed's long-term securities holdings could conceivably exert some upward pressure on bond yields and interest rates.

A recent paper by the Fed[(2)] released in April 2017 focused only on the portfolio balance channel and estimated that the 10-year US Treasury term premium effect was around negative 100 basis points at end-2016. In other words, this implies that the yield on a 10-year US Treasury security would be 100 basis points higher at end-2016 in the absence of the Fed's asset purchases and subsequent reinvestments, if considering solely the drag effect from this particular channel. Another Fed research paper[(3)] looked at whether the Fed's balance sheet reduction would have similar effects as raising interest rates. It is estimated that a US$675 billion reduction in the Fed's balance sheet over a two-year period could raise the term premium by around 25 basis points, which is roughly equivalent to around a quarter-point increase in the federal funds rate. But this result is largely dependent on the estimated term premium effect and the long-run neutral real rate of interest, which can vary when using different model frameworks and assumptions.

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(2) Bonis, Brian, Jane Ihrig, and Min Wei (2017). "The Effect of the Federal Reserve's Securities Holdings on Longer-term Interest Rates", Board of Governors of the Federal Reserve System, FEDS Notes, April 20.

(3) Davig, Troy, A. Lee Smith (2017). "Forecasting the Stance of Monetary Policy under Balance Sheet Adjustments", Federal Reserve Bank of Kansas City, The Macro Bulletin, May 10.

Box 2.1 (Cont'd)

Financial markets have reacted calmly to the Fed's announcement of its balance sheet normalisation plan thus far. Arguably, the looming balance sheet reduction by the Fed may have already been expected by market participants. However, uncertainties still abound, as the Fed did not offer a clear indication of the preferred size of its normalised balance sheet. So far, the Fed only stated that it would bring down its securities holdings to a level appreciably below that seen in recent years but larger than that before the GFC. Such a level would reflect the banking system's demand for reserve balances and the Fed's decisions about how to implement monetary policy most efficiently and effectively in the future. More importantly, while the Fed affirmed that changing the federal funds rate remains the primary means of adjusting its monetary policy stance, it is uncertain whether and how the scale-back of its balance sheet might affect the pace of its concomitant interest rate normalisation process going forward. In addition, although the European Central Bank and the Bank of Japan have maintained their asset purchase programmes in recent months, different monetary policy actions by major central banks could alter and complicate global financial and liquidity conditions.

Market speculations about these uncertainties could spark abrupt changes in risk sentiment and unintended increases in borrowing costs, and trigger sudden reversals of capital flows and oversized financial market reactions. Hence risks of renewed financial market volatility cannot be ruled out in the period ahead. For instance, in late May 2013, when the Fed signalled its intention of tapering its monthly asset purchases sometime later in the year, financial markets misinterpreted the Fed's signal as a tightening of its monetary policy stance and massive sell-offs in stock and bond markets took place across the globe. In the subsequent three months, the 10-year US Treasury yield advanced by almost 100 basis points.

Looking ahead, it is thus important that the Fed could give clarity about its future policy intentions with effective market communications, thereby containing the risks of a sharp tightening of liquidity conditions and abrupt disruptions to financial markets during the course of the Fed's monetary policy normalisation. Under such a more benign scenario, the US economy and the global economic and financial environment should hopefully be able to hold up.

As an international financial centre, massive capital flows go in and out of Hong Kong. Although the Fed's eventual balance sheet normalisation has added uncertainty to the global monetary environment, Hong Kong is capable of navigating through capricious global financial conditions with our resilient and robust financial system and strong economic fundamentals. That said, the Fed is poised to proceed with raising interest rates gradually, though the timing and pace of future interest rate hikes remain data-dependent. Under the Linked Exchange Rate System, interest rates in Hong Kong will eventually follow the movements of the US interest rates. The Government will continue to closely monitor the US monetary policy developments and stay vigilant to their possible impacts on the Hong Kong economy.

Imports of goods

2.7 *Imports of goods* grew further by 6.4% year-on-year in real terms in the second quarter, though moderated from 9.0% growth in the preceding quarter. Both imports for subsequent re-exports as well as retained imports saw further notable growth. *Retained imports,* referring to the imports for domestic use, which accounted for around one-quarter of total imports, grew appreciably by 8.1% year-on-year in real terms in the second quarter, after growing by 9.7% in the first quarter. The strong growth in retained imports largely mirrored the robust expansion in domestic demand in the second quarter.

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

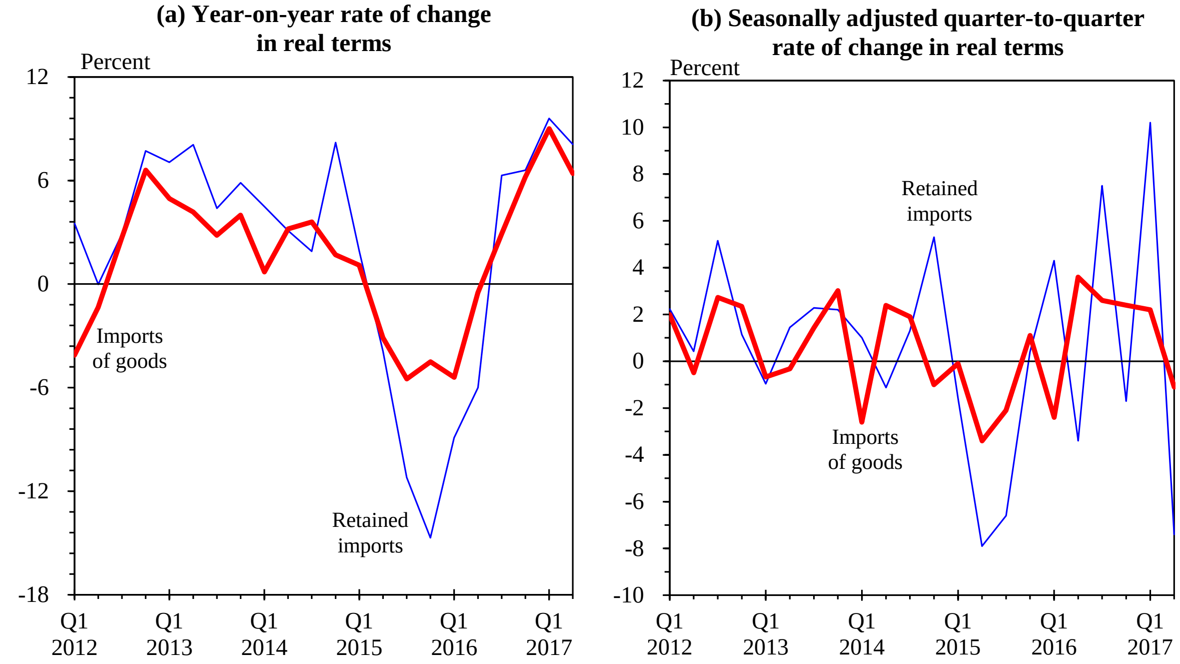
		Imports of goods				Retained imports[a]			
		In value terms	In real terms[+]		Change in prices	In value terms	In real terms		Change in prices
2016	Annual	-0.9	1.0		-1.7	-4.1	-0.6		-3.2
	Q1	-8.2	-5.4	(-2.4)	-2.8	-13.5	-8.9	(4.6)	-5.0
	Q2	-3.2	-0.5	(3.6)	-2.6	-10.6	-6.0	(-3.7)	-5.2
	Q3	1.2	2.9	(2.6)	-1.4	4.1	6.3	(7.6)	-2.1
	Q4	5.6	6.2	(2.4)	-0.1	4.0	6.6	(-1.8)	-0.6
2017	Q1	10.7	9.0	(2.2)	1.6	11.6	9.7	(10.2)	1.5
	Q2	8.2	6.4	(-1.1)	1.8	10.4	8.1	(-7.4)	2.5

Notes : (a) Based on the results of the Annual Survey of Re-export Trade conducted by the Census and Statistics Department, re-export margins by individual end-use category are estimated and adopted for deriving the value of imports retained for use in Hong Kong.

(+) The growth rates here are not strictly comparable with those in the GDP accounts in Table 1.1. Figures in Table 1.1 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.*

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

Diagram 2.12 : Imports and retained imports sustained notable year-on-year growth

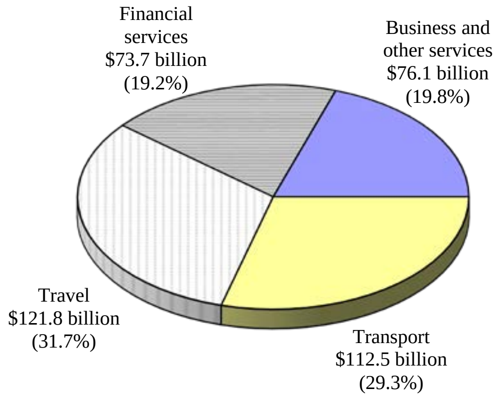


Services trade

Exports of services

2.8 *Exports of services* grew steadily by 2.3% year-on-year in real terms in the second quarter, after 2.8% growth in the first quarter, supported by the generally benign global economic environment. Exports of transport services grew notably, mirroring reviving regional trade and cargo flows. Meanwhile, exports of financial services sustained moderate growth, on the back of increased cross-border financial transactions. Exports of business and other services increased marginally. Nevertheless, exports of travel services dipped slightly, as visitor arrivals grew at a slower pace in the second quarter and tourist spending had yet to resume growth.

Diagram 2.13 : Travel, transport and financial services are the major service components within exports of services



Exports of services in the first half of 2017: $384.1 billion

Diagram 2.14 : Exports of services grew steadily

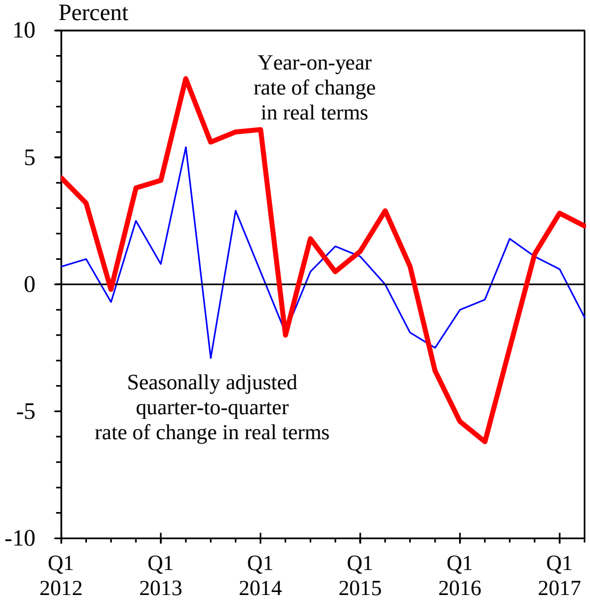


Table 2.4 : Exports of services by major service group (year-on-year rate of change in real terms (%))

		Exports of services		*Of which :* Transport	Travel[(a)]	Financial services	Business and other services
2016	Annual	-3.2		2.2	-8.6	-3.7	-1.0
	Q1	-5.4	(-1.0)	-2.0	-13.1	0.1	-2.6
	Q2	-6.2	(-0.6)	-1.1	-8.9	-15.1	-0.7
	Q3	-2.5	(1.8)	2.5	-8.1	-1.7	-1.1
	Q4	1.2	(1.1)	9.6	-4.0	-0.2	0.2
2017	Q1	2.8	(0.6)	9.2	-1.1	2.4	0.9
	Q2	2.3	(-1.3)	7.5	-2.1	2.8	0.6

Notes : 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.*

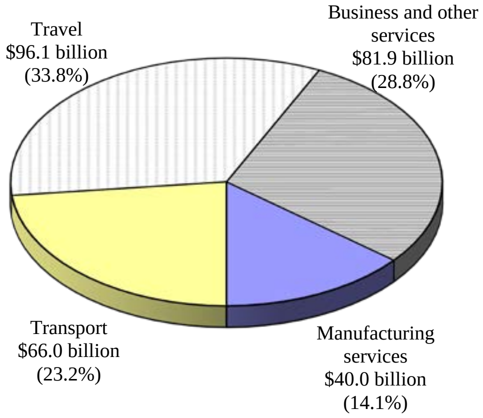
(a) Comprising mainly inbound tourism receipts.

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

Imports of services

2.9 *Imports of services* rose by 3.5% in real terms in the second quarter over a year earlier, up from 0.9% growth in the preceding quarter. Within this, the year-on-year growth in imports of travel services turned visibly faster, mainly attributable to the stronger growth of outbound tourism due to the difference in timing of the Easter holidays, which fell in late March in 2016 but in mid-April in 2017. On balance, imports of travel services in recent quarters were underpinned by the keen interest of local residents in overseas travel amid generally favourable job and income conditions. Imports of transport services picked up slightly in growth, along with increasing regional trading activities. Imports of business and other services also grew at a slightly faster pace. However, imports of manufacturing services declined further, reflecting the shrinking of outward processing activities.

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



Imports of services in the first half of 2017: $284.1 billion

Diagram 2.16 : Imports of services picked up in growth

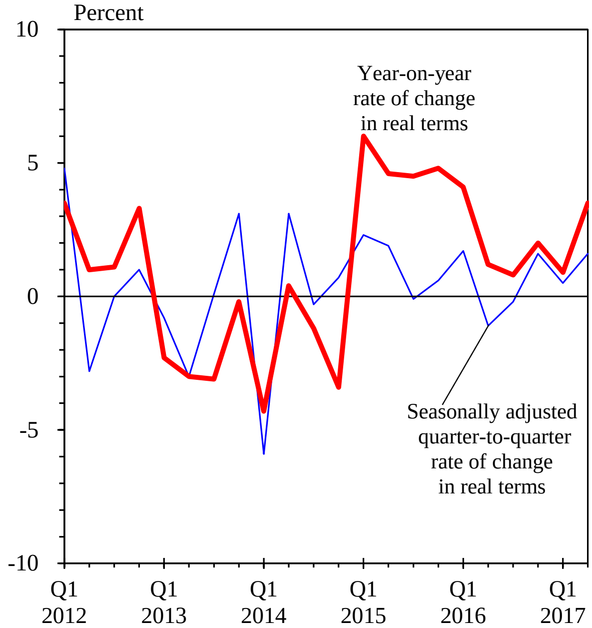


Table 2.5 : Imports of services by major service group (year-on-year rate of change in real terms (%))

		Imports of services		*Of which :* Travel[(+)]	Transport	Manufacturing services[(^)]	Business and other services
2016	Annual	2.0		5.9	-0.3	-1.9	1.8
	Q1	4.1	(1.7)	13.0	-0.5	0.9	0.2
	Q2	1.2	(-1.1)	2.9	-1.2	-0.5	2.5
	Q3	0.8	(-0.2)	3.7	-1.0	-2.8	1.6
	Q4	2.0	(1.6)	4.7	1.5	-4.1	2.8
2017	Q1	0.9	(0.5)	0.4	2.0	-4.4	2.5
	Q2	3.5	(1.6)	8.4	2.9	-5.5	3.1

Notes : 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.*

(+) Comprising mainly outbound travel spending.

(^) This includes the value of processing fees paid by Hong Kong to the processing units outside Hong Kong and raw materials / semi-manufactures directly procured by these processing units.

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

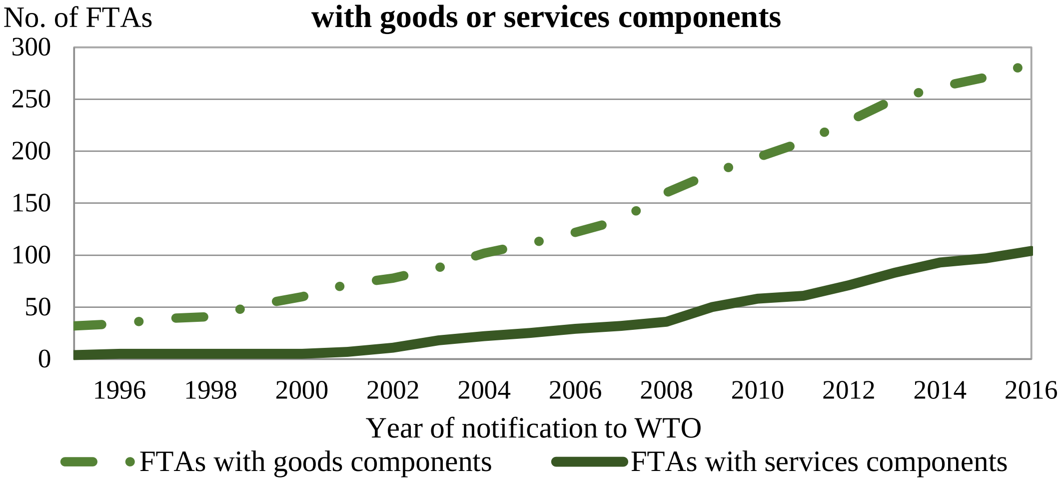
Box 2.2

Overview on the development of international services trade cooperation

Services are playing an increasingly important role in the modern world. Partly due to the continuous economic upgrading across the globe and also partly to the expansion of global value chains that has driven up the demand for such producer services as logistics, finance and professional services, the services sectors altogether now account for around 70% of the world's GDP, up from some 60% twenty years ago. Moreover, technology advancement has allowed many services to be delivered in a timely manner and be produced and consumed simultaneously but in different economies. Against this, policymakers worldwide have increasingly emphasised on how to promote services trade on their cooperation agenda. This article attempts to provide an overview of the development in Free Trade Agreements (FTAs) and other policies that facilitate services trade in the past two decades.

The World Trade Organization (WTO)'s General Agreement on Trade in Services (GATS), the first multilateral trade agreement that aims at removing barriers to services trade, entered into force in 1995. In contrary to the "barriers" to trade in goods which mostly relate to tariffs and border control arrangements, "barriers" to services trade are much more diverse given the unique characteristics of each sector, often in various forms of business regulations that limit market access of foreign service providers. The conclusion of the GATS formed a basis for international negotiations on services trade facilitation, and the number of FTAs that includes provisions on services flourished thereafter (***Chart 1***). According to the WTO, in 1995 only four out of the 32 FTAs in force covered the services sector. Yet by the end of 2016, provisions on services have already become an integral part of the overall landscape, with nearly 40% (104 out of 284) of the total number of FTAs in force having a services component.

Chart 1 : Numbers of FTAs in force with goods or services components



Source: Regional Trade Agreements Information System, WTO.

The way to facilitate services trade has also evolved over time. Under the GATS, market access obligations and national treatment commitments are made on a "positive listing" approach, in which the liberalisation commitments of each signatory are explicitly listed out so that the facilitation measures can be tailored to fit their national policy objectives. In recent years, the alternative "negative listing" approach has become more popular in FTA negotiations. The "negative listing" approach opens up all sectors to market access and national treatment except those on the "list(s) of non-conforming measures", and is hence generally more attractive to foreign businesses for its higher degree of stability and

Box 2.2 (Cont'd)

predictability[(1)]. Both approaches are in use nowadays, depending on the signatories' economic structures and their industries' stages of development[(2)].

Another important form of cooperation on services trade is international investment agreement (IIA). As companies establish commercial presence in the consumers' economy, foreign investment is involved and an IIA would help clarify some regulatory uncertainties and even provide preferential treatment. While the degree of liberalisation under IIA is smaller than a full-fledged FTA, it could serve as an initial step to foster closer economic relations. Indeed, according to the United Nations' World Investment Report and its Investment Policy Hub, the number of IIA rose rapidly in the past two decades from some 1 300 as at end-1996 to over 3 400 by end-2016.

In the context of Hong Kong, the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) vividly demonstrated the evolution of services liberalisation over time. In the early years after the signing of CEPA in 2003, the Mainland's liberalisation of services sector to Hong Kong adopted the "positive listing" approach with the coverage continuously enhanced through the ten Supplements. The Agreement between the Mainland and Hong Kong on Achieving Basic Liberalisation of Trade in Services in Guangdong signed in 2014 and the Agreement on Trade in Services signed in 2015 signified the shift to the "negative listing" approach that further expanded the market liberalisation to cover 95.6% of all the services sectors. More recently, the Investment Agreement and Agreement on Economic and Technical Cooperation signed in June this year further enhanced the CEPA framework by expanding commitments on admission of investment and investment protection and broadening the cooperation areas to cover especially the Belt and Road Initiative and Sub-regional Cooperation, making CEPA a comprehensive modern FTA.

As a highly developed services economy and an international financial centre, Hong Kong will spare no efforts in promoting services trade and actively participate in international initiative on services trade liberalisation. Notwithstanding the resurgence of protectionist sentiments in various parts of the world in recent years, we will continue our steadfast commitment on maintaining an open and free trade regime. For instance, we have been participating actively in the negotiations of Trade in Services Agreement (TiSA), which seeks to further liberalise trade in services with 22 WTO Members, representing more than 70% of the world's trade in services. Within Asia, on top of the continuously enhanced CEPA mentioned above, the negotiation work on the FTA with the Association of Southeast Asian Nations (ASEAN) is also progressing at full speed. Looking ahead, with the advancement in information and communications technologies, services trade is expected to further expand both in breadth - to encompass more professions and industries - and in geographical reach, made possible through business process outsourcing and offshoring practices. This global trend would certainly provide significant opportunities for Hong Kong to further expand our portfolio of services trade and in turn create more business opportunities which are beneficial to our long-term economic growth.

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(1) The "list(s) of non-conforming measures" provides flexibility to businesses with the comprehensive coverage assumed. It includes all sector-specific measures and other restrictions that do not comply with full openness (therefore called non-complying or non-conforming measures).

(2) Latrille, P. and Lee, J. (2012), "Services rules in regional trade agreements: How diverse and how creative as compared to the GATS multilateral rules?", Working Paper ERSD-2012-19, WTO, Geneva.

Goods and services balance

2.10 Compiled based on the change of ownership principle, the goods deficit widened in the second quarter, as growth in retained imports, underpinned by a notable expansion in domestic demand, outpaced growth in exports of goods. Adding the services surplus, the combined goods and services account registered a deficit of $29 billion in the second quarter of 2017, equivalent to 2.4% of total import value. This was larger than the corresponding deficit of $18 billion in the second quarter of 2016, equivalent to 1.6% of total import value.

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

		Total exports		Imports		Trade balance			
		Goods	Services	Goods	Services	Goods	Services	Combined	As % of imports
2016	Annual	3,900	767	4,037	578	-136	189	53	1.1
	Q1	849	194	892	138	-44	55	12	1.1
	Q2	929	177	987	138	-57	39	-18	-1.6
	Q3	1,025	196	1,037	148	-12	48	36	3.1
	Q4	1,098	200	1,121	153	-24	47	23	1.8
2017	Q1	942	201	1,000	141	-58	60	2	0.2
	Q2	994	183	1,063	143	-69	40	-29	-2.4

Notes : 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*.

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

Other developments

2.11 Hong Kong's economic ties with the Mainland, our most important economic partner, made further progress. In June, two agreements under the CEPA framework were signed, namely the Investment Agreement and the Agreement on Economic and Technical Cooperation (Ecotech Agreement). The agreements broadened CEPA's scope to become a comprehensive modern free trade agreement covering trade in goods, trade in services, investment, and economic and technical cooperation. In particular, the Investment Agreement is the Mainland's first investment agreement with pre-establishment national treatment commitments made under a negative listing approach. The Ecotech Agreement provides Hong Kong businesses with good opportunities for participating in the national development strategies, including the Belt and Road Initiative as well as the development of Guangdong-Hong Kong-Macao Bay Area. The two agreements marked another milestone of CEPA's development.

2.12 Hong Kong has always been a staunch supporter of open and free trade policy. In May, the FTA negotiation between Hong Kong and Australia was officially launched, which is envisaged to include, among other elements, elimination or reduction of tariffs, reduction of non-tariff barriers, better market access for trade in services, promotion and protection of investments. The FTA between Hong Kong and Australia, if materialised, would provide a new platform for enhancing economic and financial collaborations between the two places. In July, Hong Kong Customs and Australia Customs signed a Mutual Recognition Arrangement, providing trade facilitation between the two economies.

2.13 In addition, the Government strived to promote investment flows between Hong Kong and other parts of the world. In April, Hong Kong and Korea signed a Memorandum of Understanding (MoU) on investment promotion cooperation. According to the MoU, both sides will exchange information on the investment environment, investment opportunities, experience in attracting foreign investment as well as best practices in investment promotion.

2.14 As a responsible member of the international community, Hong Kong has all along been supportive of international efforts to promote tax transparency and combat tax evasion. In June, the agreements with Ireland and Indonesia on conducting automatic exchange of financial account information in tax matters (AEOI) were signed, raising the number of total AEOI partners to 13.

Notes :

(1) Changes in merchandise exports and imports in real terms are derived by discounting the effect of price changes from changes in the value of the trade aggregates. Estimates of price changes for the trade aggregates are based on changes in unit values, which do not take into account changes in the composition or quality of the goods traded, except for some selected commodities for which specific price indices are available. The real growth figures reported here are based on the external trade quantum index series compiled using the chain linking approach, which were first released in March 2015 to replace the previous trade index numbers compiled using the Laspeyres method with a fixed base year. The series are not comparable with the real trade aggregates under GDP (reported in Chapter 1) which 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*. Apart from this, non-monetary gold is recorded as a separate item in the statistics of merchandise trade and not included in the trade aggregates reported in Chapter 2, but is included in the trade aggregates under GDP in accordance to the international compilation standard.

(2) Upon the completion of 2017 Article IV Mission to China in June, the IMF raised Mainland's economic growth forecasts to 6.7% in 2017 and an average of 6.4% per year between 2018 and 2020. Its previous Mainland's economic growth forecasts made in April 2017 were 6.6% in 2017, 6.2% in 2018, 6.0% in 2019 and 5.9% in 2020.

(3) Re-exports are those goods which have previously been imported into Hong Kong and are subsequently exported without having undergone in Hong Kong any manufacturing processes which change permanently the shape, nature, form or utility of the goods.