CHAPTER 2 : THE EXTERNAL SECTOR

Summary

- *The global economy sustained broad-based growth in the first quarter of 2018. Major advanced economies saw solid expansion, while the Mainland economy maintained strong momentum. The favourable developments continued to render firm support to global trade flows to the benefit of Hong Kong and other Asian economies. However, trade tensions between the US and the Mainland have increased recently. The situation is still evolving and warrants close attention.*

- *Amid continued expansion in global demand, Hong Kong's merchandise exports accelerated to grow by 7.3% year-on-year in real terms*[(1)] *in the first quarter. Exports to Asian markets as a whole grew notably along with robust regional production activities, particularly so for those to the Mainland, Singapore and Taiwan. Exports to the US and Europe also gathered pace thanks to firming demand in these economies.*

- *Exports of services likewise displayed strength, picking up to show broad-based growth, which was the fastest since the second quarter of 2013. Specifically, exports of travel services accelerated to attain double-digit growth as inbound tourism improved further. Exports of financial services likewise picked up to sizeable growth, bolstered by active global financial market activities. Exports of transport services grew solidly amid buoyant regional trade flows. Meanwhile, exports of business and other services expanded steadily.*

- *The 2018-19 Budget laid out a bundle of initiatives to strengthen and consolidate Hong Kong's edge as an international trading and business centre. Meanwhile, the Government continued to expand Hong Kong's tax treaty network, by signing a comprehensive agreement for the avoidance of double taxation (CDTA) with India in March. The Government will also actively seek to expand our Free Trade Agreement (FTA) and Investment Promotion and Protection Agreement (IPPA) networks. In the face of rising trade protectionism, the Government will continue to uphold the principle of free trade, which is the cornerstone of Hong Kong's economic success. It is also all the more important for Hong Kong businesses, through active participation in the Belt and Road Initiative and the Bay Area development, to get access to the rapidly-expanding markets and to capture the vast opportunities so arisen. This will enable the Hong Kong economy to sustain its long-term growth and development.*

Goods trade

Total exports of goods

2.1 The global economy sustained solid, broad-based growth in the first quarter of 2018, underpinning the vibrant manufacturing and trading activities in the Asian region. Many Asian economies saw visible export growth in the quarter. As part of this regional phenomenon, Hong Kong's *merchandise exports* grew notably by 7.3% year-on-year in real terms in the first quarter of 2018, picking up from 4.6% growth in the preceding quarter.

2.2 The growth of major economies became more entrenched in the first quarter of 2018. The US economy expanded solidly, showing further job gains and a multi-year low unemployment rate. This supported a widely-expected interest rate hike in the US in March, marking the sixth hike since the lift-off in December 2015 by the Federal Reserve amid its ongoing monetary policy normalisation. The euro-area economy likewise sustained above-trend expansion. The Brexit negotiations also made progress, with the European Council endorsing a 21-month transition period till end-December 2020 that paved the way for a new phase of negotiations. Japan's economy held firm, amid strong export performance and improved domestic demand. Meanwhile, the Mainland economy sustained robust growth of 6.8% in the first quarter, against the backdrop of vibrant exports and resilient domestic demand. Many other Asian economies also registered notable growth amid buoyant manufacturing and trading activities in the region. The International Monetary Fund (IMF) in April maintained its global economic growth forecast for 2018 at 3.9%, compared to the 3.8% growth in 2017. While the IMF believed that there could be some upside to its near-term outlook considering the prevailing growth momentum in the global economy, it expressed concerns about the possibility of some abrupt tightening in the global financial conditions due to such factors as a faster pick-up in inflation in the US. The IMF also highlighted the potential downside risk from a worsening of trade tensions and imposition of broader barriers to cross-border trade that would not only take a direct toll on economic activity, but would also weaken confidence.

2.3 While global trade flows continued to thrive in the first quarter, the threat of trade protectionism also turned more visible. Following the imposition by the US of tariffs on imports of washing machines, solar panels, and some specific aluminium and steel items in early 2018, trade tensions between the US and the Mainland escalated in the more recent months. The Office of the US Trade Representative (USTR) in early April proposed to impose an additional tariff of 25% on imports from the Mainland involving more than 1 300 products worth around US$50 billion (constituting around 10% of the total value of US' imports from the Mainland in 2017)[(2)] and restrict the Mainland's investments in industries or technologies deemed important to the US. The Mainland subsequently announced its plan of counter-measures and the US indicated its intention to impose more tariff barriers on the trade flows between the two economies. Most of these plans or proposals of trade measures since early April have yet to be implemented. The trade conflicts will be averted if the two sides can reconcile their differences in the near term. Given that the US and the Mainland are the two largest economies and trading entities in the world, how their economic and trade relations would evolve has become the major source of uncertainty clouding the external trading environment.

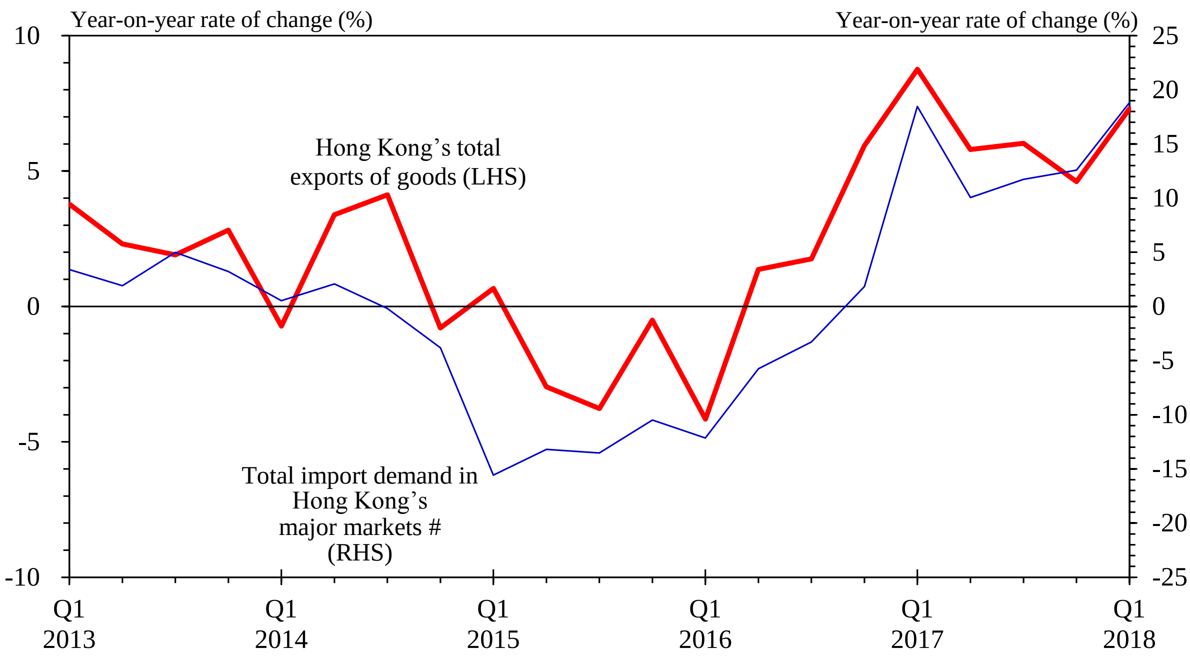
Table 2.1 : Total exports of goods
(year-on-year rate of change (%))

		Total exports of goods			
		In value terms	In real terms[(a)]		Change in prices
2017	Annual	8.0	6.2		1.8
	Q1	10.3	8.8	(0.2)	1.6
	Q2	7.4	5.8	(1.0)	1.6
	Q3	8.0	6.0	(0.5)	1.9
	Q4	6.8	4.6	(2.6)	2.2
2018	Q1	9.7	7.3	(2.2)	2.3

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*.

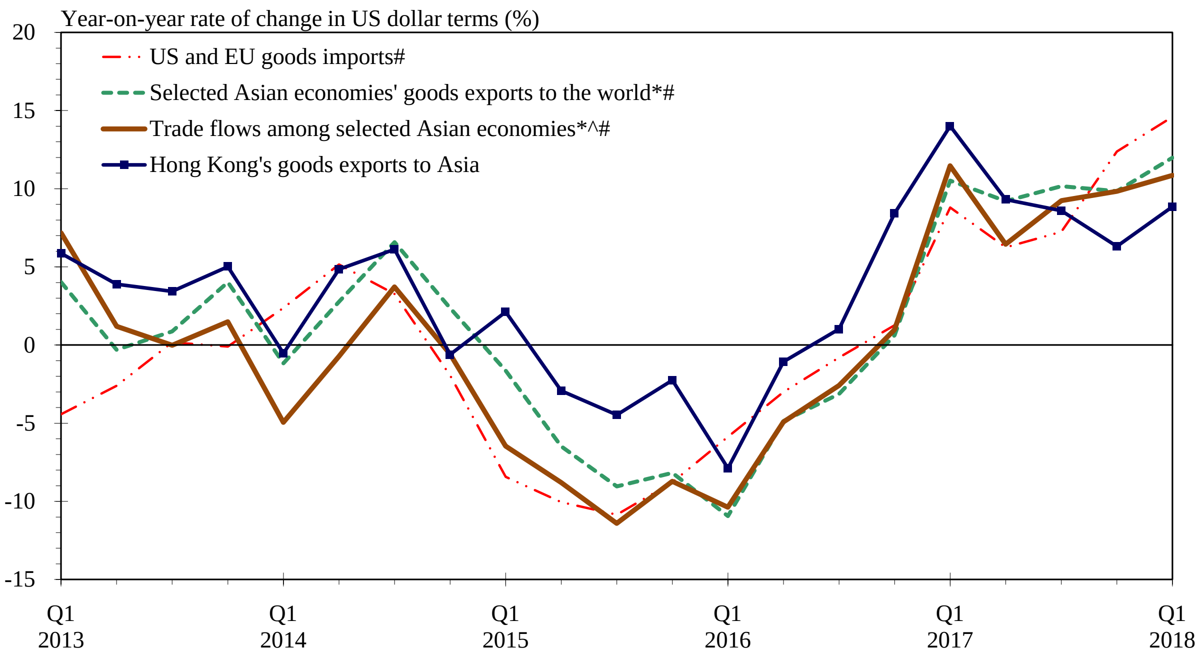
Diagram 2.1 : Merchandise exports grew notably in the first quarter of 2018



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 first quarter of 2018 is based on statistics for January and February 2018.

Diagram 2.2 : Intra-regional trade was vibrant amid continued expansion in global demand

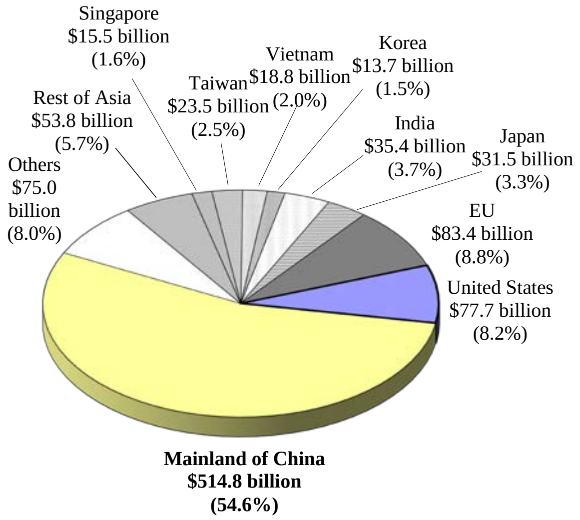


Notes : (*) "Selected Asian economies" include the Mainland of China, Hong Kong, Singapore, Korea, Taiwan, Japan, Indonesia, Malaysia, Thailand and the Philippines.

(^) 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 US, the EU and "selected Asian economies" for the first quarter of 2018 are based on the information available as of early May 2018.

Diagram 2.3 : Exports to Asia sustained solid growth and those to non-Asia picked up further



Total exports of goods in the first quarter of 2018:
$943.0 billion

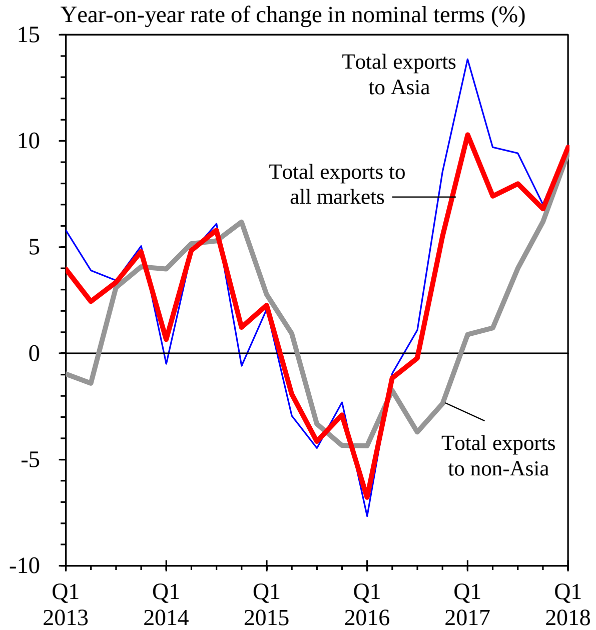


Table 2.2 : Total exports of goods by major market (year-on-year rate of change in real terms (%))

	2017					2018
	Annual	Q1	Q2	Q3	Q4	Q1
Mainland of China	5.4	9.3	3.9	6.0	3.0	9.4
United States	1.9	3.4	1.1	-0.5	3.8	5.1
European Union	4.6	3.0	1.3	5.0	8.5	9.1
India	35.1	40.1	53.8	9.9	39.5	-7.6
Japan	10.3	7.5	12.0	10.8	10.6	5.2
Taiwan	16.1	44.3	23.0	14.7	-5.4	8.4
Vietnam	8.7	10.8	11.9	6.8	5.9	0.9
Singapore	1.8	-1.2	3.9	11.7	-6.2	10.5
Korea	3.3	15.3	-2.8	-1.5	3.5	-3.1
Overall*	6.2	8.8	5.8	6.0	4.6	7.3

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*.

2.4 In the first quarter, trading and manufacturing activities in Asia remained buoyant, as manifested by the notable growth in the region's intake of raw materials and semi-manufactures. Against this backdrop, Hong Kong's merchandise exports to Asian markets as a whole continued to record robust growth. Analysed by individual market, exports to the Mainland picked up visibly, while those to Japan grew notably in the first quarter over a year earlier. Exports to Taiwan and Singapore reverted to considerable increases. Yet exports to Vietnam moderated, while those to India fell back following successive quarters of upsurge. Exports to Korea also relapsed to some moderate year-on-year decline.

2.5 Exports to the US and the EU picked up firmly in the first quarter, thanks to sustained improvement in final demand in these economies. Exports to the US gathered pace alongside the solid expansion in household spending and business investment there. Exports to the EU likewise saw accelerated year-on-year growth, as the EU economy maintained above-trend growth momentum.

Diagram 2.4 : Exports to the Mainland picked up visibly in the first quarter

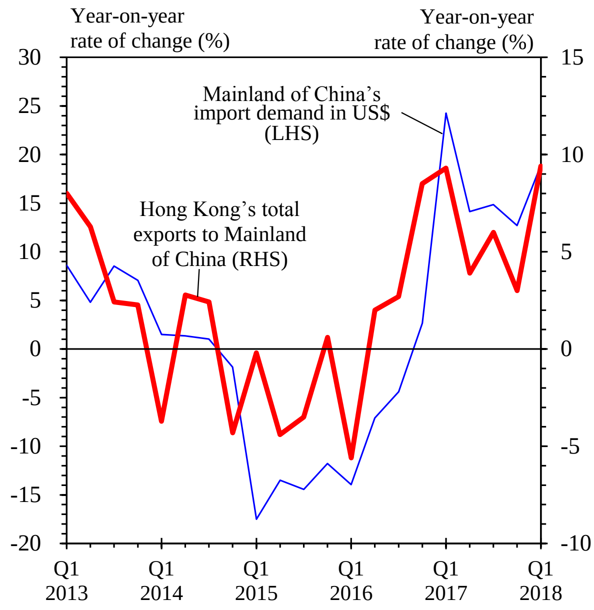


Diagram 2.5 : Exports to the EU saw accelerated growth

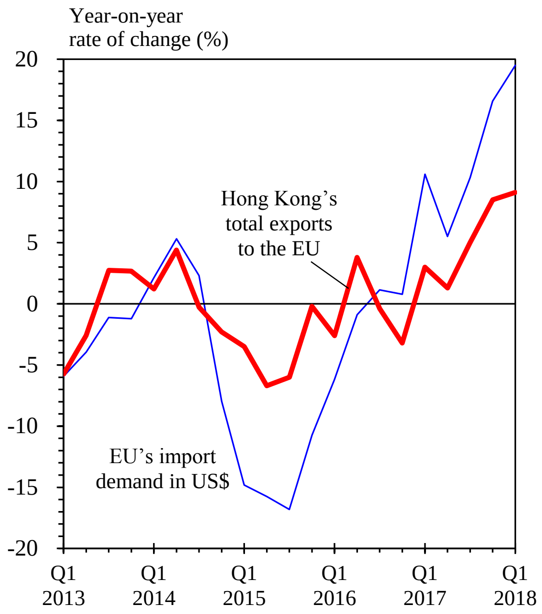


Diagram 2.6 : Exports to the US likewise gathered pace

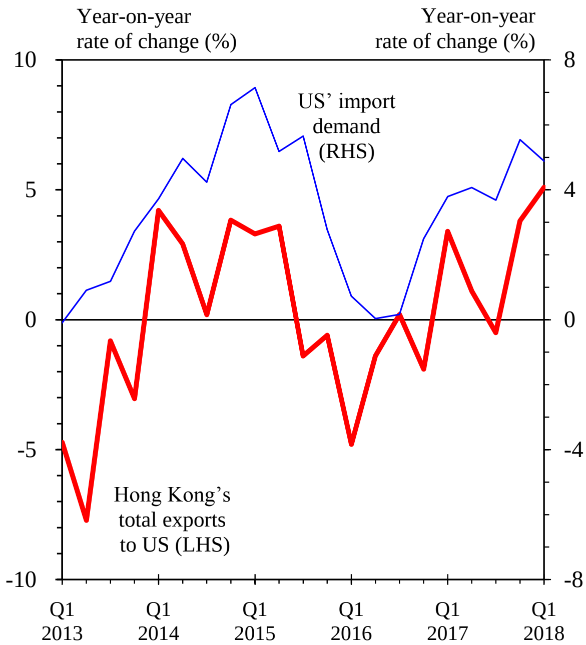


Diagram 2.7 : Exports to Japan grew notably

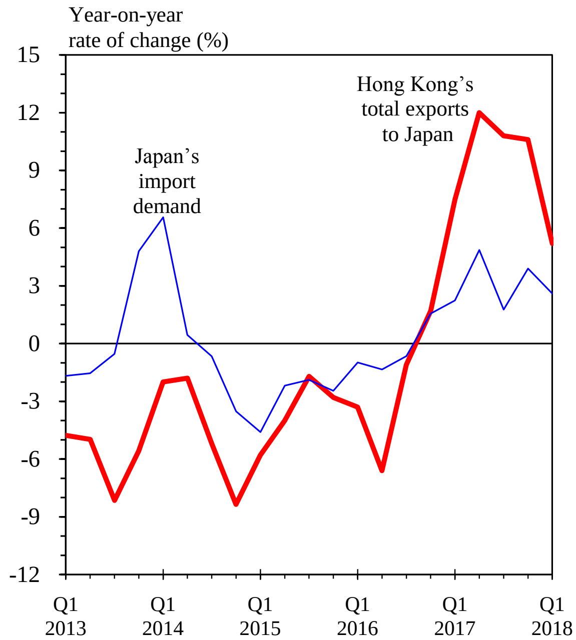


Diagram 2.8 : Exports to India fell back after successive quarters of upsurge

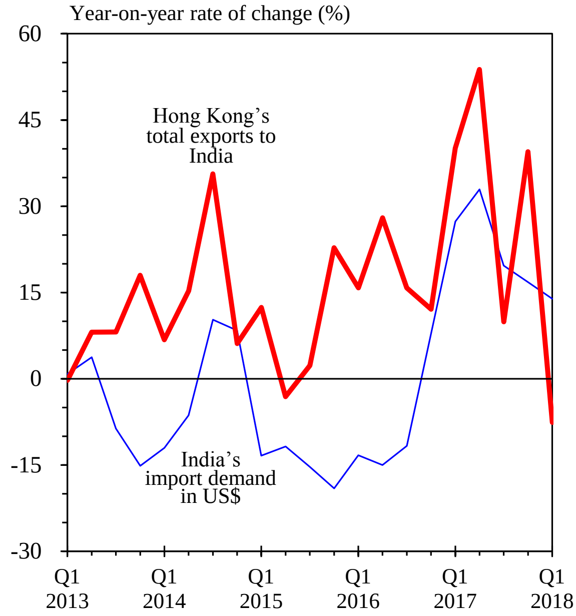


Diagram 2.9 : Exports to Taiwan saw a strong recovery

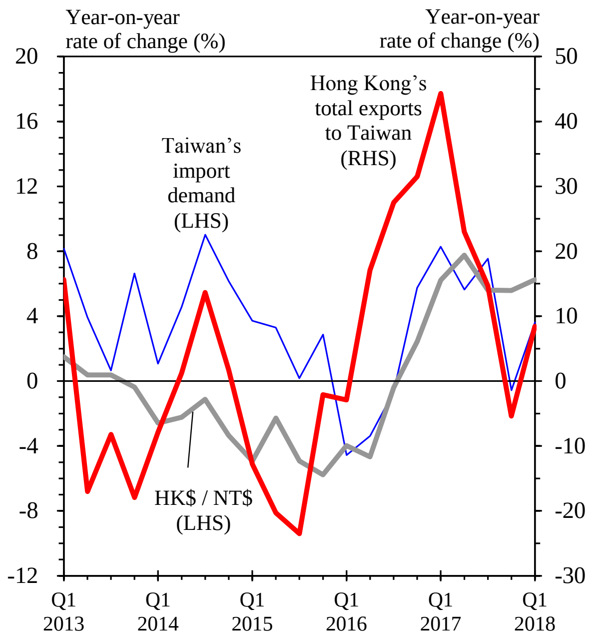


Diagram 2.10 : Exports to Korea relapsed to moderate decline

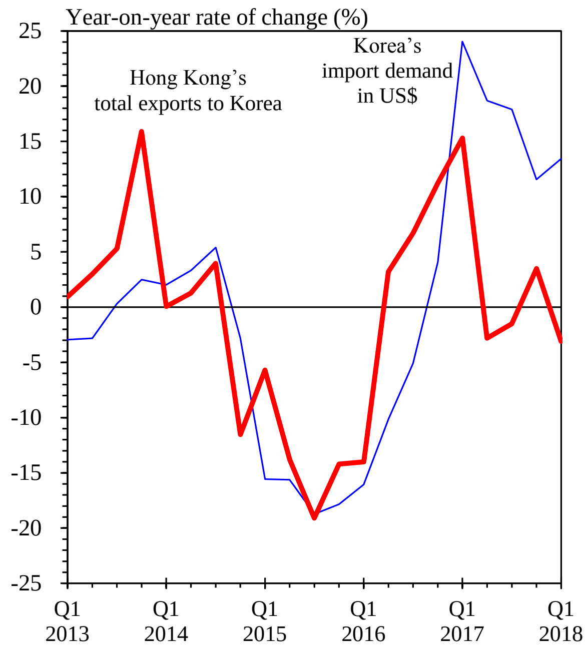
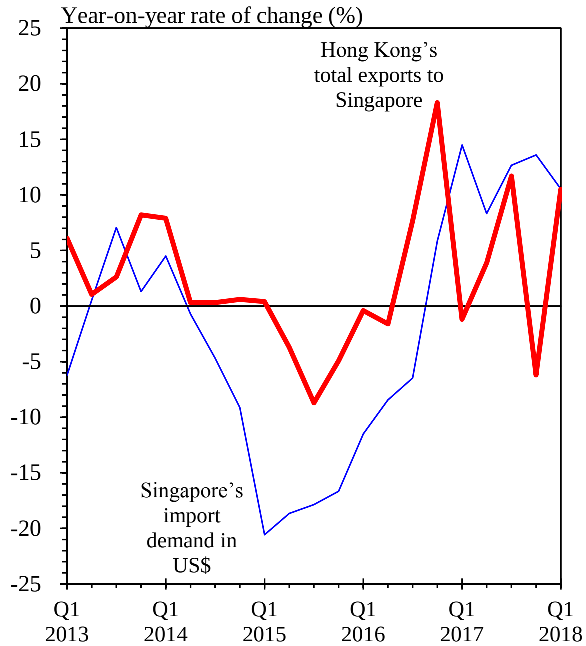


Diagram 2.11 : Exports to Singapore rebounded visibly



Box 2.1

Recent labour market and inflation situations in the US

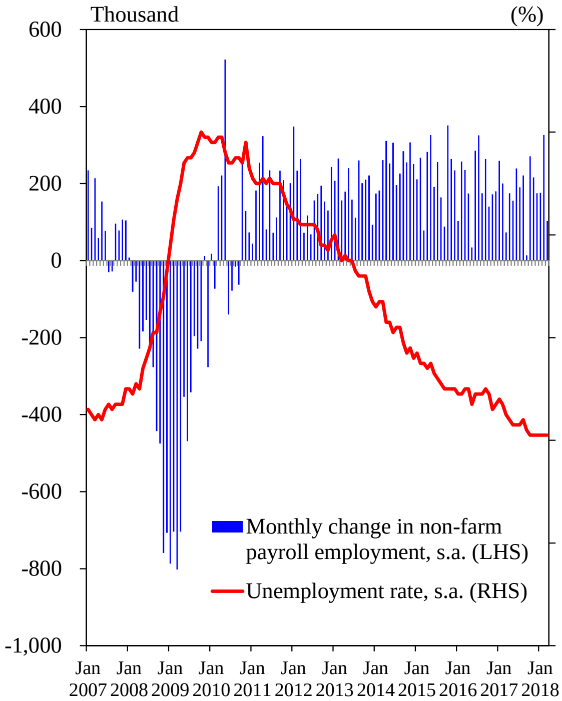
The labour market and inflation conditions in the US have long been closely watched over by financial market participants around the world, given their implications for policy actions by the US Federal Reserve (Fed), as the US central bank is committed to the dual mandate of fostering maximum employment and price stability. With improving prospect of the US economy, there have been of late firmer market expectations of gradual interest rate hikes in the US. It is thus worth reviewing the recent labour market and inflation situations in the US, in an attempt to shed more light on the US interest rate outlook.

Month-to-month fluctuations aside, the US labour market created employment steadily in recent years. The non-farm payroll employment rose by a monthly average of around 202 000 in the first quarter in 2018[(1)], on par with the average monthly increase of around 209 000 over 2013-2017. Against this backdrop, the unemployment rate fell progressively over the years. In particular, it had hovered around 5% throughout 2016 and then followed a broad trend of gradual decline in 2017 to levels below those considered normal over the longer run by the Federal Open Market Committee (FOMC) members[(2)]. It hit a 17-year low of 4.1% in October 2017, and has since stayed put (***Chart 1a***).

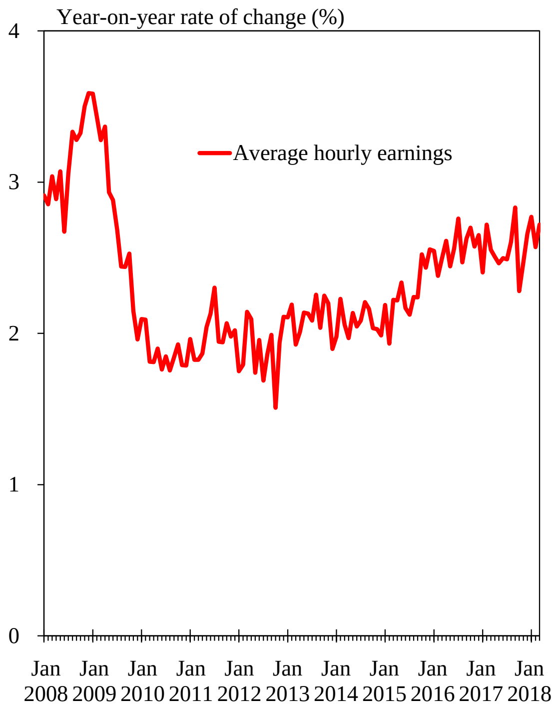
Nonetheless, wages in the US only increased moderately in recent years. The year-on-year growth in average hourly earnings, at 2.7% in first quarter of 2018, was only somewhat higher than the 2.5% growth in 2017 and 2.6% in 2016 (***Chart 1b***).

Chart 1 : Unemployment rate fell to 17-year low, while wage pressure remained moderate

(a) Employment growth and unemployment rate



(b) Wage inflation



Generally speaking, a low unemployment rate usually signifies a tight labour market, which should in turn exert upward pressure on wages. Yet, a combination of low unemployment rate and a lack of obvious wage pressures tend to suggest that the unemployment rate alone may not paint a complete picture of the tightness of the labour market.

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(1) Based on the statistics released on 6 April 2018.

(2) In their meeting in March 2018, the central tendency of the normal unemployment rate over the longer run as projected by FOMC members was in the range of 4.3%-4.7%.

Box 2.1 (Cont'd)

A look at a wider range of labour market indicators may offer a more comprehensive view on the prevailing tightness of the labour market. For instance, an alternative gauge for slack in the labour market is the share of full-time workers in total employment, which fell sharply during the US recession in 2008-2009. It recovered gradually afterwards. The latest readings only fell short of its pre-crisis average in 2003-2007 by around 0.4 percentage point, equivalent to around 0.7 million of employed persons (***Chart 2***). Considering that there could be some structural factors behind a decline in the share of full-time workers such as changing industry structure or preference of workers, it seems that the extent of slackness in the US labour market, once prominent in the years following the 2008-2009 recession, has been rather close to being worked off. If we look at another indicator, the employment-to-population ratio for those at the prime working ages of 25-54, it has been on a rising trend and come close to its pre-crisis average level, also suggesting a closing gap between labour supply and demand (***Chart 2***).

Chart 2 : Slackness in labour market has been largely worked off

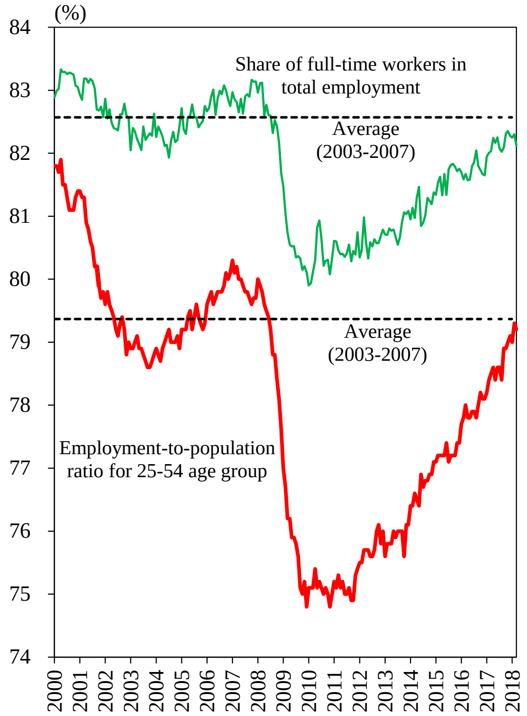
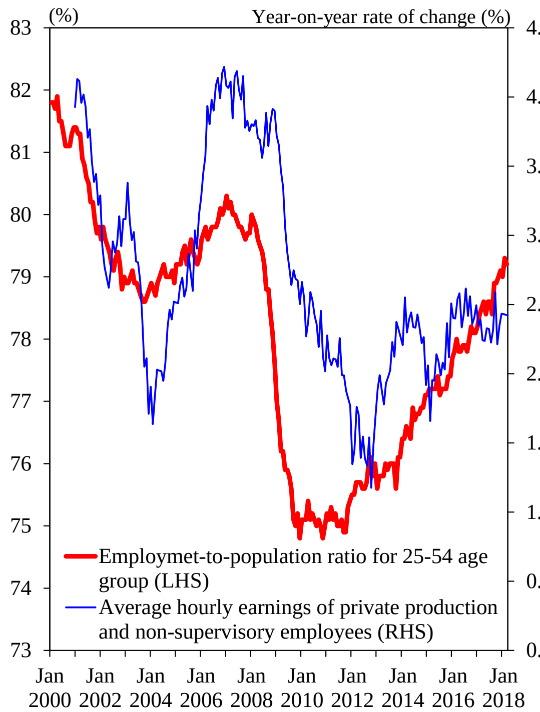


Chart 3: Wage growth could go up in the near term



As such, while the existence of some slackness in the labour market in the earlier period might be the factor underpinning the moderate increase in earnings to date, there is a possibility that wage growth can go up in the near term as the slackness has largely been worked off (***Chart 3***).

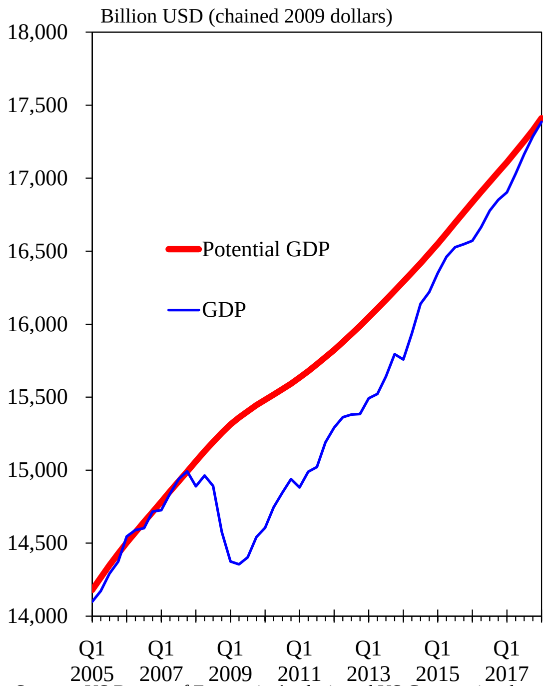
In fact, taking a broader perspective, the output gap in the US economy, which has been in the negative domain since 2008, was largely closed in early 2018 (***Chart 4***). Considering that the US economy is widely expected to have above-trend growth in 2018 and 2019 with the extra demand boost from the tax cuts implemented late last year, the output gap should return to positive territory in the near term, rendering more inflationary pressure at the macro level.

While inflationary pressure stays relatively modest at present, with core PCE deflator increasing by 1.9% y-o-y in March, it is likely to go up gradually in the near term. This would also be aided by the fading of some transient factors that held back inflation in the previous quarters (e.g. the price reduction in communication-related items). Nevertheless, the growth in labour productivity as observed of late, if continued, might continue to provide some offset to the increase in labour cost pressure (***Chart 5***). Meanwhile, inflation

Box 2.1 (Cont'd)

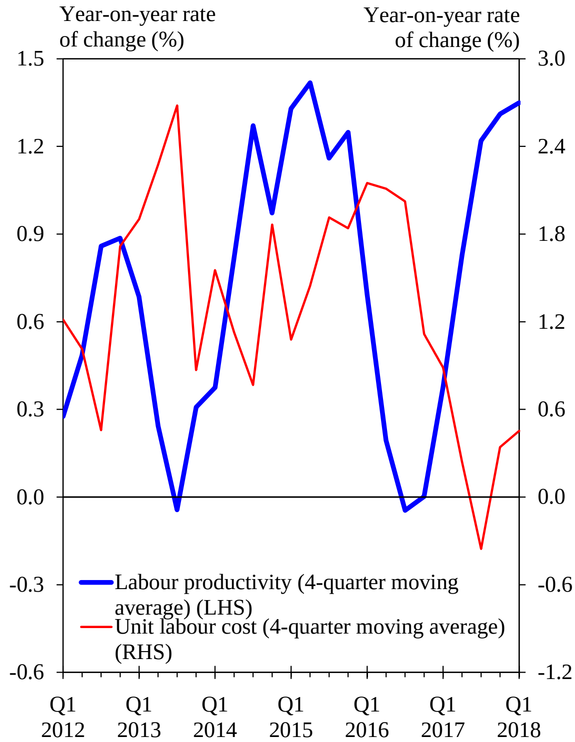
expectations in the US over a longer term, as suggested by survey or the pricings of relevant financial market instruments, remained stable at moderate levels(3).

Chart 4 : Inflation pressure could intensify as output gap is approaching positive territory



Sources: US Bureau of Economic Analysis and US Congressional Budget Office.

Chart 5: Pick-up in productivity growth in 2017 helped keep unit labour cost at bay



However, as for the near-term outlook, there is indeed a possibility that inflation in the US will pick up slightly faster than the FOMC perceived, rendering somewhat quicker moves in raising rates. The median projection by FOMC members in March 2018 suggested a gradual rise in inflation, where the core PCE inflation was expected to go up from 1.9% in fourth quarter of 2018 to 2.1% in fourth quarter of 2019. While the median projection by FOMC members still pointed to only two more rate hikes in the rest of 2018, more members projected three more rate hikes in the rest of 2018 than their December 2017 projection.

Indeed, the World Economic Outlook issued by the Internal Monetary Fund in April also suggested a potential downside risk to the near-term global outlook is the possibility of a sudden tightening in the global financial conditions, in the midst of high global debt level, triggered by a faster pick-up in inflation in the US. While the Hong Kong economy has sound fundamentals and robust regulatory framework to navigate through the external uncertainties, there would unavoidably spill-overs on asset prices and economic sentiment in Hong Kong should such a scenario realise. The Government will stay vigilant and continue to closely monitor the situation.

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(3) For example, the expected inflation implied by the US 10-year Treasury inflation protected securities was around 2.1% for the next 10 years on average in April 2018, similar to that of 2.0% in January 2018.

Imports of goods

2.6 The year-on-year growth in *imports of goods* accelerated to 8.2% in real terms in the first quarter from 6.2% in the preceding quarter, as *re-exports*[(3)] picked up amid vibrant global trade flows. Brisk local consumption on the back of robust labour market conditions and optimistic sentiment also drove up *retained imports*, which refer to the imports for domestic use and accounted for around one-quarter of total imports. Retained imports grew strongly by 10.5% year-on-year in real terms in the first quarter, compared to 10.9% increase in the preceding quarter.

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

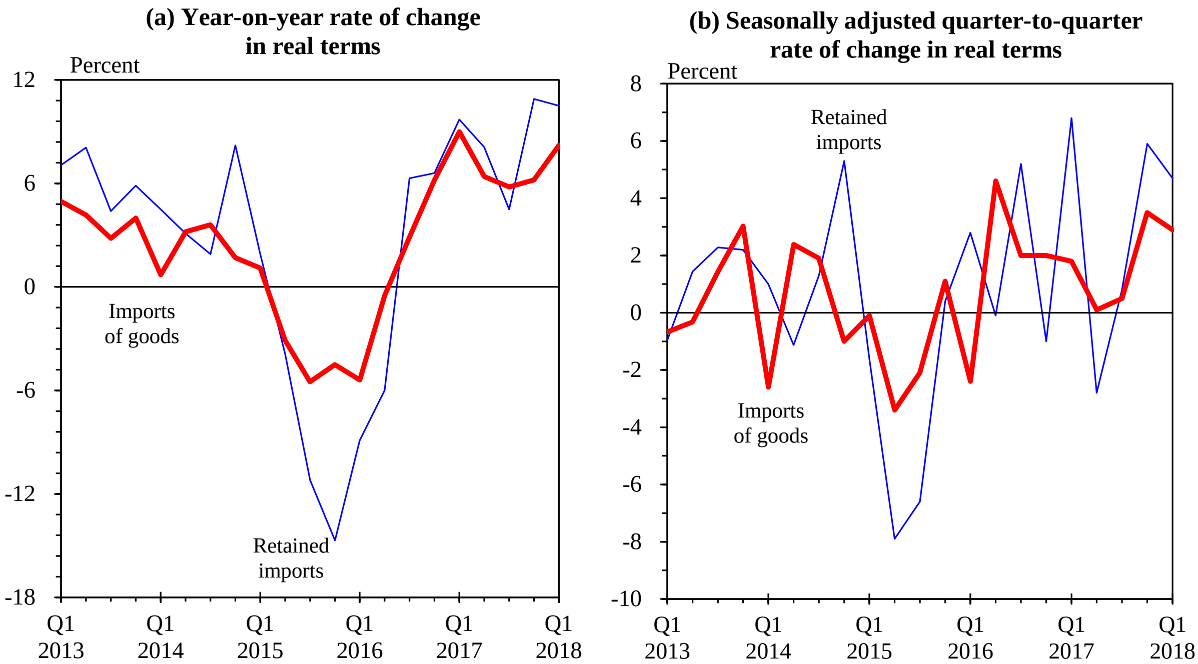
		Imports of goods				Retained imports[(a)]			
		In value terms	In real terms[(+)]		Change in prices	In value terms	In real terms		Change in prices
2017	Annual	8.7	6.8		1.9	10.5	8.3		2.1
	Q1	10.7	9.0	(1.8)	1.6	11.6	9.7	(6.9)	1.5
	Q2	8.2	6.4	(0.1)	1.8	10.4	8.1	(-2.9)	2.5
	Q3	7.7	5.8	(0.5)	1.9	6.3	4.5	(0.8)	2.3
	Q4	8.5	6.2	(3.5)	2.2	13.6	10.9	(6.0)	2.4
2018	Q1	10.6	8.2	(2.9)	2.3	12.6	10.5	(4.7)	2.3

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 strong growth

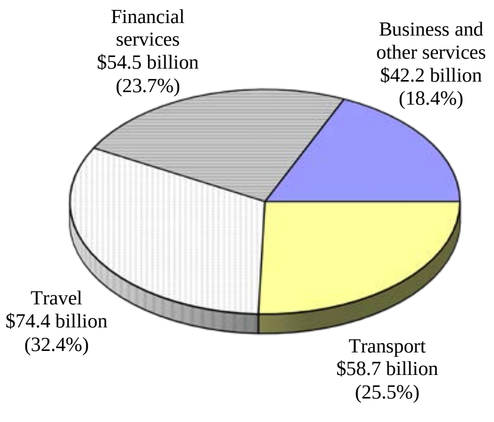


Services trade

Exports of services

2.7 *Exports of services* likewise displayed strength, benefitting from the favourable global economic environment and picking up to show a broad-based growth of 7.5% year-on-year in real terms in the first quarter, the fastest growth since the second quarter of 2013. Exports of travel services strengthened further to show double-digit growth of 11.8%, on the back of strong growth in visitor arrivals and improvement in tourist spending. Notwithstanding some jitters during the quarter, various major stock markets in the world were generally on a higher plateau in the first quarter than a year earlier, accompanied by active global financial market activities. In tandem, exports of financial services also picked up visibly to show double-digit growth. Exports of transport services sustained solid growth amid flourishing global trade flows. Meanwhile, exports of business and other services grew steadily.

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



Exports of services in the first quarter of 2018: $229.8 billion

Diagram 2.14 : Exports of services saw the fastest growth in nearly five years

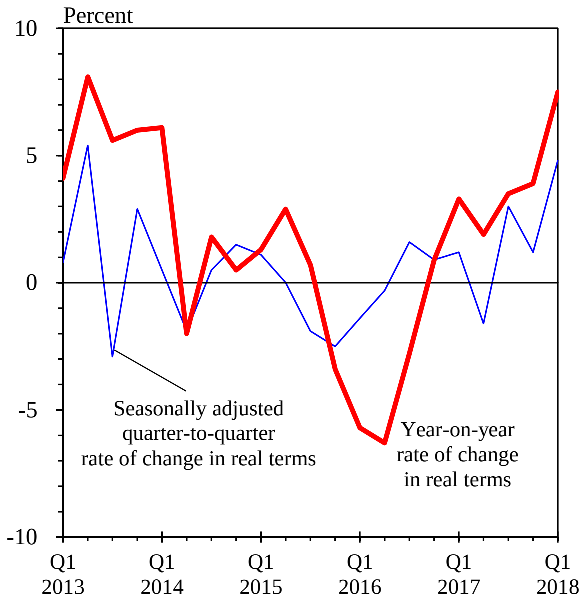


Table 2.4 : Exports of services by major service group (year-on-year rate of change in real terms (%))

		Exports of services	*Of which :* Transport	Travel[(a)]	Financial services	Business and other services
2017	Annual	3.2	6.1	1.5	4.4	0.7
	Q1	3.3 (1.2)	8.0	1.5	2.1	1.1
	Q2	1.9 (-1.6)	6.9	-1.8	2.6	0.4
	Q3	3.5 (3.0)	6.5	1.8	5.0	0.8
	Q4	3.9 (1.2)	3.3	4.0	8.0	0.7
2018	Q1	7.5 (4.8)	4.1	11.8	10.7	1.4

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.*

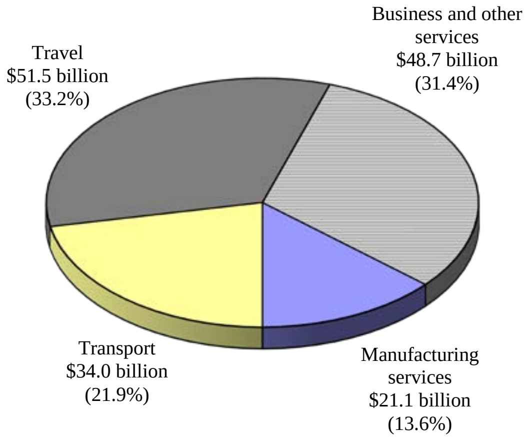
(a) Comprising mainly inbound tourism receipts.

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

Imports of services

2.8 *Imports of services* grew notably by 3.8% in real terms in the first quarter over a year earlier, much faster than the 0.8% growth in the preceding quarter. Growth in imports of travel services was in particular visible in the first quarter, partly due to the robust local demand for outbound travel amid optimistic consumer sentiments, and also partly due to an earlier arrival of the Easter holidays which straddled March and April this year (as compared to mid-April in 2017). Imports of transport services grew solidly, mirroring the sustained momentum in global trade flows. Imports of business and other services picked up somewhat to show moderate growth, as cross-border financial and commercial activities thrived under the improved global economic environment. Imports of manufacturing services reverted to modest growth after a setback for two years.

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



Imports of services in the first quarter of 2018: $155.3 billion

Diagram 2.16 : Imports of services grew notably in the first quarter

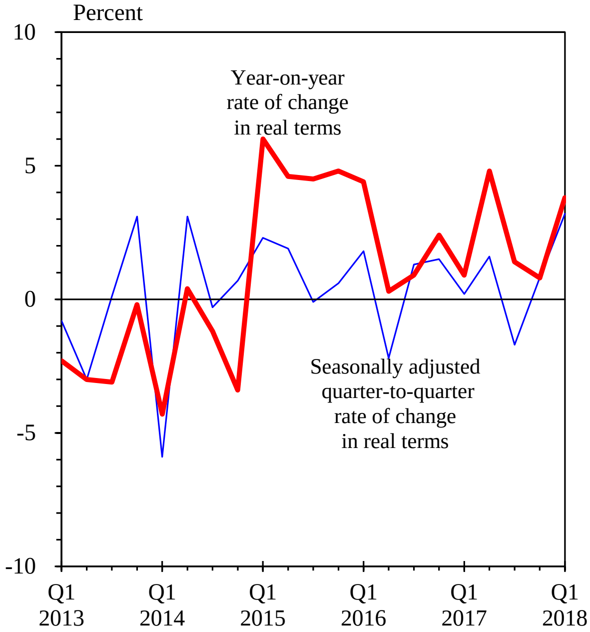


Table 2.5 : Imports of services by major service group (year-on-year rate of change in real terms (%))

		Imports of services		*Of which :* Travel(+)	Transport	Manufacturing services(^)	Business and other services
2017	Annual	1.9		4.0	2.6	-5.5	3.0
	Q1	0.9	(0.2)	-0.2	2.4	-3.9	3.0
	Q2	4.8	(1.6)	11.1	3.6	-5.6	3.5
	Q3	1.4	(-1.7)	3.5	2.1	-5.7	2.7
	Q4	0.8	(0.8)	1.8	2.2	-6.4	2.8
2018	Q1	3.8	(3.2)	5.3	4.0	0.7	3.4

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.*

(+) 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.

Goods and services balance

2.9 Based on the GDP accounting framework, the goods deficit in the first quarter widened from a year earlier, as the growth in imports of goods amid robust domestic demand outpaced that in exports of goods. With the goods deficit partly offset by the surplus in services trade, the combined goods and services account registered a small deficit of $2 billion in the first quarter of 2018, equivalent to 0.2% of total import value, as compared to a small surplus of $5 billion (or 0.5% of total import value) in the first quarter of 2017.

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
2017	Annual	4,191	811	4,378	601	-187	211	24	0.5
	Q1	941	203	998	141	-57	62	5	0.5
	Q2	995	184	1,063	143	-68	41	-27	-2.2
	Q3	1,099	208	1,116	154	-17	53	37	2.9
	Q4	1,156	216	1,201	162	-46	55	9	0.6
2018	Q1	1,017	230	1,094	155	-77	75	-2	-0.2

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

2.10 To strengthen and consolidate Hong Kong's edge as an international trading and business centre, the Financial Secretary in the 2018-19 Budget highlighted the key strategy of enlarging the hinterland for business development of Hong Kong enterprises and expanding the boundaries and scale of Hong Kong's market. Against this backdrop, the Budget pledged that the Government will actively seek to sign FTAs, IPPAs and CDTAs with other economies, including those along the Belt and Road, in order to facilitate trade and investment flows between Hong Kong and other economies in the world. In March, the Government signed a CDTA with India, which will help attract more enterprises to use Hong Kong as their base for overseas investments and bring trade relations between the two places to a new level. Also, Hong Kong and the UK issued a Joint Statement on Closer Collaboration between UK and

Hong Kong on Trade and Economic Matters in March, with collaboration areas covering global free trade, innovation, creative industries and the Belt and Road Initiative.

2.11 The Government has been proactively implementing policies and measures to tap opportunities arising from the Belt and Road Initiative. In February, the Government held a large-scale Belt and Road seminar in Beijing to promote Hong Kong's distinctive edge in finance and investment, professional services, and commerce and trade to Mainland ministries and state-owned enterprises. Separately, in March, the Secretary for Commerce and Economic Development led a Hong Kong delegation of business people and professional service providers to visit Cambodia and Vietnam to establish closer economic ties with economies along the Belt and Road.

2.12 The Bay Area development is another national policy of strategic significance to Hong Kong. The Budget stressed the enormous potential in the Bay Area market for Hong Kong's financial and high-end service industries, a huge room of complementarity between Hong Kong and the rest of the Bay Area in such areas as the innovation and technology industries and land resources. According to the Government Work Report of the State Council as announced in early March, a detailed development plan for the Bay Area will be unveiled and implemented soon to encourage a freer flow of talents, goods, capital and information within the region, with the aspiration of building it into a world-class city cluster.

2.13 As to the trading and logistics industry, the Government set aside $5 billion in the Budget for the redevelopment of the Air Mail Centre at the Hong Kong International Airport. Separately, to encourage the trading and logistics industry to move up the value chain, the Government announced in the Budget to cap the trade declaration charge at $200 to further lower the cost of importing and exporting high-value goods to and from Hong Kong.

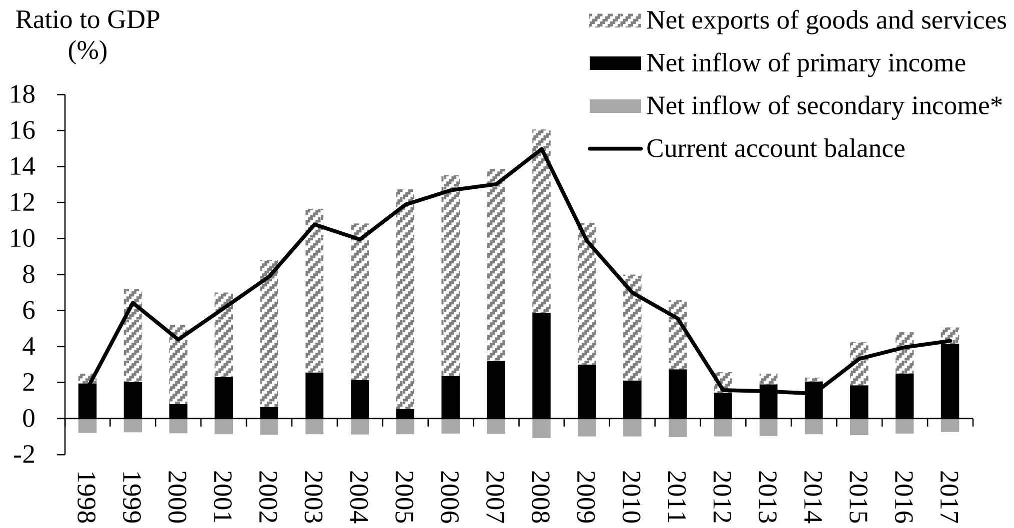
Box 2.2

Hong Kong's current account: Some salient observations

The current account in the balance of payments records the flows of goods, services, primary income and secondary income between residents and non-residents of an economy for a specific period of time(1). It is an important indicator for evaluating an economy's external vulnerability. Generally, the current account balance is driven by various macroeconomic factors such as the stage of business cycle in the global economy, strength of domestic demand, competitiveness of exports, exchange rates and conditions of the financial markets worldwide. For quarter-to-quarter movements, seasonality also exerts an important influence.

While a prolonged period of huge current account surplus may not be desirable from the perspective of balanced economic development, a large and persistent current account deficit deserves more attention from policymakers as it could be a sign of vulnerability in terms of macroeconomic stability. This is because a persistent and widening deficit in the current account, which can only be financed by external funds, is not sustainable for most economies. When external financing proved unavailable, the abrupt re-balancing of the current account could end up with painful domestic economic adjustments or notable exchange rate devaluation. Hong Kong, with strong economic fundamentals and flexible markets, has persistently registered current account surpluses. This article examines the prominent features of Hong Kong's current account and their economic implications.

Chart 1: Hong Kong's current account has registered sustained surpluses



Note : (*) Negative values mean net outflows.

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(1) The current account could be divided into three components: (a) the goods and services account that records external transactions in goods and services; (b) the primary income account that shows the amounts receivable and payable abroad in return for providing or obtaining use of labour, financial resources or natural resources to or from non-residents (i.e. mainly compensation of employees and investment income); (c) the secondary income account that records current transfers between residents and non-residents, such as workers' remittances, donations, official assistance and pensions.

Box 2.2 (Cont'd)

Hong Kong ran a current account surplus every year over the past twenty years (see ***Chart 1***), with its size following the ebb and flow of global economic developments. Following the Mainland's accession to the World Trade Organization (WTO) in 2001, Hong Kong as a conduit between the Mainland and the rest of the world in trading activities gained in significance. The current account surplus surged from 1.7% of GDP in 1998 to 15.0% of GDP in 2008. However, the current account surplus shrank after the outbreak of the Global Financial Crisis (GFC) in 2008, to 1.4% of GDP in 2014, as the reduced demand from the advanced economies dragged our exports. In recent years, the current account surplus climbed up again, to 4.3% of GDP in 2017.

On average, the current account surplus in Hong Kong was smaller in the post-GFC period as compared with the preceding decade, weighed by the shrinking size of net exports of goods and services.

The smaller net exports of goods and services in Hong Kong in the post-GFC period were partly due to the slow and bumpy global economic recovery during the period. Major advanced economies had undergone a prolonged period of deleveraging. The European economy was further dented by the sovereign debt crisis. Held back by the flagging global demand, exports of goods and services grew by just 2.5% per annum in nominal terms in the five-year period from 2011 to 2016, only to register visible growth in 2017 in tandem with the synchronised global economic upturn. Yet, domestic demand in Hong Kong was rather resilient during most of the period after GFC, underpinned by the full-employment labour market conditions since 2011. To a lesser extent, the positive wealth effects arising from rising asset prices amid ultra-loose global monetary conditions also boosted local consumption sentiment. Thanks to the resilient domestic demand, retained imports were bolstered. Taken together, net exports of goods and services became smaller in the post-GFC period, driving down the current account surplus. Nonetheless, Hong Kong, as a mainly service economy, attained annual surpluses in net exports of goods and services throughout the past two decades, reflecting our strong competitiveness as a service provider bridging the Mainland and the rest of the world.

The sustained positive current account balances point to a healthy Hong Kong economy from the perspective of external vulnerability, as the economy has not consumed or invested beyond what it earned domestically or externally during the period(2). It has also enabled the economy to accumulate vast external financial assets on net over years. Our net International Investment Position (IIP) reached 409% of GDP at end-2017, up significantly from 287% of GDP in 2008. This means that Hong Kong is a net exporter of capital to the rest of the world. Both external financial assets and liabilities were huge, at 1606% of GDP and 1197% of GDP respectively at end-2017, a typical feature of a prominent international financial centre. The large net IIP position provides us with a strong buffer in the presence of global financial volatilities.

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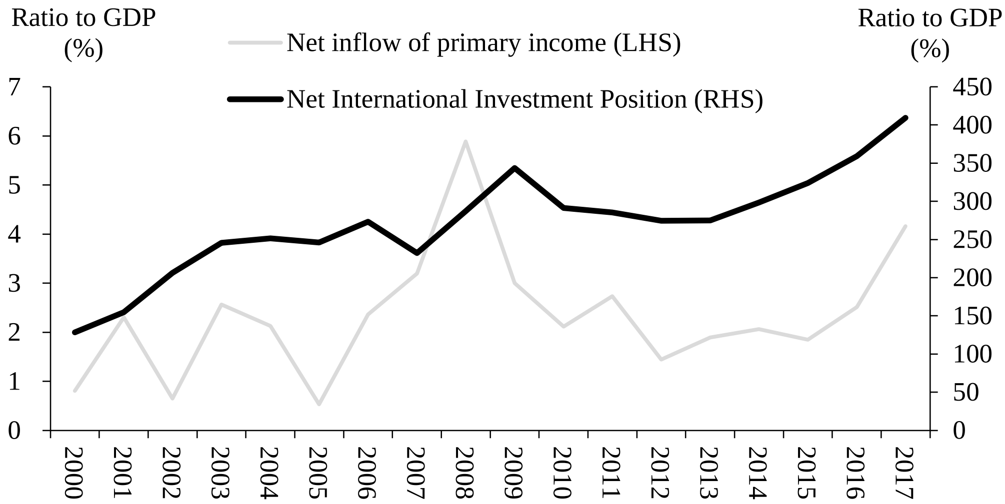
(2) Analytically, current account balance can be interpreted as the difference between gross savings and gross domestic capital formation. Gross savings refer to the residual by subtracting private consumption expenditure and government consumption expenditure from gross national disposable income. Gross national disposable income is the sum of GDP and the net inflow of primary and secondary income.

Box 2.2 (Cont'd)

Chart 2: Rising net external assets have driven up the net inflow of primary income in recent years



As a net creditor, Hong Kong has enjoyed a net primary income inflow (the other major component of the current account on top of net exports of goods and services(3)) over the past two decades (see ***Chart 2***). In the run-up to the 2008 GFC, the net primary income inflow climbed up, attributable to the upbeat financial markets worldwide and increased rates of returns on external financial assets from 2004 to 2008. Nevertheless, the net primary income inflow fell after the GFC amid the "new normal" of lower yields that affected investments in general. During 2015-2017, the net primary income inflow saw a sharper uptick despite the persistence of low-yield environment, on the back of the rapid increase in Hong Kong's net IIP, in which the increases in portfolio investment and reserve assets were most prominent. In fact, the net inflow of primary income reached a record high of $110.7 billion in 2017, contributed mainly by the increases in the net inflow of portfolio investment income and reserve assets income against the backdrop of buoyant global financial markets.

The increased net inflow of primary income raised the total income available to Hong Kong residents. In particular, with the net primary income inflow as a ratio to GDP rising from 0.8% in 2000 to 4.2% in 2017, there was slightly faster growth of nominal Gross National Income (GNI(4))than its GDP counterpart over the period, at 4.3% per annum versus 4.1% per annum in Hong Kong. In particular for 2017, thanks mainly to the robust net primary income inflow amid a synchronized global economic upturn, nominal GNI rose markedly by 8.6%, outpacing the growth of nominal GDP by 1.8 percentage points.

In conclusion, Hong Kong's current account has been persistently in surplus since data available 20 years ago, resulting in a huge amount of net external financial assets, which provide the economy with a strong cushion against sudden external shocks.

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(3) There has long been a small net outflow in secondary income in Hong Kong over the years. However, the net outflow had been rather stable and should be analytically insignificant in terms of macroeconomic stability.

(4) GNI denotes the total income earned by residents of an economy from engaging in various economic activities, irrespective of whether the economic activities are carried out within the economic territory of the economy or outside. In other words, GNI is obtained by adding to GDP the primary income earned by residents from outside the economic territory and deducting primary income earned by non-residents from within the economic territory.

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) As far as Hong Kong's trade flows are concerned, the tariff measures imposed by the US on their imports from the Mainland would also be applied to Hong Kong's re-exports of the Mainland origin to the US. Separately, Hong Kong's offshore trade involving the two sides would also be affected. For the products affected by tariffs already implemented by the US earlier this year (i.e. washing machines, solar panels, specific items in steel and aluminium), the value of re-export trade flows from the Mainland through Hong Kong to the US should be relatively small. Using 2017 as the reference year, it is estimated that the value of re-export trade flows affected would be equivalent to less than 0.02% of Hong Kong's total exports of goods. For the list of items proposed by the USTR targeted at imports from the Mainland as announced on 3 April 2018, again using 2017 as the reference year, it is crudely estimated that the value of those affected goods would amount to some 19% of Hong Kong's re-exports of Mainland origin to the US or around HK$52 billion, constituting around 1.3% of Hong Kong's total exports of goods.

(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.