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Hong Kong's Recent Economic Situation and Near-term Outlook

The Government released the Third Quarter Economic Report 2010 in mid-November. The Economic Report, together with the press release containing the updated economic forecasts for the whole year of 2010, have been furnished to LegCo Members.

This paper analyses Hong Kong's overall economic development in the most recent period, summarises the updated economic forecasts by the Government for 2010 as a whole, and briefly discusses the various factors which may affect the outlook in 2011.

Economic Analysis Division
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22 November 2010

Recent Situation and Near-term Outlook For the Hong Kong Economy

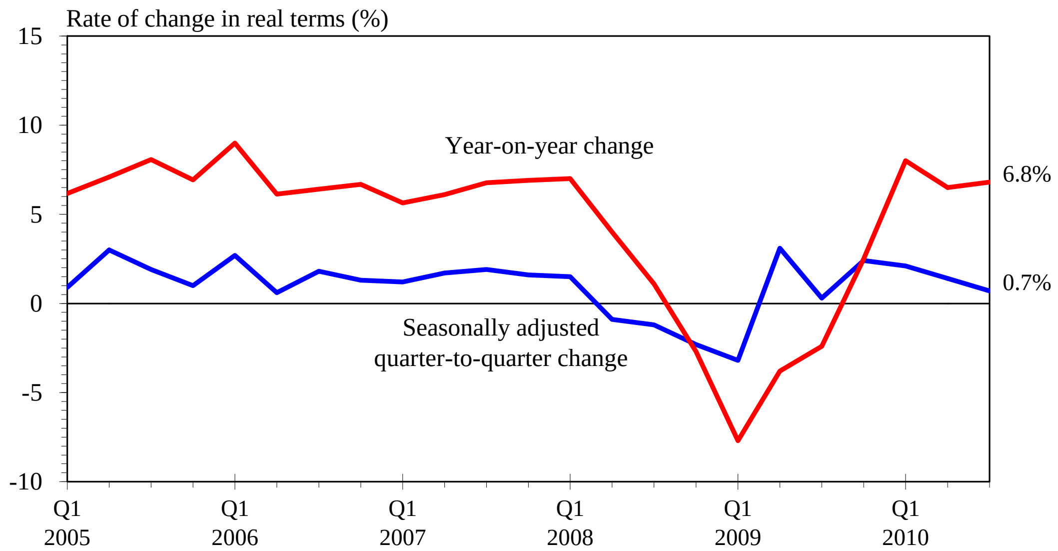
Introduction

This paper analyses the latest development in the Hong Kong economy and briefly discusses the updated economic forecasts for 2010 as a whole and the economic outlook for 2011.

Recent economic situation

2. The Hong Kong economy continued to see a robust recovery in the third quarter of 2010. Real GDP leaped by 6.8% over a year earlier, following a strong 7.2% growth in the first half of the year. On a seasonally adjusted quarter-to-quarter comparison, real GDP grew by 0.7% in the third quarter, the sixth consecutive quarter of expansion ***(Chart 1)***. As a result, the seasonally adjusted GDP level in the third quarter surpassed the pre-crisis peak in the first quarter of 2008 by some 2.3%.

Chart 1 : Robust recovery continued in the third quarter



3. Total exports of goods maintained strong growth momentum in the third quarter. Merchandise exports surged by 20.8% in real terms over a year earlier, further to the 20.1% growth in the second quarter ***(Chart 2(a))***. The Asian markets continued to be the key driver for growth in merchandise exports, thanks to the strong domestic demand in these economies and also increase in intra-regional production activity. Exports to the US and Europe improved further, as their import demand continued to rise back from their troughs in 2009. Yet the demand in the US and European markets had yet to return to their pre-crisis peaks in 2008. On a seasonally adjusted quarter-to-quarter basis, total exports of goods stayed steady in real terms in the third quarter.

4. Exports of services continued to perform well in the third quarter, up 14.0% in real terms over a year earlier, after the 17.1% increase in the second quarter. Exports of travel services were buoyed by robust growth in incoming visitors across most major markets, in particular the Mainland and other Asian markets. Exports of transportation and trade-related services continued to benefit from the vibrant trade flows in the region and the resurgence in trade with the rest of the world. Exports of financial and business services expanded further even from the higher base of comparison a year earlier. On a seasonally adjusted quarter-to-quarter basis, exports of services grew further by 0.8% in real terms in the third quarter ***(Chart 2(b))***.

Chart 2(a) : Merchandise exports maintained strong growth momentum in the third quarter

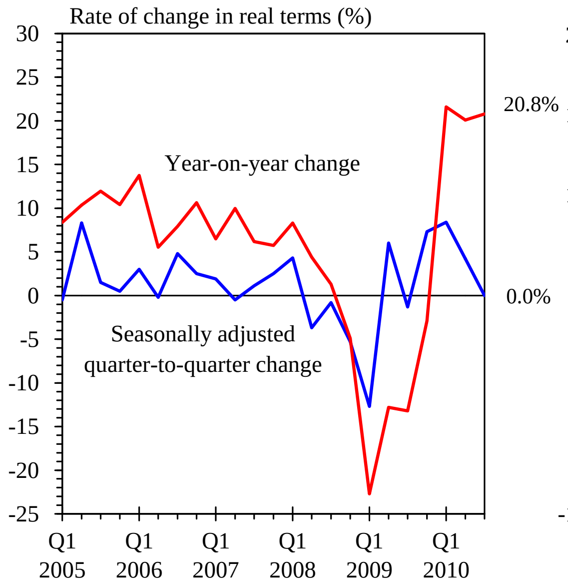
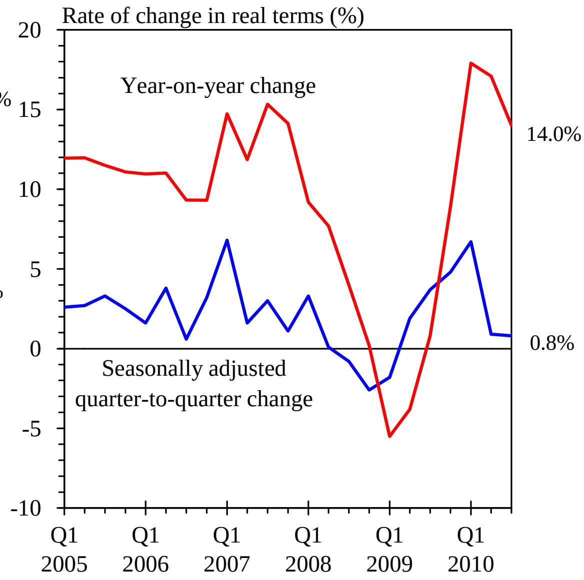


Chart 2(b) : Exports of services continued to perform well in the third quarter



5. The domestic sector held up well in the third quarter. Supported by improving job and income prospects, private consumption expenditure picked up further in the third quarter, by 5.7% year-on-year in real terms, following a 4.4% growth in the second quarter. On a seasonally adjusted quarter-to-quarter comparison, private consumption expenditure leaped by 1.7% in real terms in the third quarter ***(Chart 3(a))***.

6. Overall investment spending increased marginally by 0.3% in real terms in the third quarter over a year earlier, after the strong growth of 15.6% in the second quarter ***(Chart 3(b))***. The slower growth of overall investment in the third quarter, despite the largely sanguine business confidence, was mostly due to the 6.4% decline in machinery and equipment acquisitions after three quarters of double-digit year-on-year growth. The latter is a highly volatile component which can show big fluctuations from quarter to quarter. Expenditure on building and construction grew notably further by 9.2% in the third quarter, again driven by the continued surge in public sector works. Private sector construction activity was still flat.

Chart 3(a) : Private consumption picked up further as supported by improving job and income prospects

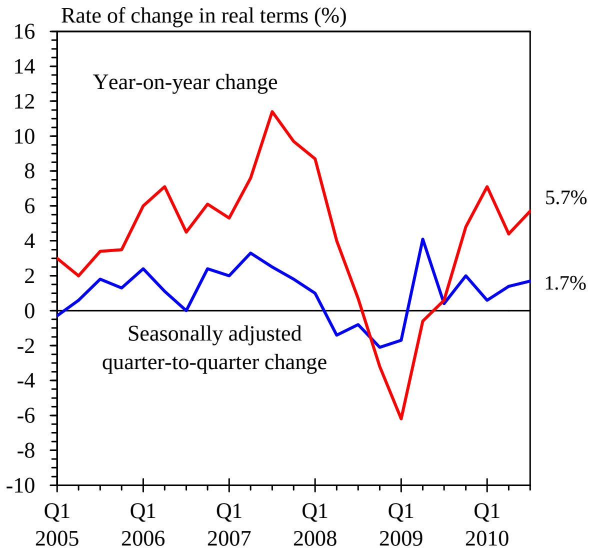
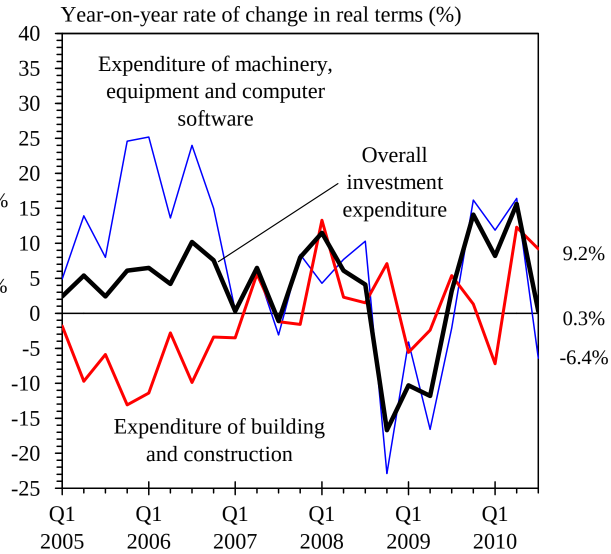
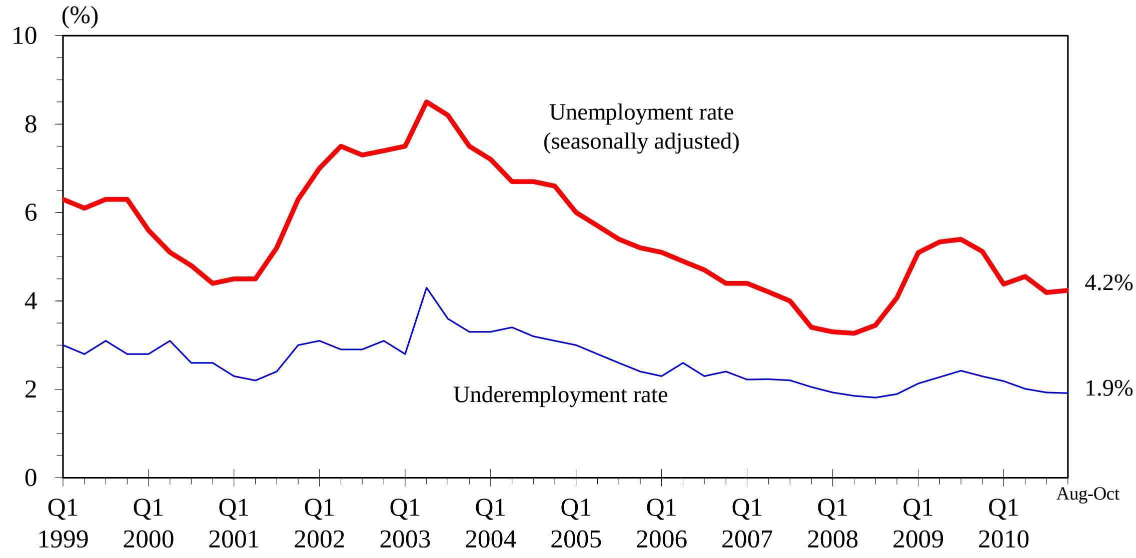


Chart 3(b) : Growth in investment spending slowed after three quarters' surge



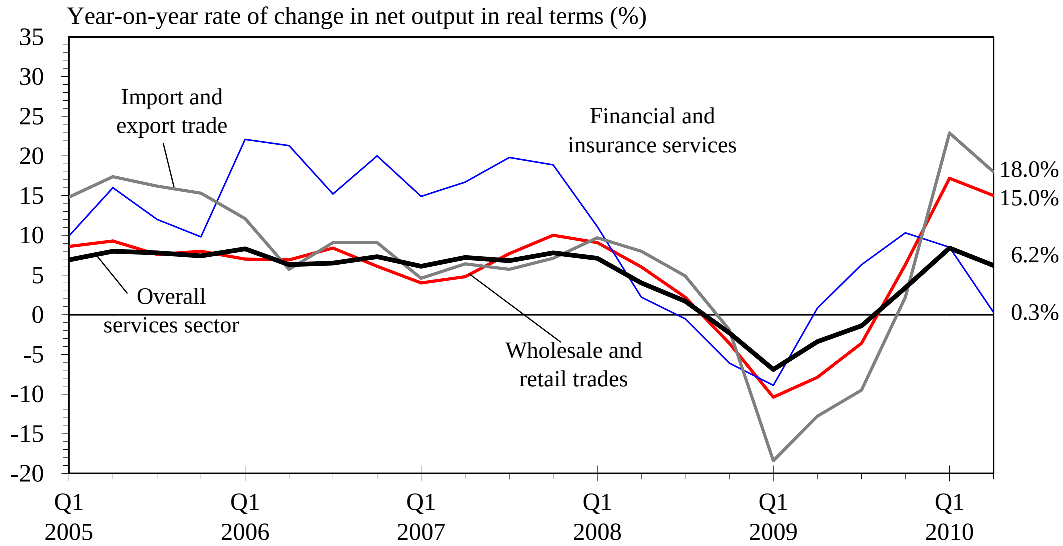
7. The labour market improved further on a broad front, thanks to an increasingly entrenched economic recovery. Total employment continued to climb back, pushing the seasonally adjusted unemployment rate down further to 4.2% in August-October 2010, the lowest level since end-2008 ***(Chart 4)***. The underemployment rate also continued its downtrend, reaching 1.9% in August-October 2010. Meanwhile, labour wages and earnings rose further in the second quarter.

Chart 4 : Labour market improved further on a broad front, thanks to an increasingly entrenched economic recovery



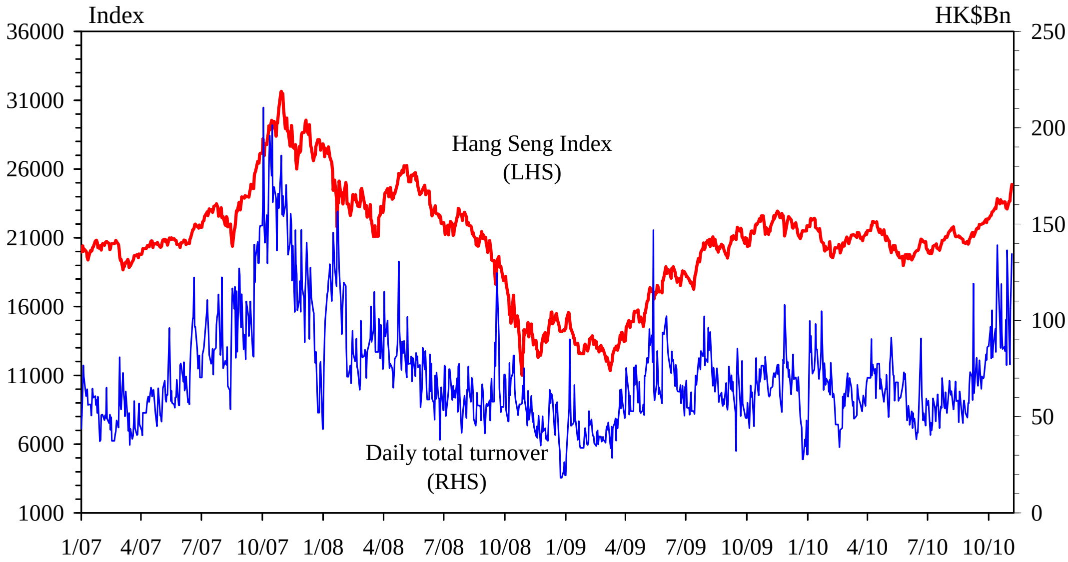
8. With the economic recovery becoming more entrenched, activity across most major sectors saw further expansion by varying extents. Latest available statistics indicate that the services sector, the mainstay of Hong Kong's economy, leaped further by 6.2% in the second quarter over a year earlier **(*Chart 5*)**. Thanks to thriving trade flows and business activity, import and export trade continued to see the sharpest growth, followed by wholesale and retail trades, and transport and storage. Growth in financing and insurance decelerated notably alongside the intensification of the European sovereign debt problem in the earlier part of the second quarter. The manufacturing sector expanded moderately further by 2.5% in the second quarter, after reverting to growth in the first quarter. Construction sector expanded robustly by 16.2% over a year earlier, helped mainly by the surge in public sector works.

Chart 5 : With the more entrenched economic recovery, activity across most major sectors saw further expansion by varying extents in the second quarter



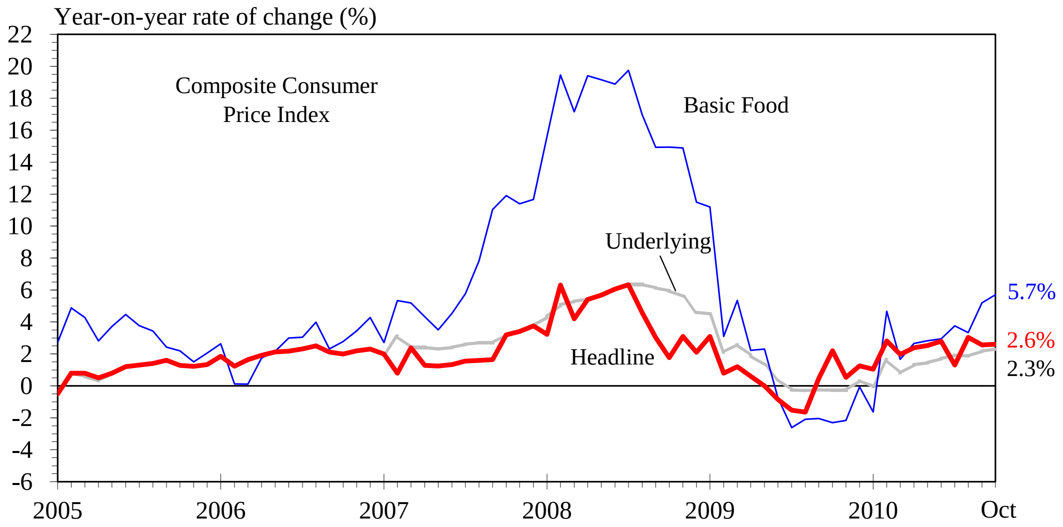
9. The local stock market showed some rebound in July but fell again in August, generally range-bound as market sentiments remained under the influence of the ongoing sovereign debt problem in Europe and the bumpy recovery in the advanced economies. Nevertheless, local stock market resumed an uptrend alongside other major markets worldwide on entering September, on expectations of an extension of the super-loose monetary stance in the advanced economies, especially a new round of easing in the United States. The Hang Seng Index rallied during September, closing the month at 22 358, up 11% and 2% respectively over end-June this year and end-2009. Trading also picked up sharply in September, though average daily turnover for the third quarter as a whole, at $61.8 billion, still declined by 1.8% from the preceding quarter or 7.5% from a year earlier **(*Chart 6*)**. Activities in Initial Public Offerings were in particular active among the overall fund raising activities. A total of 28 newly listed companies raised $110.0 billion of equity funds in the third quarter, representing a sharp jump of 142% over a year earlier or 569% over the preceding quarter.

Chart 6 : Hang Seng Index rebounded in September



10. As for prices, underlying consumer price inflation, which excludes the effects of the Government's relief measures to give a more accurate indication of the inflation trend, rose to 2.0% in the third quarter from 1.5% in the second quarter. Underlying consumer price inflation rose further to 2.3% in October, reflecting the prevailing rapid economic growth and faster increases in import prices. Taking into account the effect of Government's one-off measures, headline consumer price inflation stood at 2.3% and 2.6% in the third quarter and October respectively, as compared to 2.6% in the second quarter ***(Chart 7)***. The narrowing gap between the headline and underlying inflation rates in recent months was largely due to the dissipation of the lower base effect created by the electricity subsidy with the final payment ended in August last year, as well as an extra month of public housing rental waiver in the third quarter this year as compared to the previous year.

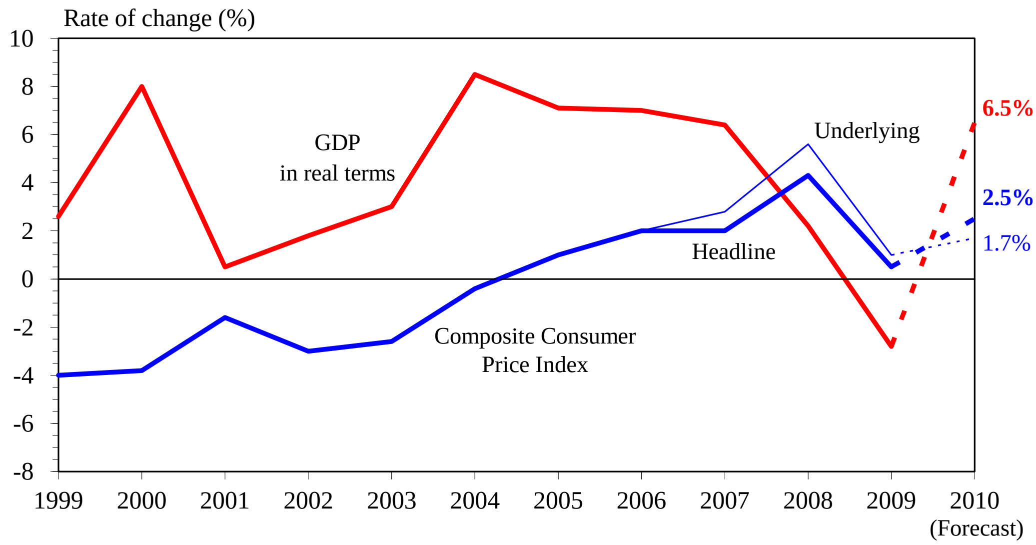
Chart 7 : Underlying consumer price inflation rose further in October



Updated short-term economic forecasts for 2010

11. In the first three quarters of 2010, GDP expanded strongly by 7.1% in real terms over a year earlier. Even allowing for some possible deceleration in the fourth quarter, economic growth in 2010 should exceed the forecast of 5-6% announced in August. Thus, the GDP growth forecast for 2010 as a whole is revised upwards to 6.5% ***(Chart 8)***.

Chart 8 : Economic growth forecast for 2010 is revised upwards to 6.5%

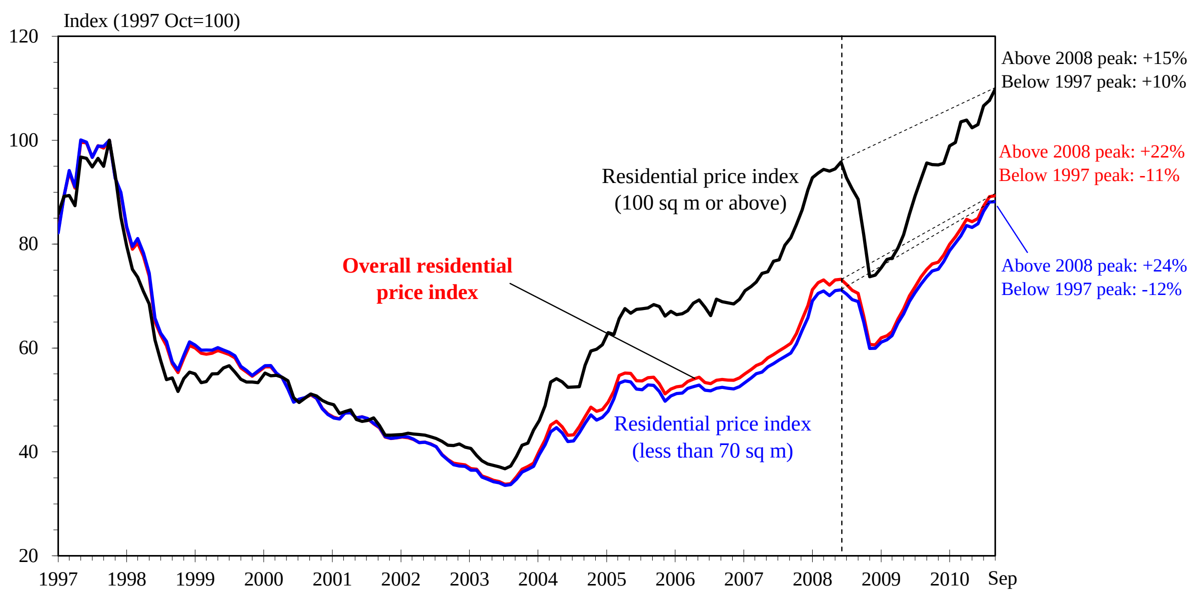


12. Inflation in Hong Kong is likely to go up further, as the rise-back in domestic costs, as well as higher import prices amid a weaker US dollar and elevated global food and commodity prices, continue to feed through. The new round of "quantitative easing" in the US could trigger further funds influx into the region, thereby posing upside risks to inflation. Nevertheless, the sustained productivity growth in the economy should provide a partial offset. Underlying consumer price inflation, which averaged at 1.5% in the first ten months of 2010, is now forecast at 1.7% for the year as a whole, revised upwards from 1.5% in the August round. The forecast rate of headline consumer price inflation for 2010 as a whole is also revised upwards accordingly, from 2.3% to 2.5%.

Property market

13. On the back of abundant global liquidity, exceptionally low interest rates and relatively tight supply of residential properties in the recent years, flat prices staged an unusual rally starting early 2009. In overall terms, flat prices rose by a total of 15% during the first nine months of 2010, and registered a cumulative gain of 22% over the recent peak in 2008 (***Chart 9***).

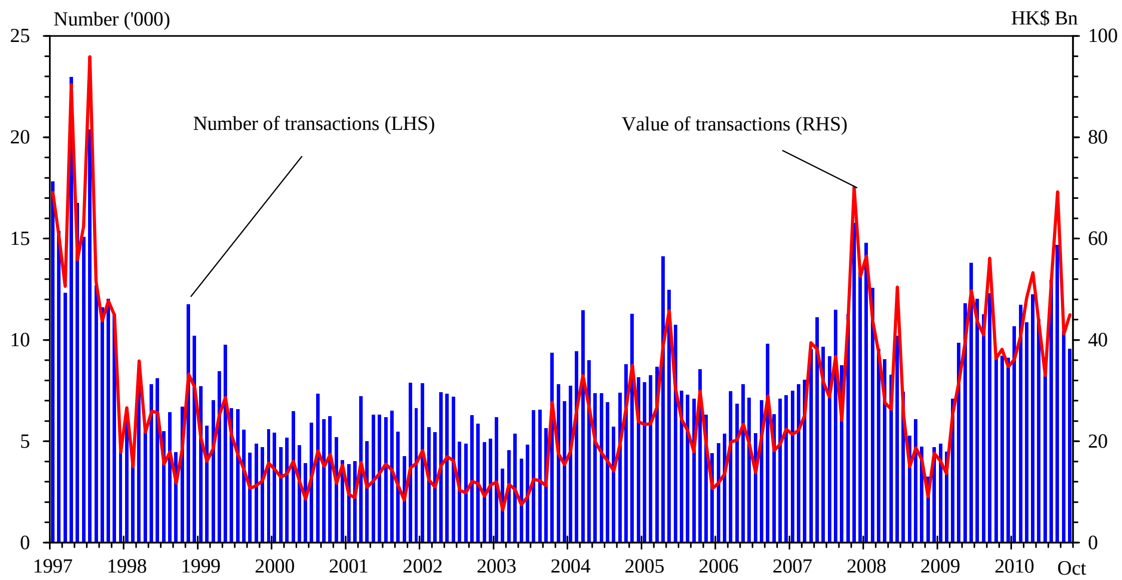
Chart 9 : Flat prices rose sharply starting early 2009



14. Amongst flats of various sizes, prices of large flats (size of at least 100 square metres) have already exceeded the peak in 1997 by 10%. While prices of mass market flats (size of less than 70 square metres) were still 12% below the peak in 1997, lately there are signs that the pace of increase is accelerating. Between March and September 2010, prices of mass market flats rose by 8.1%, faster than the gain of 6.1% for large flats.

15. Trading activities were active. In the first ten months of 2010, transaction volume soared by 17% over a year earlier (***Chart 10***). In contrast to last year's situation, secondary market transactions for mass market flats in the first nine months of 2010 increased by 17% over a year earlier while those for large flats declined by 4%. Both prices and transactions indicated that market exuberance has started spreading from the luxurious market to the mass market.

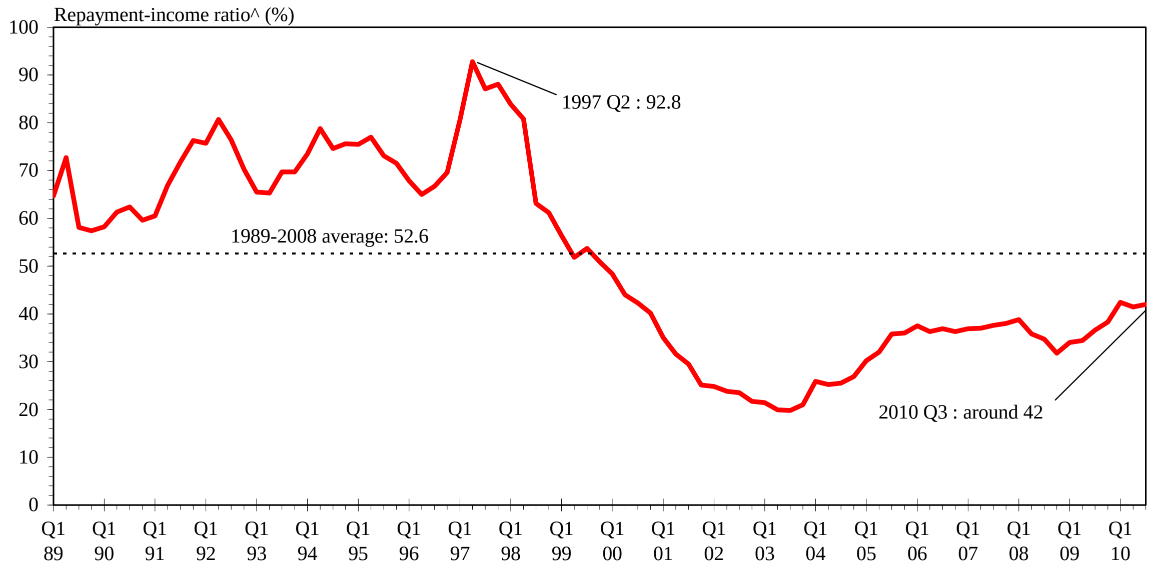
Chart 10 : Property market transactions were very vibrant



16. Boosted by the abundant liquidity and low interest rates, speculative sentiment in the property market became increasingly pronounced, with a sharp pick-up in short-term trading activities. In the first three quarters of 2010, short-term resale (i.e. resale within 24 months) jumped by 32% over a year earlier. Within this total, resale within 12 months soared by 114% but resale between 12-24 months declined by 18%, suggesting that speculative activities have shifted to a shorter horizon. Further analysis indicated that short-term resale activities this year concentrated more in low/medium-priced flats.

17. The rapid gains in flat prices have exceeded the income growth of the general public. Notwithstanding the exceptionally low interest rates at present, home purchase affordability has deteriorated from 32% in the fourth quarter of 2008 to around 42% in the third quarter of 2010 (***Chart 11***). Should interest rates increase by 3 percentage points, the affordability ratio would rise significantly to 54%, exceeding the long-term average for the past 20 years.

Chart 11 : Home purchase affordability is deteriorating



Note : (^) The ratio of mortgage payment for a flat with saleable area of 45 sq m (assuming 70% loan-to-value ratio and tenor of 20 years) to median income of households (excluding those living in public housing).

18. The Government has been mindful of the risks of a property market bubble. In February, April and August, the Financial Secretary has announced three rounds of measures to ensure a healthy and stable property market along four directions, *viz.* increase the flat supply via focusing on land supply, discourage property speculation, ensure transparency in property market, and prevent excessive expansion in mortgage lending. In October, the Chief Executive introduced in the 2010-11 Policy Address measures premised on three principles of the Government's housing policy to stabilise the property market and subsidise home ownership.

19. The various Government measures have yielded some of the intended effects. In the first three quarters of 2010, a total of 43 sites that together could produce some 16 300 residential units were disposed, lifting the total supply of flats in the coming few years from 53 000 units as estimated at end-2009 to 61 000 units as estimated at end-September 2010. Following the Government's measures to forestall excessive leverage, the average loan-to-value ratio of new mortgages fell from 64.0% in 2009 to 61.2% in the first eight months of 2010 and further to 58.6% in September after the further tightening of mortgage standards by the Hong Kong Monetary Authority (HKMA). Commercial banks also followed the HKMA's prudential guidelines on debt-servicing ratio when extending mortgage loans.

20. However, the US has announced another round of "quantitative easing" measures in early November, significantly boosting the global liquidity. More funds are expected to flow into the emerging economies including Hong Kong. Some economies might introduce various restrictions to prevent excessive capital inflows. Given Hong Kong's strong economic fundamentals, its high degree of

openness and free flow of capital, it is natural that more capital will be attracted to Hong Kong.

21. Under such abnormal circumstances, market exuberance is expected to intensify further, increasing the risks of a property market bubble. Once global capital flows reverse and interest rates rebound, flat prices could face downward pressure, thereby affecting overall economic and financial stability. Therefore, on 19 November, the Financial Secretary announced the introduction of a Special Stamp Duty on short-term resale of residential property. The HKMA also further tightened the loan-to-value ratio of mortgage loans for various classes of property. These are exceptional measures to address the abnormal environment of abundant liquidity and exceptionally low interest rates, with the aim of maintaining the stability of the property market and also overall economic and financial stability. The Government believes that these measures could curb overheated speculative activities and prevent excessive leverage in mortgage lending. The Government will continue to closely monitor the situation, and introduce suitable measures without hesitation when necessary.

Economic outlook for 2011

22. The economic prospects of Hong Kong in 2011 hinge on the economic performance of the major economies, in particular whether the domestic demand in regions such as the US, Europe and Japan can maintain endogenous growth when the stimulating effects of the fiscal measures introduced earlier dissipate. Whether the new round of "quantitative easing" in the US can bolster its economic recovery remains to be seen. This will in turn depend on whether the banking systems in the US and Europe will resume proper functioning, and whether employment situations in these economies will improve notably to support their domestic demand. On the bright side, Asian economies are expected to continue to grow notably further. In particular, the Mainland economy will enter the first year of the 12th Five-Year Plan in 2011. With the implementation of the structural shift towards domestic demand as a driver for economic growth, the Mainland's import demand should further strengthen. The sustained robust performance of intra-regional trade in Asia will provide impetus to growth in economies in the region. Yet it has to be noted that economic activities in Asia remain to some extent related to the final demand in the US and Europe. In sum, the external environment is still dominated by uncertainties, and the road of recovery in the US and Europe could be rather bumpy. Also, we must stay alert to the elevated risk of asset bubble in Asia, with the new round of "quantitative easing" in the US. Nevertheless, the bright economic prospect of the Asian region alongside the continued strong growth in the Mainland, the successive implementation of large-scale infrastructure projects locally, and the

still solid domestic economic sector, will all be positive to Hong Kong's economic performance in 2011. For reference, the latest forecast of Hong Kong's economic growth in 2011 by the International Monetary Funds (IMF) is 5-5.5%. The figure from the private sector analysts is 4.6% on average.

23. Inflation outlook for 2011 will depend on a number of external factors, including the movements of the US dollar and the extents of increases in global commodity prices. The new round of "quantitative easing" in the US has also added to the inflationary pressure in the region. On the domestic front, market rentals for private residential units have been rising since the beginning of 2009. These more recent levels of market rentals will be gradually fed into consumer price inflation alongside the successive renewals of expiring tenancies. This feed-through process is expected to have a more notable effect on the inflation rate next year. Also, with the full-fledged recovery in Hong Kong, various business costs, including wages and rentals, will also be subject to upward pressure. Nevertheless, the sustained productivity growth in the economy should provide a partial offset. In sum, the upside risk to inflation has been rising progressively, and the inflation rate in 2011 is expected to be higher than this year. The Government will remain watchful over the development in inflation, and its impacts on the livelihood of low-income families. For reference, the IMF forecast Hong Kong's consumer price inflation rate to reach around 5% by end-2011. The latest forecast of Hong Kong's inflation rate next year from the private sector analysts is averaged at 3.1%.

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Annex

Recent situation of household income[1]

Background

This Annex provides a regular update on the movement of household income both in overall terms and with respect to households with monthly household income below $4,000.

Latest situation

2. Benefited from the sustained strong economic growth, labour market conditions improved progressively. Employment gained further in the third quarter of 2010, reaching its highest level since late-2008, while labour wages and earnings were also generally on the increase. Similarly, household income improved across-the-board, with the median monthly household income rising further by 3.7% in the third quarter of 2010 over a year earlier, after a 2.9% year-on-year increase in the second quarter. The figure largely returned back to the pre-crisis level in 2008. After discounting price change, the year-on-year gain in the third quarter was 1.4% in real terms ***(Table 1)***.

Table 1: Median monthly household income, labour wages and labour earnings (year-on-year rate of change in nominal terms (%))

Period	Median monthly household income	Labour wages	Labour earnings
Q1 2008	5.7	4.0	3.1
Q2 2008	4.6	4.1	4.6
Q3 2008	5.7	4.6	5.2
Q4 2008	1.1	0.9	-2.1
Q1 2009	-2.7	-0.9	-0.2
Q2 2009	-3.9	-1.9	-0.7
Q3 2009	-5.7	-1.8	2.1
Q4 2009	-3.9	0.8	0.9
Q1 2010	0.0	1.9	1.1
Q2 2010	2.9	2.2	4.9
Q3 2010	3.7	n.a.	n.a.

Note : n.a. Not yet available.

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(1) Foreign domestic helpers are excluded from the analysis.

Households with monthly household income below $4,000

3. As the overall situation of household income improved alongside the broad-based economic recovery, the number of households with monthly household income below $4,000 ("low-income households") fell significantly by 10 800 (or 6.1%) to 166 200 in the third quarter of 2010 from 177 000 over a year earlier. In proportionate terms, the respective share in total domestic households also decreased appreciably, from 7.7% to 7.1% ***(Table 2)***. The decrease of low-income households over this period was attributable entirely to a fall in the relevant economically active households (i.e. with at least one economically active household member). This reduction was consistent with the declining unemployment rate observed for lower-skilled workers from 5.8% to 4.6% over the same period. The numbers of economically inactive households (i.e. with all members being economically inactive) and elderly households (i.e. with all members aged 60 or above), showed little change over the same period.

Table 2: Distribution of domestic households by monthly household income

	Q3 2000 (10 years ago) (%)	Q3 2009 (1 year ago) (%)	Q3 2010 (%)
Less than $4,000	8.1	7.7	7.1
$4,000 - $7,999	9.9	12.7	12.2
$8,000 - $11,999	14.1	13.5	12.9
$12,000 - $15,999	13.5	12.5	12.4
$16,000 - $23,999	18.9	17.5	17.5
$24,000 - $39,999	19.4	18.9	19.2
$40,000 - $99,999	14.0	14.5	15.8
$100,000 or above	2.1	2.8	2.9

Note : The purchasing power of the income (as measured by the Composite CPI) in Q3 2000 and Q3 2009 were 104% and 102% of that in Q3 2010 respectively.

4. When compared with ten years ago (i.e. third quarter of 2000), the proportion of low-income households in all domestic households decreased from 8.1% to 7.1%. A compositional analysis indicated that within this household group, the number and proportion of economically active low-income households moved broadly in line with the economic cycles. During 2000 and 2008 when the economy performed persistently well for most of the period, the proportion of economically active low-income households decreased successively from 1.5% in the third quarter of 2000 to 0.9% in the third quarter of 2008. After the outbreak of the global financial tsunami in late-2008, the Hong Kong economy mired into recession, thereby leading to a rise in the proportion of economically active low-income households, to 1.3% in the third quarter of 2009. As the economic

recovery gradually took hold afterwards, the proportion fell back to 0.9% in the third quarter of 2010 ***(Table 3)***. On the other hand, movement of the number of elderly low-income households and economically inactive low-income households were less related to economic cycles. Due to the progressive trend of population aging, the number of elderly households persistently stayed above 100 000 over the past ten years, while the number and proportion of economically inactive households also showed some increase over the period. Conceivably, this trend reflected the on-going socio-economic changes such as an increased tendency of early retirement, increased incidence of single parents and older persons with prolonged illness amid population ageing, thereby leading to the withdrawal of these people from the workforce, and the ensuing rise in the number of economically inactive households over the past ten years ***(Chart 1)***.

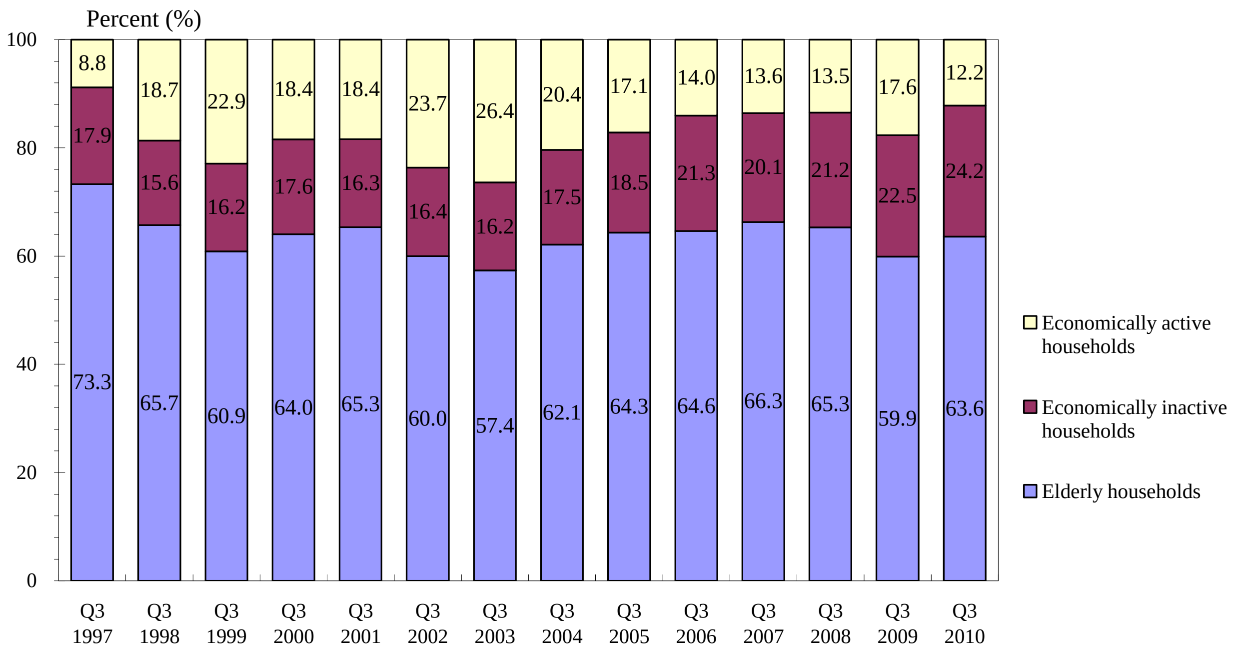
Table 3: Number and breakdown of low-income households*

	Elderly households	Economically inactive households	Economically active households	Total
Q3 2000	105 600	29 000	30 400	165 000
	(5.2)	(1.4)	(1.5)	(8.1)
Q3 2005	119 700	34 500	31 900	186 100
	(5.5)	(1.6)	(1.5)	(8.5)
Q3 2009	106 000	39 800	31 200	177 000
	(4.6)	(1.7)	(1.3)	(7.7)
Q3 2010	105 700	40 200	20 300	166 200
	(4.5)	(1.7)	(0.9)	(7.1)

Notes : * Low-income households refer to those with monthly household income below $4,000.

( ) Share in all domestic households.

Chart 1 : Composition of low-income households

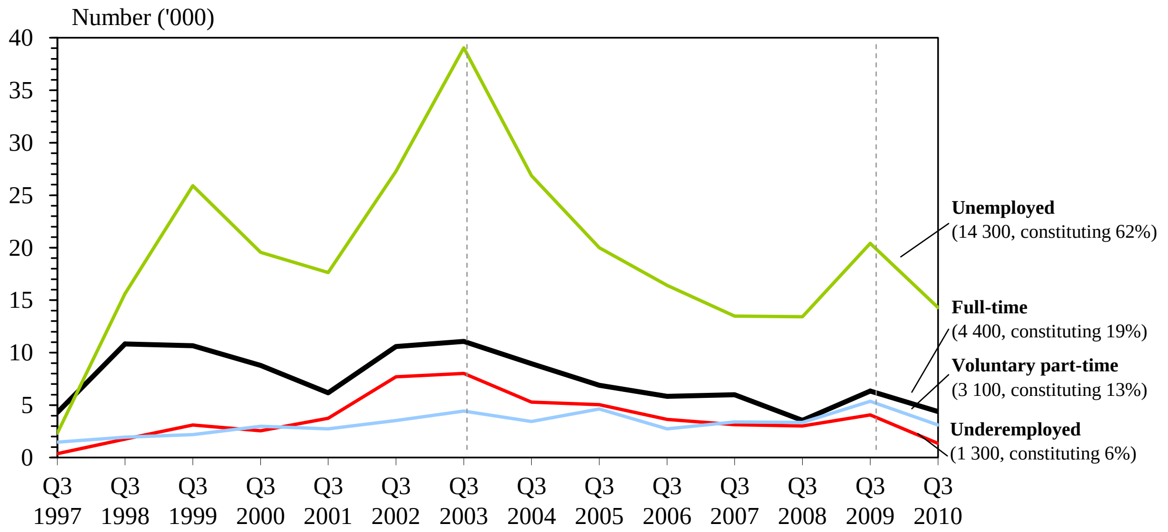


5. Further analysis of the low-income households in the third quarter of 2010 yields the following observations:

- 64% of them comprised 1-person households, in which the majority (76%) were households with elderly persons aged 60 or above.

- As to the economically active low-income households, there were 23 100 economically active persons living there in the third quarter of 2010, significantly less than the 36 200 persons a year earlier by 13 000. Among them, the number of unemployed persons in such households decreased notably by 30% from 20 400 to 14 300 over the period. When matched with the decrease of 23% in the number of overall unemployed persons over the same period, this showed that the economic recovery can indeed lead to a general improvement in employment situation of low-income households. Likewise, the number of full-time employed persons declined visibly by around 30% from 6 300 to 4 400, suggesting that these persons were also able to benefit from the economic growth, and can therefore successfully move out of the group of low-income household. A breakdown by employment status revealed that 62% of these economically active persons were unemployed, while employed part-time workers (working voluntary for less than 35 hours per week, or involuntarily for the same amount of time, i.e. underemployed) and full-time employment were 19% each ***(Chart 2)***.

Chart 2 : Composition of economically active persons in low-income households*



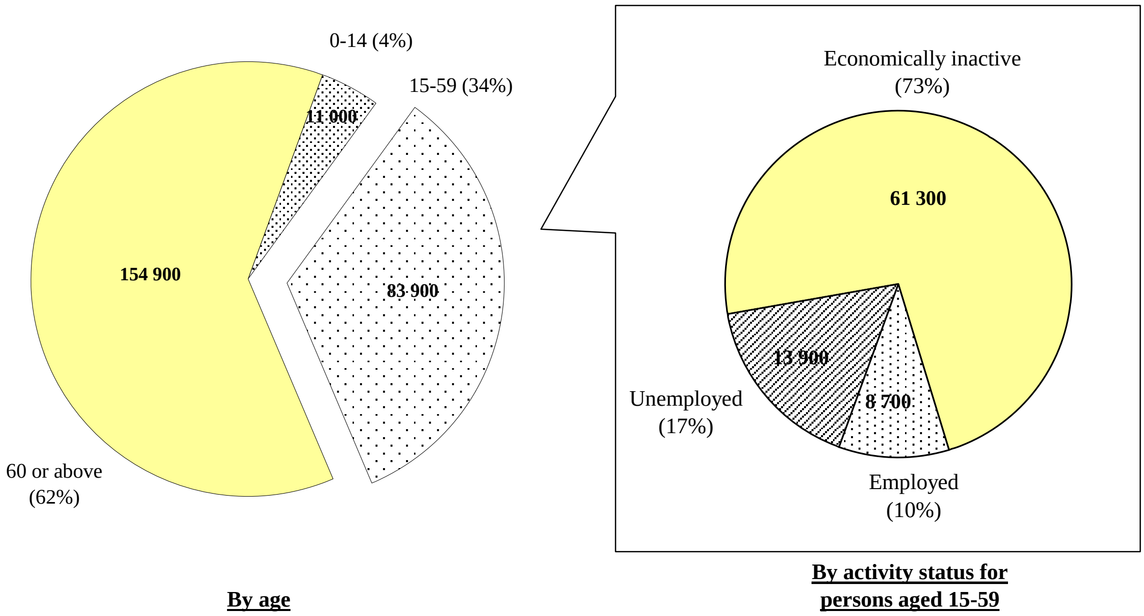
Notes : (*) This does not include economically active persons in the low-income households with elderly members only, but the numbers involved are insignificant.
Figures in brackets represent the number of economically active persons in Q3 2010.

- As for the 76 300 persons living in economically inactive low-income households, 37% of them comprised elderly persons at 60 and above (90%

being retirees) or teenagers below 20 (mainly students). The remaining 63% or 48 200 persons were aged 20-59. Among them, 28% were homemakers, 24% were retirees, 16% were persons suffering prolonged illness, and 4% were students.

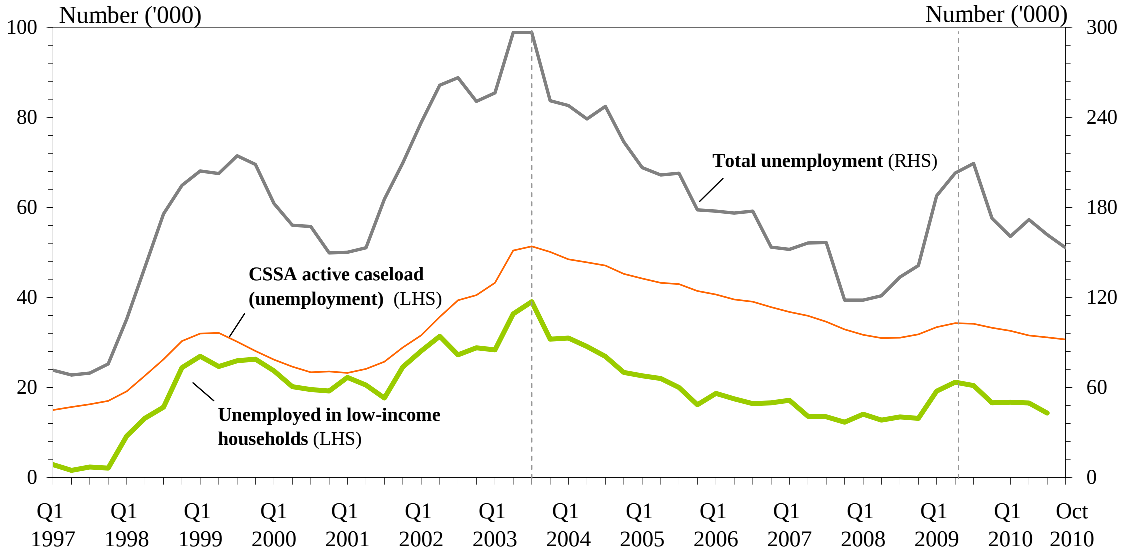
- Taken together, there were thus 249 800 persons in low-income households (down 7% year-on-year). Of this total, 62% (or 154 900 persons) comprised elderly persons aged 60 or over. As to the 83 900 persons aged 15-59, 73% of them were economically inactive, while the remaining 17%, 5% and 5% were unemployed, part-time and full-time workers respectively ***(Chart 3)***. In proportionate terms, those who were unemployed and full-time workers actually witnessed a decrease over the past year, again indicating that the employment conditions of the low-income households have improved in tandem with the economic revival.

Chart 3 : Persons living in low-income households by age and activity status, Q3 2010



- In fact, during the current economic recovery, the unemployment rate for lower-skilled workers fell successively from a high of 6.2% in mid-2009 to 4.2% in August – October 2010, making a cumulative fall of 2.0 percentage points. This was even larger than the decrease in the overall unemployment rate over the same period. Concurrently, the number of CSSA cases also fell steadily. At 284 828 in October 2010, the number of CSSA cases was down by 5 414 (or 1.9%) from the high of 290 242 in August 2009. The unemployment caseload witnessed a more notable improvement, the number fell cumulatively by 3 605 (or 10.5%) to 30 661 ***(Chart 4)***.

Chart 4 : The relationship between the unemployed in low-income households*, CSSA active caseload (unemployment)^, and total unemployment in the economy



Notes : (*) This does not include economically active persons in the low-income households with elderly members only, but the numbers involved are insignificant.

(^) Monthly period-end figures.

- Despite the recent improvements in economic and labour market conditions, the Government will not let up on its efforts to assist the low-income households. The Government will strengthen employment / training and re-training services, so as to provide further support for job-seekers. The implementation of statutory minimum wage should be able to protect grassroots workers, while the "Work Incentive Transport Subsidy Scheme" could also relieve the burden on their daily travelling expenses. Meanwhile, through social welfare policies, such as the existing social safety net and the newly established Community Care Fund, the Government will continue to adopt a multi-pronged approach to assist the vulnerable groups, enabling them to share the benefits from economic growth. More importantly, we will keep on investing substantially on education (e.g. increasing tertiary degree places and related subsidies) in order to improve the competitiveness and skills of the labour force, enhance social mobility and reduce inter-generational poverty. In the longer term, the fundamental solution to improve the livelihood of people living in low-income households is to promote overall economic growth so as to provide more employment and income opportunities for this vulnerable group.

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