

Hong Kong, China

Robust economic growth continued in 2007, powered by strong domestic demand and supported by a vibrant services sector. The expected slowdown in the United States (US) and the People's Republic of China (PRC) will trim growth in 2008, with a slight pickup expected in 2009. Inflation, partly imported from the PRC, will accelerate this year. Longer-term challenges involve skills shortages, pollution, and an aging population.

Economic performance

The economy grew by 6.3% in 2007, decelerating from about 7% in the previous 2 years. Growth was driven by domestic demand (Figure 3.10.1). Private consumption increased by 7.8% and contributed 4.5 percentage points to GDP growth. This spending was supported by a strong labor market and buoyant asset markets. The unemployment rate fell to 4.0%, the lowest level since 1998, and average monthly wages rose by 4.6% in the third quarter from a year earlier (Figure 3.10.2). As a consequence of strong employment, rising incomes, and increasing tourist arrivals, the volume of retail sales rose by 10.5% last year, nearly double the rate of 2006.

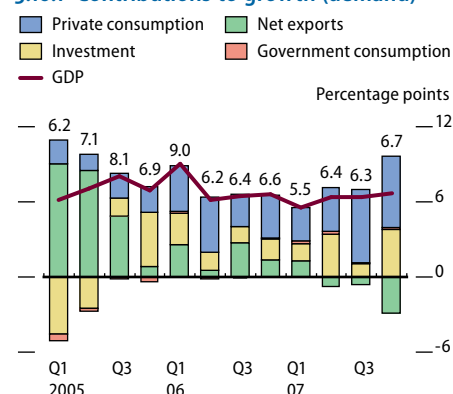
Buoyant asset markets boosted household wealth and thus supported consumption growth. The index of share prices rose by 39% in 2007, despite a market retreat in the last 2 months of the year. The property market also revived, helped by lower mortgage interest rates and improved incomes. House prices rose by 11.5% in 2007 and the number of residential property transactions surged by about 50% (Figure 3.10.3). Rents for offices, retail premises, and factory space also increased, reflecting rising demand by businesses.

Gross domestic fixed capital formation rose by 6.0% in 2007 and contributed 1.3 percentage points to GDP growth, reflecting strong business confidence and a need to expand productive capacity. Total investment, including changes in inventories, grew by 11.6% and contributed 2.4 percentage points to GDP growth. Investment in building and construction rebounded to register growth of 0.2%, after falling for several years, while investment in machinery and equipment rose by 6.6%.

Relatively low real interest rates supported both consumption and investment growth. Given that the US and Hong Kong dollars are linked, interest rates in Hong Kong, China generally follow those in the US. Consequently, nominal interest rates declined in the second half of 2007. Real rates tended to fall faster, especially in the fourth quarter when inflation started to pick up (Figure 3.10.4).

Net exports of goods and services in real terms, on the other hand, declined for the first time since 2001. Real exports of goods and services

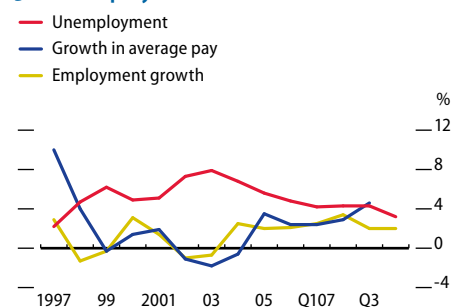
3.10.1 Contributions to growth (demand)



Source: Census and Statistics Department, available: <http://www.censtatd.gov.hk/>, downloaded 28 February 2008.

[Click here for figure data](#)

3.10.2 Employment indicators



Source: Census and Statistics Department, available: <http://www.censtatd.gov.hk/>, downloaded 21 February 2008.

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increased by 7.9%, outpaced by real imports that rose by 8.9%. Domestic merchandise exports in nominal terms fell by 18.9%, partly as a result of softening demand from the US, the second-largest market for domestic exports. By contrast, reexports, accounting for 96% of total merchandise exports, grew by 10.8%, benefiting from the continuing surge in global trade with the PRC, the main source of the economy's reexports, and a gradual depreciation of the real effective exchange rate. Services exports, bolstered by rising tourism, financial market activity, and external trade, more than compensated for a widening merchandise trade gap and the current account surplus in 2007 rose to the equivalent to 13.3% of GDP (Figure 3.10.5). After accounting for investment flows, the overall balance of payments registered a surplus of 7.1% of GDP in 2007, well above the year-earlier level (Figure 3.10.6).

The services sector dominates the economy, producing over 90% of GDP, and it generated all the GDP growth on the supply side in 2007. Agriculture, manufacturing, and construction all contracted. Among services, finance and insurance grew by about 19% in 2007, reflecting strong expansion in banking and buoyant financial market activity, much of it involving fund-raising for PRC companies. Yuan-denominated banking services also expanded. Other services activities to perform well were real estate and business services; import and export trade services; and hotels, restaurants, and retail trading (the last group benefiting from healthy consumer and tourist spending).

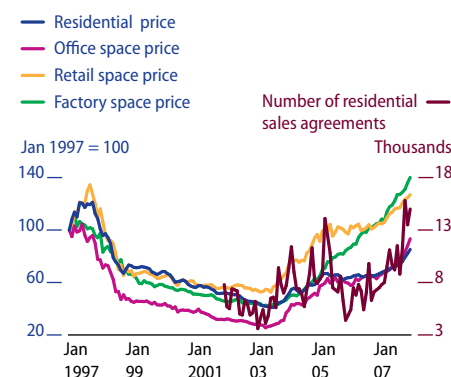
Solid economic growth strengthened the fiscal position in FY2007 (ended 31 March 2008). The fiscal surplus rose to an estimated 7.2% of GDP, even after income tax rates were cut and general rates (taxes) for properties were waived for 3 quarters, among other concessions. Government revenues surged by 22.6%, benefiting from much higher stamp duty receipts from stock and property transactions. Government spending rose by just 3.4%.

Inflation was about 1.5% for the first 9 months of 2007, but then accelerated to 3.5% in the last 3 months to average 2.0% for the year (Figure 3.10.7). The pickup after October was due to the ending of the waiver on property rates and an increase in food prices and services costs. Much fresh food is imported from the PRC, where prices of food, especially pork, jumped last year. A gradual depreciation of the Hong Kong dollar against the yuan also contributed to food price inflation. In addition, labor productivity growth trended down in 2007 (Figure 3.10.8), such that rising labor costs began to put some upward pressure on inflation.

Economic prospects

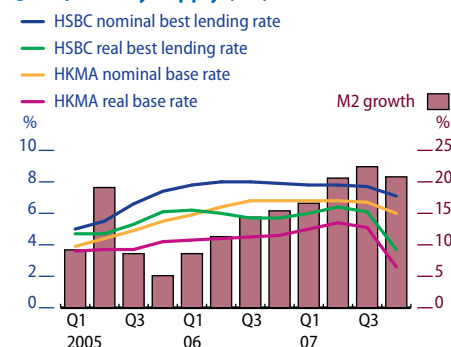
Key assumptions include a slowing in PRC economic growth in 2008 and a sharp pullback in US growth, followed by some recovery in the US in 2009. Others are that the yuan will appreciate gradually against the US dollar and that the Hong Kong dollar's link with the US dollar will be maintained. Domestic interest rates are expected to continue to decline this year alongside those in the US. The Government projects that the budget will turn to a small deficit in FY2008 and return to surplus the following fiscal year. The FY2008 budget lowers personal and corporate

3.10.3 Property price indexes and transactions



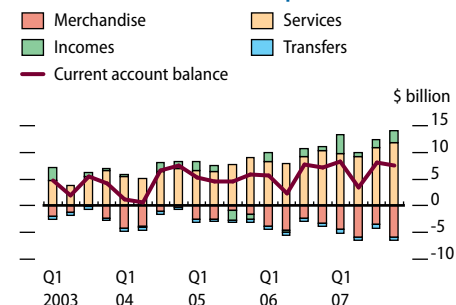
Source: Rating and Valuation Department, available: <http://www.rvd.gov.hk>, downloaded 21 February 2008.
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3.10.4 Money supply (M2) and interest rates



HKMA = Hong Kong Monetary Authority.
 Source: Hong Kong Monetary Authority, available: <http://www.info.gov.hk/hkma/>, downloaded 21 February 2008.
[Click here for figure data](#)

3.10.5 Current account components



Sources: Census and Statistics Department, available: <http://www.censtatd.gov.hk/>, downloaded 25 March 2008; Hong Kong Monetary Authority.
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income taxes by 1 percentage point to 15.0% and 16.5%, respectively. The projected budget turnaround to a deficit from last year's surplus is expected to provide support for domestic demand.

Domestic demand is expected to drive growth again, although it is unlikely to be as strong as last year. Private consumption will be underpinned by low real interest rates, buoyant consumer confidence, tax cuts, and wage increases. Investment, too, will be supported by low real interest rates as well as the strong property market. Furthermore, some large infrastructure projects are scheduled to start construction this fiscal year and next.

Merchandise exports are forecast to weaken because of the slowdowns in the PRC, US, and other markets. The likely appreciation of the yuan is also expected to erode real reexports originated from the PRC. However, in line with a weaker US dollar, the Hong Kong dollar is projected to depreciate against many currencies, supporting exports to Asian and other markets. On the balance of these influences, GDP growth is expected to decline to 4.5% in 2008 and then to lift to 4.8% in 2009 if a recovery gets under way in industrial economies.

Weaker merchandise exports in 2008 will widen the trade deficit, but another large surplus on services trade will outweigh this. The current account surplus is expected to decline, but remain substantial at 9.5% of GDP in 2008.

Rising food prices and rents will underpin higher inflation in 2008. Indeed, inflation jumped to 6.3% in February 2008, the highest rate in about 10 years, propelled in part by some one-time factors. Housing has the biggest weighting in the Composite Consumer Price Index and rents for private housing are rising sharply along with property values. The price of imported food, the second-largest component in the index, is also moving up. The expected weaker US dollar and firmer yuan will raise import prices and the tight labor market will put some upward pressure on inflation. Against this, another waiver on property rates for FY2008, a 1-month waiver on public housing rents, and a one-time grant to subsidize household electricity costs will moderate the increase in inflation to a forecast average of 3.4% this year. The Government estimates that inflation would increase to 4.5% without these budget concessions.

Changes in prices of petroleum products have a relatively mild impact on growth and inflation, since the economy is heavily services oriented (fuel accounts for only about 2% of total business costs). Just over half the electricity is generated by coal (the rest from oil). Fuel use has become more efficient over recent years, and fairly high taxes are imposed on private cars and gasoline. A 10% increase in global oil prices would reduce GDP growth by 0.28 percentage points and increase inflation by 0.14 percentage points, a milder impact than in many other Asian economies, according to the Oxford Economics quarterly global model.

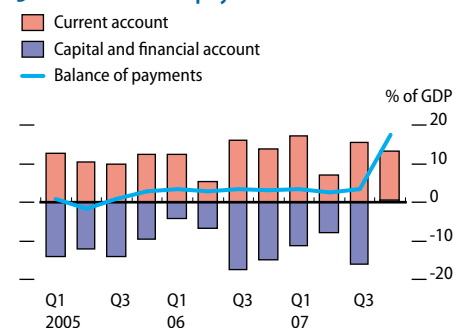
The forecasts are subject to various, interlinked downside risks. A steeper than expected slowdown in the US as well as the PRC would further damage global trade and thus Hong Kong, China's growth prospects. The overall impact would be much worse if there was also a general slump in financial and property markets. A more serious financial market slump than foreseen could also sharply weaken the US dollar, flowing through to the Hong Kong dollar and giving inflation an upward jolt.

3.10.1 Selected economic indicators

	2008	2009
GDP growth	4.5	4.8
Inflation	3.4	2.8
Current account balance (% of GDP)	9.5	12.0

Source: Staff estimates.

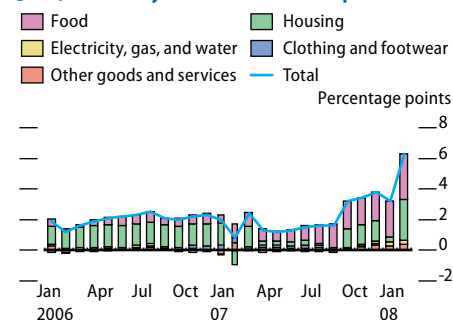
3.10.6 Balance-of-payments indicators



Sources: Census and Statistics Department, available: <http://www.censtatd.gov.hk/>, downloaded 25 March 2008; Hong Kong Monetary Authority.

[Click here for figure data](#)

3.10.7 Monthly inflation and components



Source: CEIC Data Company, Ltd., downloaded 20 March 2008.

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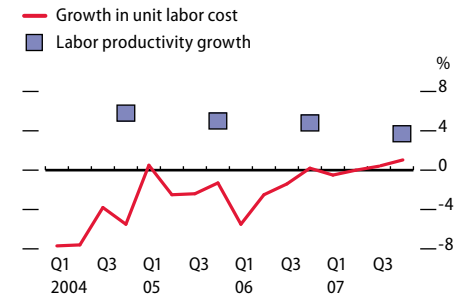
Development challenges

Shortages of skilled labor are a constraint on growth. With a booming economy, Hong Kong, China's demand for skilled labor such as accountants, construction specialists, and lawyers is on the rise. Many such skills are also lacking in the PRC, reducing the chances of companies sourcing staff there. As Hong Kong, China continues its drive toward a knowledge-based economy, there is a need to keep its education system under close review to ensure that it can meet the needs of students as well as produce enough skilled people to meet the growing demand.

The ability to attract internationally mobile professionals can be hampered by Hong Kong, China's reputation for air pollution. Pollutants come mainly from motor vehicles, industry, and power plants in both Hong Kong, China and neighboring Guangdong province. Some progress is being made in controlling emissions, though power companies must substantially reduce emissions if they are to achieve targets set for 2010.

A longer-term challenge is an aging population. The population division of the United Nations Secretariat projects that 52.7% of the population will be aged 50 and above by 2050, compared with 31.0% in 2007. This will raise the costs of subsidized health care and other aged care and could constrain government spending in areas such as education and infrastructure over the medium to long term. The Government is studying options for the private sector to bear a greater share of health care costs.

3.10.8 Labor indicators



Source: Calculations based on General Household Survey 2007.

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