Hong Kong, China

Fragility in the global economy dampened trade, but resilient domestic demand ensured modest growth. A rebound is expected in the next 2 years as the global economy gains momentum and trade picks up. Inflation will remain at around 4%, fuelled by rising property prices, and the current account surplus will widen. A liquidity glut and low interest rates entail the risk of asset price bubbles. Ample fiscal reserves provide flexibility to implement corrective measures against shocks.

Economic performance

Growth in Hong Kong, China was slow in the beginning of 2012. Global trade weakened as the fragile international economy failed to pick up because of the unresolved financial crisis in the euro area, lingering fiscal uncertainties in the US, and moderating growth in the People’s Republic of China (PRC), strongly affecting this small, open economy. Encouraging developments in the fourth quarter, however, helped to push economic performance for the full year to modest 1.4% growth.

Domestic demand was the main engine of growth, with private consumption continuing to make the largest contribution, albeit substantially less than a year earlier (Figure 3.10.1). Consumer sentiment was cautious, despite low unemployment at 3.3% and increasing wealth with rising asset prices and real income, as measured by changes in the payroll index. The contribution of government consumption to growth improved but remained small.

Stronger investment in 2012 also contributed to growth, as construction and the private acquisition of machinery and equipment expanded. Net exports declined.

On the supply side, manufacturing contracted, but growth was spurred by the service sector, which provided more than 90% of GDP and accelerated by 2% in 2012, down from 5.2% a year earlier. Growth in the sector was driven by real estate and business services, public administration, social and personal services, and information and communication services (Figure 3.10.2). The other components of the sector posted more subdued growth. Retail sales grew more slowly than in 2011, despite the steady stream of visitor arrivals. The number of tourist arrivals grew by 16%, about the same as in 2011.

Exports and imports both contracted in the early part of the year but recovered somewhat in the second half. Much of the city’s merchandise exports are re-exports, which moved in tandem with slower global trade, resulting in a larger increase in imports than in exports. Net service exports lost some of the dynamism of previous years, growing at 40%
compared with 192% in 2010 and 62% in 2011 and barely managing to overcome the deficit in merchandise trade.

Reflecting these developments, the current account recorded a small surplus of 1.1% of GDP in 2012, down from 4.8% in 2011 (Figure 3.10.3). The overall balance of payments was still in surplus, and foreign reserves amounted to $317.3 billion, equivalent to over 7.5 months of imports.

Inflation moderated but remained elevated as property prices rose on low interest rates. Moderated food prices, electricity subsidies, and 2 months of free rent for public housing tenants contained the price rise to 4.1% in 2012, down from 5.3% in 2011 (Figure 3.10.4).

The budget for FY2012 (ended 31 March 2013) is estimated to have recorded a surplus of 3.2% of GDP (Figure 3.10.5). Although only a meager 2.9% higher than in FY2011, estimated revenues far exceed the budgeted amount. Expenditures grew by 3.9% but also fell short of the budgeted amount by HK$13.1 billion because of lower social spending. Larger-than-budgeted surpluses in the past few years have led to the accumulation of fiscal reserves equal to 23 months of average government expenditure. The ample size of the reserves has prompted calls for the government to spend more on social welfare programs.

With the exchange rate pegged to the US dollar under the currency board, interest rates in Hong Kong, China track the policies of the US Federal Reserve. Accommodative monetary policy in the US meant low interest rates and ample liquidity, with broad money expanding by 11.1%. Bank credit grew by 9.6% as banks’ exposure to the property sector rose to around 30% of loans outstanding. Low interest rates fueled demand for real estate and a 26% surge in residential property prices. Amid concerns regarding the risk to the banking sector posed by overheating in the property market, the Hong Kong Monetary Authority required banks to tighten underwriting criteria for mortgage loans on borrowers who already own at least one property.

The Hong Kong dollar real effective exchange rate rose at a moderate pace compared with Asian counterparts, preserving export competitiveness (Figure 3.10.6). The expansion of transactions denominated in PRC renminbi continued in 2012, with renminbi deposits amounting to 9.1% of the all deposits in the banking system. The number of banks engaged in the renminbi business is growing, and their services are broadening.

**Economic prospects**

Growth in the forecast period is expected to fall short of the 5-year average prior to the global financial crisis but will accelerate to 3.5% in 2013 and 3.8% in 2014, benefiting from expanded trade, robust domestic demand, and increased government support for industry and lower-income groups (Figure 3.10.7). Higher anticipated growth in the PRC will benefit Hong Kong, China in particular through increased trade and expanded renminbi business and payments.

Private consumption will grow with rising wages reflecting a tight labor market and an increase in the minimum wage to HK$30/hour from HK$28/hour on 1 May 2013 (Figure 3.10.8). The wealth effect from rising property prices is also expected to buoy consumer spending. Investment
should continue to grow as public construction intensifies further and private construction picks up.

The four industry pillars—financial services, business and professional services, tourism, and trading and logistics—are expected to pick up during the year with support from the government. The proposed doubling of the government bond program from $100 billion to $200 billion and the lowering of profits tax on the offshore business of insurance companies will benefit the financial sector. Other sectors will gain from plans to attract large international events and meetings, develop Hong Kong’s logistics services, provide additional funding for universities to facilitate technology transfer and innovation, and enhance special concessions for small and medium-sized enterprises.

With the expansion of external trade, exports are expected to grow more quickly, but the trade deficit will remain. Services receipts should pick up, supported by vibrant tourism and a recovery in transport services. The current account surplus is expected to widen to 4% of GDP in 2013 and 5% in 2014.

Inflation is unlikely to moderate substantially during the forecast period. It is expected to fall marginally to 3.9% in 2013 from 4.1% in 2012 as international food prices ease (Figure 3.10.9). However, expected wage increases could rekindle inflationary pressure, as could likely food price increases in the PRC, from which Hong Kong, China imports much of its food. Echoing the policies of the US Federal Reserve, low interest rates can be expected to prevail in the next 2 years, pushing up property and other asset prices and requiring tighter macroprudential measures to curb speculative demand and tame inflation to 4.3% in 2014.

Fiscal policy in FY2013 and FY2014 will be geared toward stimulating economic growth and supporting the development of established and emerging industries, while maintaining a prudent fiscal stance. A small deficit of 0.2% of GDP is projected for this fiscal year. Despite repeated revenue outcomes above budget in previous years, revenues for FY2013 are conservatively projected at HK$435 billion, lower than the revised estimate in FY2012. Expenditures are to increase to HK$440 billion on both higher capital outlays and increased current expenditure.

The growth scenario will be threatened if the PRC or US economy weakens or the euro area financial crisis deepens. Less likely but possible, a sudden reversal of the interest rate trend could derail growth prospects and adversely affect the health of banks. The availability of ample fiscal reserves provides the government with flexibility to implement corrective measures if any of these risks materialize.

### Policy challenge—providing adequate and affordable housing

The rise of property prices has been a major concern in Hong Kong, China. Supply shortages and high and growing demand combine to stir up a vibrant property market. The low interest rate environment and improved income prospects have contributed to a widening demand-supply imbalance. Appetite for investment in housing units in all segments of the market continues to grow in response to abundant
liquidity and low interest rates, despite the macroprudential measures applied to curb speculative demand and protect the stability of the financial sector. As the rise in flat prices continues to outpace income growth, the affordability ratio had risen to nearly 50% by December 2012 (Figure 3.10.10).

Housing supply has perennially fallen short of demand largely because of inadequate land made available for residential use. For the medium term, the government has announced that it will make land available for the private development of about 20,000 housing units each year and the public development of 79,000 rental flats over 5 years starting in FY2012. It also plans to build for sale to the public about 17,000 flats over 4 years starting in FY2016. Given the time required for implementing a housing project, however, the mismatch between supply and demand can be expected to linger at least for the next 2 years.

The government’s plan to develop a long-term housing strategy toward promoting the development of a healthy and stable property market is welcome, especially as land premiums and stamp duties are important sources of budgetary revenue. A strong commitment to act as necessary to protect the market from the risks of a property bubble is also essential. Indeed, policies implemented in 2012 and early 2013 have had some success in curbing speculation (Box 3.10.1), though property prices remain elevated. Housing prices are unlikely to stabilize as long as excess demand prevails and interest rates remain low. The challenge for the authorities is to maintain the stability of the property and financial markets, while meeting in a timely manner the needs of a changing population for affordable housing.

### 3.10.1 Selected measures on the property market, 2012

In September 2012, the Hong Kong Monetary Authority tightened the maximum loan tenor to 30 years for all new property mortgages and reduced the following ratios for borrowers with multiple mortgages:

- the maximum debt servicing ratio from 50% to 40%,
- the maximum stressed debt servicing ratio limit from 60% to 50%,
- the loan-to-value ratio to 30% for mortgage loans, based on applicants’ net worth, and another 10 percentage points lower for those with income derived mainly from outside Hong Kong, China.

In October 2012, the government enhanced the duty rates and extended the holding period in respect of the special stamp duty imposed on residential properties resold within 3 years of acquisition. The applicable special stamp duty rates are 20% of the property value for resale within 6 months, 15% for resale within 6–12 months, and 10% for resale within 12–36 months. A 15% buyers’ stamp duty was also introduced on residential properties acquired by buyers who are not Hong Kong permanent residents.

The measures applied in 2012 helped reduce the transaction volume from a high of 14,306 in March 2012 to 9,129 by the end of December 2012, according to the records of the Land Registry.

Sources: Financial Secretary’s Office. 2012 Economic Background and 2013 Prospects. February 2013; Hong Kong Monetary Authority.