Hong Kong, China

Spurred by domestic demand and tourism, GDP grew steadily. Growth is expected to accelerate moderately to 3.5% in 2014 and 3.6% in 2015 as inflation hovers just below 4%. Being an international financial center poses risks from volatility, but a healthy financial sector and substantial financial resources can cushion the economy. A policy challenge is to address long-term fiscal sustainability in view of an aging population and the government’s financial commitments.

Economic performance

The economy grew by 2.9% in 2013, more quickly than in 2012. Domestic demand and healthy tourism supported economic expansion. Consumption was the backbone of growth, contributing about 3 percentage points, with private consumption accounting for 92% of that contribution (Figure 3.10.1). Investment also picked up in 2013 with increased purchases of machinery and equipment, contributing 1 percentage point to growth. Sluggish external demand reduced net exports, subtracting nearly 1 percentage point from growth.

Private consumption was buoyed by rising real incomes. Reflecting a low unemployment rate of 3.3% and an upward adjustment to the statutory minimum wage in May 2013, real wages have risen. The continuing influx of tourists also played a major role in boosting private incomes. In 2013, Hong Kong, China attracted 54.3 million tourists, 75% of them from the People’s Republic of China (PRC). While tourists arrivals from other markets have remained stable, those from the PRC have increased by 80% since 2010 (Figure 3.10.2).

Gaining from high tourist arrivals in 2013, the service sector, which accounts for more than 90% of GDP, grew by 3%. Most services grew at a robust pace, with the exception of real estate, which contracted by 4%. The contribution of industry and construction was small, and that of agriculture negligible.

Export and import growth both accelerated slightly in 2013, reflecting economic recovery in the advance economies in the latter half of 2013. Net services exports grew by 33%. The combined goods and services balance produced a modest surplus of $2.9 billion, and the current account surplus widened to 2.1% of GDP from 1.6% in 2012. This outcome, together with a net capital inflow of $2.2 billion, generated a balance of payments surplus of 2.7% of GDP. Official foreign reserves increased to $311.2 billion by the end of 2013 from $305.8 billion a year earlier. Tracking movements of the US dollar, to which it is pegged, the local currency appreciated in nominal effective terms by 3.7% against the currencies of the economy’s major trading partners in 2013 (Figure 3.10.3).
Under the currency board system, interest rates generally align with the policies of the US Federal Reserve. The low interest rate environment pushed domestic credit to 170% of GDP in 2013, for a growth rate of 8.2%, and the total loan-to-deposit ratio to 72.9% in January 2014 (Figure 3.10.4). The total loan portfolio of authorized institutions, including their lending abroad, expanded by 16%, up from 10% in 2012. Tighter macroprudential policies and fiscal measures imposed in February 2013 to contain soaring property prices lowered the ratio of property loans to total loans to 30% from about 33% in 2012. The money supply grew by 12.3% in 2013, substantially outpacing nominal GDP growth and somewhat more quickly than the 11.1% rate posted in 2012.

Consumer price index inflation increased to 4.3% year on year in 2013 from 4.1% in 2012 as costs rose for rent and food, which together accounted for 79% of the index rise. Despite the sharp cooling of the property market, residential rents increased by 6.7%, albeit stabilizing in the fourth quarter (Figure 3.10.5). The number of new rental leases edged down in line with cooling in the property market, which will take time to feed through to other rental indicators. Food prices rose by 4.4%, but prices for durable goods declined on weak import prices. Headline inflation was calculated with no corrections for one-off relief measures such as tax concessions, an electricity subsidy, and 2 months’ free rent for public housing tenants.

Since 2004, the budget has recorded surpluses cumulatively amounting to $60.3 billion, providing substantial fiscal reserves at a time when higher social expenditure seems inevitable. The budget for FY2013 (ended 31 March 2014) was no exception, recording a surplus of 0.6% of GDP. Revenues rose to HK$447.8 billion, 3% more than projected, as additional land was sold for housing. Expenditure of HK$435.8 billion was lower than budgeted by HK$4.2 billion, though recurrent expenditure growth has averaged 8.5% in the past 3 years, with a huge chunk of that allotted to education, health care, and social welfare.

**Economic prospects**

The economy is forecast to grow by 3.5% in 2014 and 3.6% in 2015 (Figure 3.10.6). This is within the range of 3.0%–4.0% that the government forecast for 2014. In the next 2 years, as the economies of the US and the euro area strengthen, the external trade of Hong Kong, China is expected to pick up. Exports are expected to grow over the next 2 years by an average of 8.2%, and imports by 7.0%. Close links to the PRC economy are expected to open up more business opportunities in that market, and facilitate access to more provinces, for service companies based in Hong Kong, China. This should mitigate any adverse impact from slower growth in the PRC. Inflation is expected to moderate to 3.8% in 2014, as the slower pace of rent hikes in the last quarter of 2013 feeds through and as international food and oil prices decline with expected better supply. As these developments feed through in turn to 2015, inflation is envisaged declining slightly to 3.7%.

Domestic demand is expected to be robust in the forecast period. Private consumption will continue to be an important source of growth in 2014 and 2015. Private investment is expected to pick up from its low
base in 2013. Public spending will likely continue growing from its high base, as projects initiated over recent years keep public construction buoyant. More generally, low and stable interest rates in 2014, reflecting US monetary policy, will fuel domestic demand in 2014, but this effect may wane in 2015 if US monetary policy tightens.

Both imports and exports will grow, with the trade balance remaining in deficit. However, the current account surplus is expected to widen to 3.5% of GDP in both 2014 and 2015 on growing net service receipts and income from PRC tourists. This is despite the Government of the PRC agreeing to temporarily tighten restrictions on travel to Hong Kong, China in response to mounting concerns about the burden tourist numbers place on public infrastructure. The position of Hong Kong, China as an international financial center could strengthen as the PRC continues to open its capital account and to foster the renminbi’s expanded use internationally.

A surplus of about 0.4% of GDP is planned under the FY2014 budget, with revenue and expenditure both amounting to about 19% of GDP. This represents a 4% reduction in revenue and a 6% reduction in expenditure from the FY2013 budgetary outturn. Lower expenditure reflects reduced relief measures and transfers to various funds. The FY2014 budget cuts the amount budgeted to finance relief to HK$20 billion. The budget is in line with the recommendations of the Working Group on Long-Term Fiscal Planning, which was set up in June 2013 to contain public expenditure to 20% of GDP, close to the ratio in the past year.

Growth prospects hinge on continued expansion in the PRC, economic recovery in the advanced economies, and accommodative monetary policy in the US. As an international financial center, Hong Kong, China would feel the impact of global financial shocks, particularly those emanating from the US or the PRC. If the US tightens monetary policy in 2014, capital outflows, higher interest rates, and financial market volatility will likely ensue, curtailing domestic demand and economic growth. However, a strong fiscal position, robust and proactive oversight of the financial system, and a flexible labor market would allow the timely adjustment of the real exchange rate, if needed. Another domestic risk is a sharp rise in property prices followed by an abrupt correction, which would undercut the value of collateral securing loans and leave some mortgaged homeowners owing more than their homes are worth. This would stifle economic activity.

**Policy challenge—fiscal sustainability**

Fiscal prudence has been the hallmark of government policy in Hong Kong, China. The budget has not been in deficit since the global financial crisis, and the government has amassed reserves sufficient to finance more than 20 months of government expenditure. In the past 5 years, actual budget surpluses have substantially exceeded the budgeted amounts. This small, open economy is particularly susceptible to fluctuations in the global economy and other external factors. Its major sources of revenue, such as profit tax, land premiums, and stamp duty, have been highly volatile and susceptible to fluctuation.
Realized revenues are thus not always the same as budgeted and have often exceeded the budget, with unanticipated surpluses coming largely from land sale receipts. Unlike revenues, actual spending has rarely been allowed to exceed budgeted amounts (Figure 3.10.7).

The share of education, health care, and social welfare in recurrent spending in the FY2014 budgeted is similar to actual expenditure in FY2013. These expenditures have been on the rise since 1997 and account for about 60% of the recurrent government expenditure. The aging population has heightened the need for substantial increases in health care and welfare spending. Managing this inevitable increase while preserving fiscal sustainability presents a fiscal challenge in the years ahead. The Working Group on Long-Term Fiscal Planning has noted that, while the government's fiscal position will remain healthy in the medium term, the prospects of an aging population and a shrinking workforce pose a future fiscal challenge. With revenues assumed to grow by 4.5% annually, the fiscal position is projected to begin deteriorating in about 15 years under no service enhancement for social services—that is, with spending adjusted only to take into account demographic and price factors. With service enhancement requiring government expenditure to grow at an average of 7.5% per year, a structural deficit would result in 7 years. The working group recommended that the government implement coordinated measures to contain expenditure growth, preserve the revenue base, and save for future generations to cope with the fiscal challenges ahead.

The government of Hong Kong, China cites the continued increase in recurrent expenditure on education, health care, and social welfare as reflecting its long-term commitment to providing public services. This policy aligns with the working group’s recommendations and its analysis, which points to the need to enhance both social services and the availability of resources to fund them over the medium term. A further need, as also highlighted by the working group, is to ensure the sustainability of public finances by aligning government expenditure growth with growth in the economy and government revenue.