HONG KONG, CHINA

The economy contracted in 2022 for a third time in 4 years, dragged down by falling demand at home and abroad. Inflation edged up on moderate food and energy price rises. Growth is expected to rebound this year, as domestic demand and services recover, and improve in 2024 on more favorable global and domestic conditions. Inflation will likely remain low to the forecast horizon. Tax reform is needed in the medium term to move toward fiscal balance without damaging competitiveness.

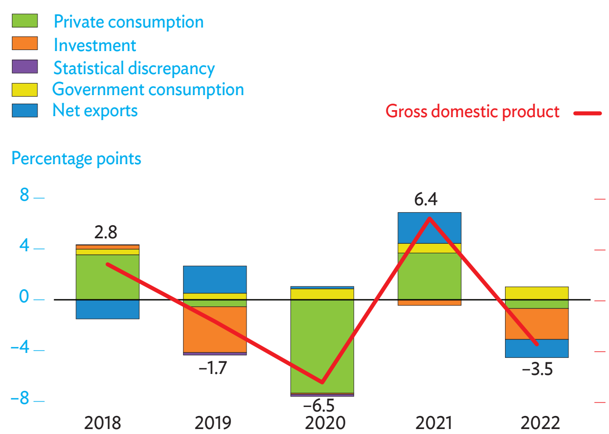
Economic Performance

The economy shrank by 3.5% last year. The economic fallout of the fifth wave of the COVID-19 pandemic included 2.6% contraction in the first half of the year. Strict pandemic containment measures took a huge toll on consumption, business sentiment, and contact-intensive activities. Even as the pandemic situation improved, tightened financial conditions and a sharp deterioration in the external environment pushed GDP into a deeper 4.4% decrease in the second half.

Domestic demand deteriorated in 2022, weighed down by pandemic restrictions and tightening monetary policy. Private consumption expenditure declined by 1.0% in real terms, subtracting 0.7 percentage points from growth (Figure 2.9.1). Retail sales volume decreased by 3.4% on average and the value of restaurant receipts by 6.3%, dragged down by pandemic disruption to retail trade early in the year (Figure 2.9.2). Financial conditions tightened with sharp interest rate hikes that battered investment and business sentiment. Gross fixed capital formation reversed an 8.3% jump in 2021 to fall by 8.5%, subtracting 1.5 percentage points from growth. Expenditure on machinery, equipment, and intellectual property products dropped by 16.1% amid a subdued business outlook and higher borrowing costs. The cost of property ownership transfer fell by 41.4% as the value of property transactions plunged by a monthly average of 39.6% year on year and volume by 38.0%. At the same time, expenditure on buildings and construction rose by 4.3% as increased public sector spending more than offset lower private sector spending. Meanwhile, government consumption expenditure rose markedly by 8.1%, reflecting the government's expansionary fiscal policies and efforts to support the economy, and contributing 1.0 point to growth.

Figure 2.9.1 Demand-Side Contributions to Growth

Growth declined last year on falling domestic and external demand.

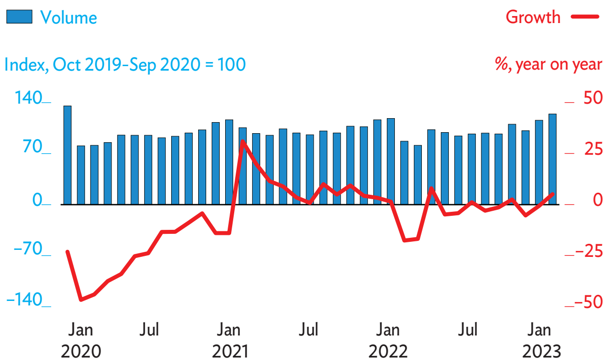


Source: Census and Statistics Department.

This chapter was written by Matteo Lanzafame of the Economic Research and Regional Cooperation Department, ADB, Manila, and Michael Timbang, consultant, Economic Research and Regional Cooperation Department, ADB, Manila.

Figure 2.9.2 Retail Sales

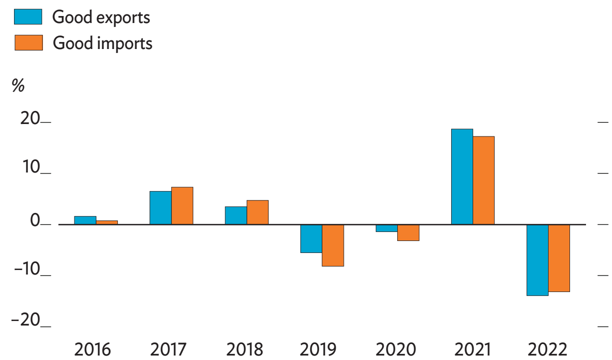
Retail sales dropped in 2022 on pandemic disruption.



Source: Census and Statistics Department.

Figure 2.9.3 Export and Import Growth

Exports deteriorated amid challenging external environment.



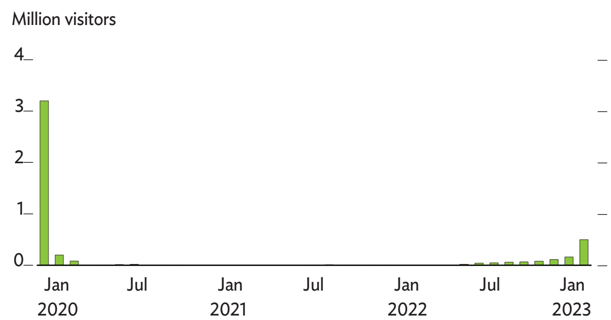
Source: Census and Statistics Department.

External demand slumped as growth in advanced economies and the People's Republic of China (PRC) softened. Exports of goods plummeted last year by 13.9% in real terms in an increasingly challenging global environment (Figure 2.9.3). Exports to the PRC declined even more, by 20.6%, stymied by cross-border truck movement disrupted primarily by strict pandemic containment measures. Exports to the US, the European Union, and other major Asian markets also declined. Service exports decreased by 0.9% as exports of financial, business, and other services contracted in line with weakened cross-border commerce and trade. Tourist arrivals increased by a factor of nearly six to 605,000 last year but remained far below the pre-pandemic annual average of 59 million in 2015–2019 (Figure 2.9.4). Meanwhile, softened domestic demand drove imports of goods down by 13.2% and of services by 1.0%. In sum, net exports subtracted 1.4 percentage points from growth.

Mirroring demand-side developments, output in most sectors declined in 2022. The combined impact of pandemic restrictions, slower global growth, and worsened financial conditions battered nearly all economic activities. Services reversed 5.9% growth year on year in 2021 to contract by 3.0%. Import and export, wholesale, and retail trade slumped by 12.1%, and accommodation and food services by 10.9%. Expansion in manufacturing output ground to a halt, slowing from 5.5% in 2021 to 0.2% a year later. Construction bucked the trend, expanding by 4.9% in real terms.

Figure 2.9.4 Tourism Indicators

Tourist arrivals increased in late 2022 but remained below pre-pandemic levels



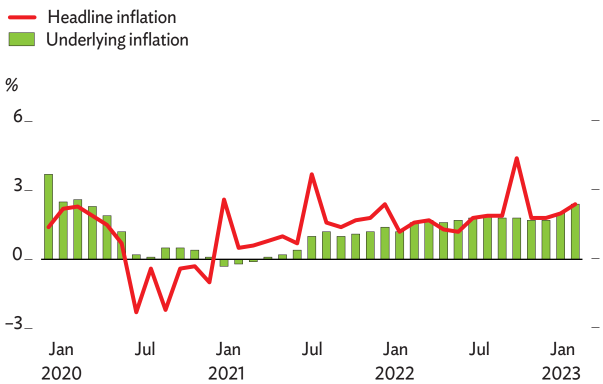
Source: CEIC Data Company.

Headline consumer price inflation edged up from 1.6% in 2021 to 1.9% last year. Pass-through from soaring global oil and gas prices was not substantial because of the low, 2.8% weight of energy (electricity, gas, and water) in the consumption basket. Additionally, low food inflation in the PRC was reflected in only moderate price increases for food imports as recession subdued domestic demand. Netting out the effects of all government one-off relief measures, the underlying inflation rate rose from an average of 0.6% in 2021 to 1.7% in 2022 (Figure 2.9.5). Meanwhile, the residential property price index retreated by 15.0% year on year in December and the property rental index by 4.1%.

The current account surplus equaled 10.7% of GDP in 2022. A decline by 1.1 percentage points from 2021 reflected a larger trade deficit mostly offset by a higher service surplus. The overall balance of payments

Figure 2.9.5 Monthly Inflation

Inflation edged up on moderate increases in food and energy prices.



Source: CEIC Data Company.

deficit meanwhile ballooned from 0.3% of GDP in 2021 to 13.0% in the same period last year, driven by huge outflows from capital and financial accounts. Gross official reserves fell from \$496.9 billion in December 2021 to \$424.0 billion at the end of 2022. Net external financial assets amounted to 4.9 times GDP at the end of 2022, providing a strong cushion against external shocks.

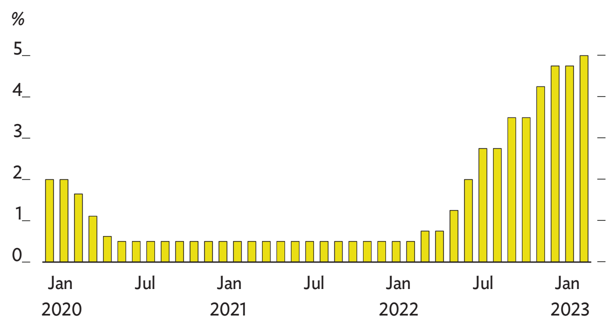
The budget deficit in fiscal year 2022 (FY2022, ended 31 March 2023) **is estimated to equal 4.9% of GDP.** This more than doubled the 1.9% originally planned. Expenditure was 0.3% higher than the original estimate, reflecting increased pandemic-related spending and massive countercyclical measures. Meanwhile, revenue was 15.7% lower than expected. Revenue from land premium and stamp duties declined significantly, owing to sluggish property and stock markets and fewer transactions.

Reflecting developments in the US, monetary policy tightened substantially in 2022. Following successive interest rate hikes by the US Federal Reserve, the Hong Kong Monetary Authority raised its base rate seven times last year to sustain the local dollar peg to the US dollar. The base rate increased from 0.50% in January to 4.75% in December, keeping the interest rate spread with the US Federal Funds rate constant at 50 basis points and the local dollar within the Linked Exchange Rate System tolerance band of HK\$7.75–HK\$7.85 to the US dollar (Figure 2.9.6).

Averaging 0.1% year on year, monthly growth in domestic credit flatlined, while broad money supply (M3) increased by only 1.6% in the year (Figure 2.9.7). Reflecting sharp monetary policy tightening by major central banks and slackening global growth, the local stock market suffered a marked correction last year. The Hang Seng Index plunged by 42.1% year on year to October 2022—to 14,687, the lowest since April 2019—as economic contraction depressed investor sentiment. It recovered strongly to 19,781 at year-end in December, and further to 21,842 in January 2023, on improved expectations following the PRC's exit from its zero-COVID strategy (Figure 2.9.8).

Figure 2.9.6 Policy Rate

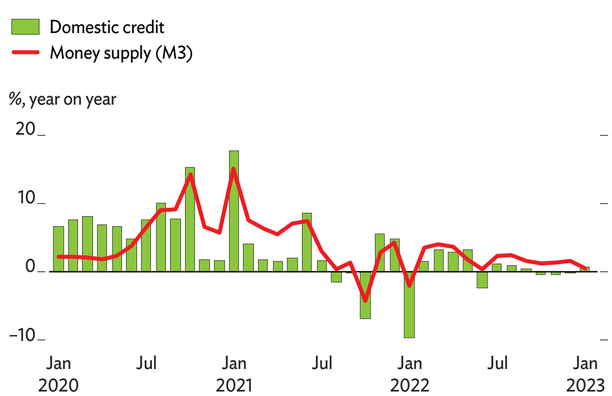
The base rate increased seven times in 2022 to keep the local dollar peg to the US dollar.



Source: CEIC Data Company.

Figure 2.9.7 Domestic Credit and Money Supply Growth

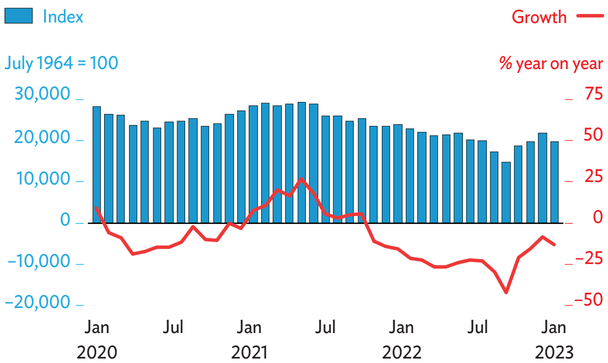
Growth in domestic credit slowed on tightened financial conditions.



Sources: CEIC Data Company and Hong Kong Monetary Authority.

Figure 2.9.8 Hang Seng Index

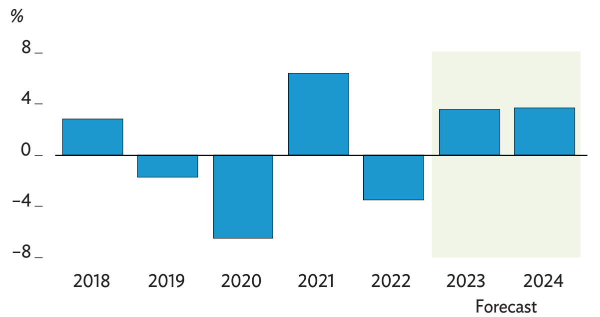
The local stock market suffered a marked correction amid tighter monetary policy.



Sources: CEIC Data Company.

Figure 2.9.9 GDP Growth

Growth will recover this year and next, buttressed by domestic demand and services.



Source: *Asian Development Outlook* database.

Economic Prospects

GDP growth is forecast to bounce back to 3.6% in 2023, buoyed by revived domestic demand and services (Table 2.9.1)**.** Reopening and the boost from a growth rebound in the PRC should support economic activity this year despite a weak global environment and lingering uncertainty about pandemic developments. GDP is projected to expand further by 3.7% in 2024 as more favorable global and domestic conditions underpin the economy's convergence with pre-2019 output (Figure 2.9.9).

Domestic demand is poised to recover, supported by a resilient labor market and improving business sentiment. The forecast assumes reopening fully accomplished in the first quarter of 2023, thus fostering robust resumption in economic activity this year. Private consumption will be the main driver of growth. Household incomes will benefit from rising employment and another round of consumption vouchers provided to eligible residents, while further relaxation of travel restrictions and containment measures will boost demand for consumer services. The labor market proved to be resilient as the seasonally adjusted unemployment rate improved to 3.3% in December 2022–February 2023, its best since November 2019. Fixed investment is seen to recover gradually on an improving business outlook. Official surveys indicated that, despite tightened financial conditions, one in five businesses in Hong Kong, China expected improved economic prospects in the first quarter of 2023. While a deteriorating external environment will continue to be a major drag on commodity exports in the first half of 2023, thereafter the anticipated acceleration of economic activity in the PRC and other major trade partners should provide some lift to the economy. Service exports are also projected to rebound alongside the pickup in growth. Tourist arrivals increased ninefold from December 2022 to February 2023 and are expected to gradually approach pre-pandemic levels this year and next. Imports of goods will rise as domestic demand continues to recover. Normalizing external and domestic conditions will sustain continued growth in domestic demand in 2024.

Table 2.9.1 Selected Economic Indicators, %

Growth will pick up this year and next, while inflation will remain moderate.

	2021	2022	2023	2024
GDP growth	6.4	−3.5	3.6	3.7
Inflation	1.6	1.9	2.3	2.1

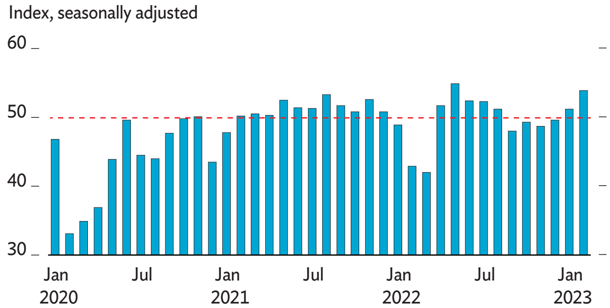
GDP = gross domestic product.

Source: Census and Statistics Department; Asian Development Bank estimates.

On the supply side, leading indicators show activity already expanding at the beginning of 2023. Easing pandemic restrictions buoyed the composite purchasing managers' index, a leading indicator of businesses' expectation of growth, from 49.6 in December 2022 to 51.2 in January (Figure 2.9.10). This reading was the first since August 2022 above the threshold at 50 separating expansion from contraction.

Figure 2.9.10 Purchasing Managers' Index

PMI edged up in January 2023 on easing pandemic restrictions.



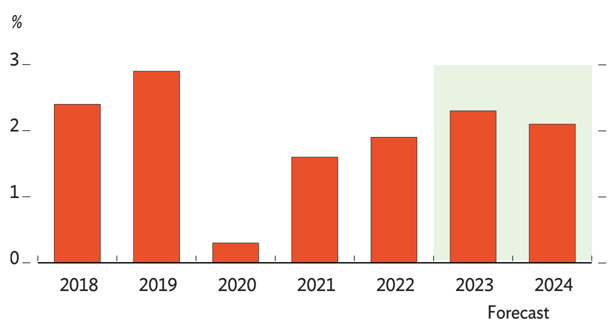
Source: CEIC Data Company.

Services, which provide 94% of GDP, will be the main engine of growth, with expansion in trade, financial, and professional services leading the recovery.

Headline inflation is forecast to average 2.3% in 2023 and 2.1% in 2024 (Figure 2.9.11). Price pressures will remain mild as the economy continues to operate below capacity and spillover from external price pressures remains largely contained. The rise in prices is expected to be gradual and broad based, with most consumer price index components picking up in tandem with the projected growth path.

Figure 2.9.11 Inflation

Inflation will remain low this year and next on muted price pressures.



Source: *Asian Development Outlook* database.

The FY2023 fiscal deficit is projected narrowing to equal 1.8% of GDP. Recurrent expenditure will increase by only 3.3%, mainly to support health care, social welfare, and education services. On the other hand, nonrecurrent expenditure will fall significantly by 53.0%, reducing total government expenditure by 6.0% to the equivalent of 25.0% of GDP. Meanwhile, earnings and profits tax are forecast to increase by 6.4%, revenue from land premium by 20.0%, and revenue from stamp duty by 27.0%. In the medium term, the government plans to contain expenditure gradually from 25.0% of GDP in FY2023 to 22.0% in FY2027 and to raise revenue from 21.0% of GDP to over 23.0%. This is projected to raise fiscal reserves to the equivalent of 25.6% of GDP by the end of FY2027, or coverage for 14 months of government expenditure.

Risks to the outlook hinge on how global headwinds evolve, lingering pandemic uncertainty, and reopening in the PRC. Unexpectedly aggressive monetary tightening by the US Fed—and, by extension, the local monetary authority—would worsen the outlook, particularly through higher mortgage rates and their depressive effect on the housing market. Persistent residual pandemic restrictions and continued weakening in global growth also pose risks, as they could dent business and consumer confidence. On the upside, recovery in the PRC that outpaces expectations would boost the projected pickup in external demand and foster faster growth in Hong Kong, China.

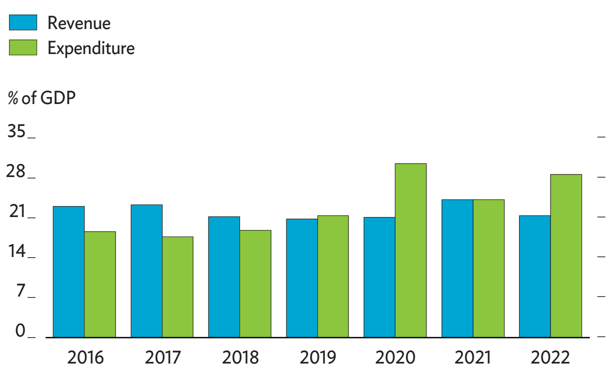
Policy Challenge—Tax Reform to Address Medium-Term Challenges

A simple and transparent low-tax system has been a key driver of economic success. According to accounting firm PricewaterhouseCoopers and the World Bank, Hong Kong, China had in 2020 the second most friendly tax system in the world, behind only Bahrain. A resident's income from employment in Hong Kong, China is taxed at progressive rates from 2% to 17%, and income earned abroad is not subject to taxation. The corporate tax rate is either 8.25% or 16.5%, depending on how much income was earned in Hong Kong, China. No taxes are charged on capital gains, interest, or dividends, and there is no net-worth, public benefit, or sales tax.

While a low-tax environment has boosted competitiveness, it leaves fiscal revenue highly dependent on the business cycle. Indeed, fiscal revenue can be volatile and fall substantially in downturns. Economic downturns slashed tax revenue by 8.4% in FY2019 and 2.5% in FY2020 compared with average tax revenue in FY2017 and FY2018. In contrast, a growth rebound in FY2021 boosted tax revenue by 10.7% (Figure 2.9.12). Partly because of uncertainty inherent in such revenue variability, the government follows a prudent fiscal approach. That is, public expenditure is allowed to increase only in line with fiscal revenue, aiming to maintain a balanced budget and substantial fiscal buffers. This strategy paid dividends during the pandemic as ample fiscal space allowed the government to provide significant support to the economy. However, two structural factors are likely to put pressure on public spending in the medium term.

Figure 2.9.12 Government Revenue and Expenditure

Government revenue increased in 2021 on robust economic growth.



Sources: Financial Services and the Treasury Bureau; The 2023-24 Budget Speech.

First, population aging will affect Hong Kong, China significantly in the coming years. Government demographic projections indicate that the share of the working-age population aged 15–64 will drop from 69% in 2022 to 64% in 2030 and further to 59% in 2050. Meanwhile, the share of people aged 70 and older will increase from 13% in 2022 to 19% in 2030 and further to 27% in 2050. With an older population, spending on pensions, health care, and other social services will have to increase.

Second, public expenditure to safeguard against adverse climate change and extreme weather is bound to increase. As a coastal city, Hong Kong, China is vulnerable to climate change in various ways. Extreme precipitation has become more frequent. Average annual temperatures increased by 0.28°C per decade during 1993–2022, while the average number of days with a maximum temperature reaching at least 33°C rose from 10 in 1981–2010 to 37 in the past 10 years. Relative to the average in 1995–2014, the annual mean sea level in 2100 is projected to rise by 0.37–0.82 meters under a scenario with intermediate greenhouse gas emissions and by 0.57–1.08 meters under very high emissions. While a green transition will provide opportunities to raise taxes, their potential benefit to the fiscal balance remains more uncertain so far than is the increased spending needed to mitigate and adapt to climate change.

A tax system structurally adjusted to increase revenue is needed to finance higher spending, sustain fiscal balance, and safeguard competitiveness. This challenge was recognized in the FY2022 budget, which highlighted broadening the tax base as the main pillar of tax reform. In this respect, the proposed introduction of a progressive rating system for domestic properties, whereby higher-valued properties pay higher rates, is a step in the right direction and would structurally increase tax revenue. The introduction of the global minimum effective tax rate on large multinational enterprise groups as advocated by the Organisation for Economic Co-operation and Development (OECD) and the implementation of the domestic minimum top-up tax should also have positive effects. As suggested by the International Monetary Fund, other alternatives include introducing a value-added tax, increasing personal income tax rates for the top brackets, and taxing capital gains and dividends. Hong Kong, China will need to strike the right balance when changing its tax system. Designing and implementing comprehensive tax reform will be key to ensuring fairness, fiscal sustainability, and competitiveness.