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Hong Kong Economic Update – November 2014

Summary

Economy

- Hong Kong's economy regained momentum and grew by 2.7 per cent (yoy) in the third quarter, driven by stronger exports and private consumption. This was better than expected and above Government's full-year forecast for 2014 (2.2 per cent).

- Private consumption expenditure strengthened after two quarters of slowdown, backed by low unemployment (3.3 per cent in October) and solid income growth. However, private investment expenditure declined further. Some businesses expressed concerns that recent protests have weakened demand.

- Housing market revived and trading volumes picked up in the third quarter. Overall flat prices in September exceeded the 1997 peak by 54 per cent and the housing affordability ratio remained relatively high at 57 per cent in the third quarter up from 44 per cent and 54 per cent respectively last quarter.

Financial Sector

- The Hang Seng Index remained volatile between June and October. Despite a volatile market, fund raising activities rebounded in the third quarter. Total equity capital raised has reached a high level as IPOs (initial public offerings) surged by 36.5 per cent compared to the previous quarter to HK$49.2 billion (£4 billion).

- Hong Kong's banking sector remained strong. Overall loan growth continued in the third quarter but at a moderate rate, slowing from double digit growth to 7.7 per cent (yoy). HKMA said it will continue to monitor with vigilance.

- HKMA has introduced a range of measures / facilities - including the Primary Liquidity Providers, Intraday Repo, and a lift of the 20,000 RMB daily conversion limit - to enhance RMB liquidity flow in preparation for the launch of the Shanghai Hong Kong Stock Connect. Norman Chan, Chief Executive of HKMA said that it has been a "bumper year" for Hong Kong's RMB business with robust growth in all areas.

- In September, the HKSARG announced its support for the common reporting standard on the automatic exchange of tax information and committed to implement the standard by end of 2018.

- The Shanghai Hong Kong Stock Connect was successfully launched (three weeks later than market expectations) on 17 November. Despite slackened demand in the short term, market participants and government officials agree on its long-term potential.

Economy

1. Hong Kong's economy regained momentum and grew at a solid rate of 2.7 per cent in the third quarter, compare to the same period last year. On a sequential basis, real GDP grew 1.7 per cent in the third quarter, rebounding from a contraction of 0.1 per cent in the second quarter. Growth performance surpassed market expectations of 1.8 – 2 per cent. The government explained that this improvement was driven by stronger exports of goods, services and private consumption. Yet, with underlying global economic issues and the uncertainties created by the ongoing Occupy movement, the government has now forecasted growth at 2.2 per cent this year, lower than IMF's forecast of 3 per cent in May.

Exports outlook remains challenging, despite improvement in total exports

2. Total exports of goods grew another 1.3 per cent in the third quarter (yoy), after a growth of 2.4 per cent in the second quarter. The government explained that improved trading environment in some external markets has helped to support export performance during the third quarter. However, uneven global recovery, particularly in advanced economies (which make up 24 per cent of HK's exports), moderate expansion in the US, sluggish and disinflationary pressure in the EU, and tax-induced economic contraction in Japan will all continue to adversely affect HK's exports. Meanwhile, the Mainland (destination of over 50 per cent of Hong Kong's exports) remained the main driver to exports growth.

Chart 2 : Total exports of goods by major markets (year-on-year rate of change in real percetage terms)

	2014		2013				
Countries	Q3	Q2	Annual	Q4	Q3	Q2	Q1
China	3.6	4.5	4.9	2.8	2.8	6.3	8.5
US	0.4	3.1	-4.3	-3.6	-1.0	-8.0	-5.0
EU	-0.4	4.3	-0.6	2.4	2.7	-2.5	-5.4
Japan	-5.1	-1.5	-6.3	-6.2	-8.3	-5.5	-4.9
India	37.9	17.4	7.7	16.8	6.7	8.0	0.3
Taiwan	13.5	0.2	-6.1	-13.9	-7.6	-12.1	14.2
Korea	7.0	4.5	6.3	18.6	4.5	2.0	0.5
Singapore	2.9	-0.6	2.5	6.2	-0.9	0.2	5.2

Source: Census & Stats Dept., HKSARG

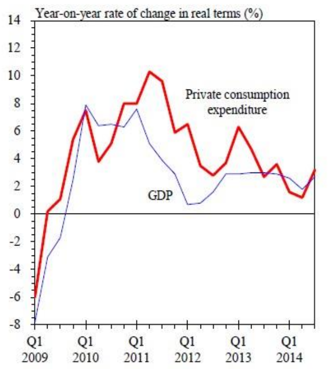
3. Exports of services improved during the third quarter, growing 2 per cent (yoy) compared to a decline of 2 per cent in the second quarter. Government explained that the primary reason was due to the pick-up in visitor arrivals, which benefited exports of

travel/tourism services during the third quarter. Secondly, reviving trade and production activities across Asia helped support trade-related services growth, which grew 2.7 per cent. Finally, vibrant cross-border financial and fund raising activities helped support exports of financial and business services.

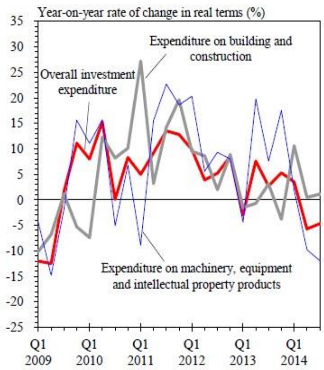
Domestic consumption remains on track, but signs that business sentiment has been dented by Occupy

4. Domestic demand grew moderately in the third quarter. Private consumption expenditure (PCE) strengthened and grew 3.2 per cent (yoy) after two quarters of slowdown; on a quarterly basis, PCE rebounded to 1.9 per cent growth. Retail sales in September grew 4.8 per cent. The government explained that demand was driven by strong sales of new smart phones. In addition, consumer sentiment was also supported by low unemployment (3.3 per cent in October) and solid income growth (general gross increase of around 4 per cent as of June and inflation of 3.4 per cent in October). In addition, under the current bi-annual revision of the minimum wage, nominal income growth of grassroots worker will continue to rise.

Private Consumption Expenditure Rebound



Investment Spending Decline further



Source: Census and Statistic Department

5. However, investment expenditure remained soft, which resulted in only modest growth in domestic demand. Overall investment spending in terms of gross domestic fixed capital formation fell for the second consecutive quarter by 4.7 per cent, after a decline of 5.7 per cent in the previous quarter. The decline was dragged by subdued machinery and equipment acquisition (-11.9 per cent) and a high base comparison due to subpar growth in recent quarters. Meanwhile, HSBC's Hong Kong Purchasing Managers' Index (PMI) was 47.7 in October, down from 49.8 in September, reflecting deterioration in the local business environment; some commentators suggested demand may have been affected by recent protest.

6. Nevertheless, Hong Kong's fundamentals remain strong and will continue to support domestic demand. The government remained cautiously optimistic on domestic consumption outlook but was conscious that business sentiment in the fourth quarter may be further impacted by the ongoing Occupy Movement.

7. The Commission on Poverty reported Hong Kong's latest poverty situation at its 15th meeting on 29 November. Hong Kong's poor population decreased from 1.02 million in 2012 to 970,000 in 2013. The overall poverty rate also dropped from 15.2 per cent of inhabitants to 14.5 per cent. The government said both indicators were at their lowest level in five years. The government explained that the recurrent cash policy intervention such as the Old Age Living Allowance has helped significantly and alleviated poverty among the elderly.

Property

8. Housing market revived and trading volume resumed in the third quarter. Trading volume on residential property grew 25 per cent in the third quarter to 19,962, but this level remains lower than the long-term average of 23,600 per quarter over 1994 - 2003. Meanwhile, residential property prices grew 6 per cent in the third quarter with a year-todate cumulative increase of 8 per cent. Overall flat prices in September exceed the 1997 peak by 54 per cent and the housing affordability ratio remained relatively high at 57 per cent in the third quarter.

9. On housing supply, latest government figure shows that primary (new) housing supply in the private market increased to 74,000 units in 2014. In the first nine months of 2014, private housing completion has reached 12,200 units, surpassing full year completions between 2011 and 2013 (and also 70% of the 17,610 annual target); new housing starts during the same period also rose 31% (yoy) to 13,900 units. Increasing housing supply will continue to be the Government's top priority both to address public demand as well as to ensure healthy development in the property market.

10. On home financing, applications for mortgages increased 5.2% in October to 11,698, compared to September. Approval of mortgage loans for both primary market homes and secondary market homes increased by 15 per cent (to HK$7.9 billion or £632 million) and 2 per cent (to HK$15.9 billion or £124 million) respectively. Meanwhile, mortgage loans for refinancing increased by 10 per cent to HK$4.5 billion (£351 million). Majority (over 80%) of the new mortgage loans prices are referenced to HIBOR. This suggests that pending global interest rate hikes could be the biggest risk to the housing market.

11. Meanwhile, risk of a property market bubble to Hong Kong's financial system remains low. Macro-prudential measures introduced by the Hong Kong Monetary Authority since 2009 have proved to be effective. The average loan-to-value ratio of new mortgages dropped from 64 per cent in January to October 2009 to 56 per cent in the third quarter of this year. The debt servicing ratio also tightened from 41 per cent in August 2010 to 36 per cent in August this year. Mortgage delinquency ratio currently stands at a very low rate (0.02 per cent).

Occupy and the Economy

12. Although Occupy has had an impact on specific areas of the Hong Kong economy and may be affecting business sentiment as noted above, its overall effect to date has been slight. Estimates of the impact on 2014 GDP growth range between 0.1 and 0.4 per cent. Indicators of confidence in Hong Kong's economy – the Hang Seng Index, the Hong Kong dollar, few signs of capital flight and votes of confidence from credit ratings agencies – have held up.

13. It has been almost business as usual for most sectors. HKMA has affirmed throughout Occupy that financial services (15 per cent of GDP) activities continue as normal; the same can be said of trade and logistics (26 per cent of GDP). Figures from individual retailers show some have seen a real impact – more acute around protest zones – but early retail statistics for September suggest continued growth (see para 4). Furthermore, concerns that the impact of Occupy on tourist numbers would be severe appears to have

been overstated: the latest figures suggest that tourist growth remained strong at or 13 per cent (yoy) in October including an 18 per cent rise in Mainland tourist arrivals. See here for BCG's other reporting on this issue.

Financial

14. The Hang Seng Index remained volatile between June and October. In the first part of the period, market sentiment was boosted by the expected launch of the Shanghai Hong Kong Stock Connect (SHKSC). Whilst the SHKSC launch occurred later than expected, this was not the main drag on the market; the HSI was principally affected by the weakerthan-expected global economic recovery and deepening global uncertainties. The HSI finished September at 23,842, 4 per cent higher than the end of the third quarter.

15. Despite a volatile market, fund raising activities rebounded in the third quarter. Total equity capital raised surged as IPOs (initial public offerings) grew 36.5 per cent quarteron-quarter to HK$49.2 billion (£4 billion).

16. Hong Kong's banking sector remained strong: robust consolidated capital adequacy ratio (16.1 per cent, well above the minimum international standards), high liquidity ratio (40.8 per cent), and strong profits (7.3 per cent, driven by net interest income). HKMA is confident that the banks will have no difficulty in complying with the BASEL III liquidity standards, which will phase in during 2015, given their favourable liquidity position.

17. Overall loan growth continued at a moderated rate, slowing from double digit growth in the previous two quarters to 7.7 per cent (yoy) in the third quarter. Meanwhile, both the Hong Kong and US dollar loan-to-deposit (LTD) ratio remained steady at 81.8 per cent and 90.5 per cent respectively. HKMA said on the demand-side, the main risk was macroeconomic uncertainties led by normalisation of the US monetary policy; on the supply-side, banks have adopted a more cautious approach to credit risk management amid some isolated loan default incidents. HKMA said it will continue to conduct supervision on banks' operations to maintain stability within the banking sector.

18. The fund management business continued to grow during the third quarter. Aggregate net asset value of the approved constituent funds under the MPF schemes edged up 0.7 per cent to HK$547 billion between end of June and end of September. The monthly average gross retail sales of mutual funds rose 12.1 per cent from the preceding quarter to US$7.7 billion in July and August. Conversely, the amount of net assets managed by retail hedge funds declined.

Financial Policy Development

19. To enhance the existing Deposit Protection Scheme (DPS), the Hong Kong Monetary Authority and the Treasury Bureau jointly issued a consultation paper in September. The consultation seeks public view to enhance compensation procedures and the use of electronic communication for notification purposes.

20. In September, the HKSARG announced its support for the common reporting standard on the automatic exchange of tax information and committed to implement the standard by end of 2018. The HKSARG has launched a consultation process before tabling necessary legislation, which the aim to pass in 2016.

21. On 13 November, Hong Kong and the United States signed an inter-governmental agreement to facilitate compliance with the US Foreign Account Tax Compliance Act (FATCA) by financial institutions in Hong Kong. Under the agreement, financial institutions in Hong Kong are required to register and conclude separate individual agreements with the US Internal Revenue Services.

RMB Business

22. Norman Chan, Chief Executive of HKMA said in a meeting with Chinese financial authorities and a delegation from the Hong Kong Association of Banks on 27 November that it has been a "year of harvest" for Hong Kong's RMB business with robust growth in all area:

    - **RMB deposits** amounted to RMB943.6 billion at end of October, a slight decrease of 0.1 per cent compare to the previous month. Shortage of RMB deposits was anticipated prior to the debut launch of the Shanghai Hong Kong Stock Connect but there are other factors including year-end demand for RMB and planning for business development in the new year. This has led banks to raise interest rates to compete for new deposits. Banks analysts are split on the prospects for CNH deposits – some predict some fluctuation but that generally level will remain flat, while other are more bullish, predicting a rise to RMB 1.3bn by the end of 2014.

    - **RMB cross-border trade settlement** amounted to RMB532 billion in October, compared with RMB 605.6 billion in September. Despite this month-on-month drop, during the first 10 months of this year, banks in Hong Kong handled RMB 5 trillion (£390 billion) of trades settled in RMB, up 73 per cent from a year earlier.

    - **RMB bond market** remained active. Issuance during the first ten months of this year has accumulated to RMB166 billion, an increase of 40 per cent from last year.

    - **RMB loan** continued to grow. Total outstanding RMB loans increased to RMB170 billion at end of October, an increase of 45 per cent from end of 2013.

    - **RMB RTGS** daily volume turnover doubled to RMB 800 billion in October this year from RMB 400 billion in 2013.

23. On 3rd November the Hong Kong Monetary Authority appointed seven banks (including HSBC and Standard Chartered) for a term of two years as **Primary Liquidity Providers** (PLPs) for offshore RMB market in Hong Kong. The initiative will help make CNH products in Hong Kong more liquid and support CNH business worldwide.

24. HKMA also announced the introduction of **Intraday Repo under the RMB Liquidity Facility**. Under the new facility, HKMA will provide intraday RMB funds of up to RMB 10 billion to assist participating authorized institutions to manage their RMB liquidity. The facility will offer greater flexibility to banks to manage their payment flows, especially when the volume of payments increase as the SHHKSC developed in the medium long term.

25. On 12th November, The Hong Kong Monetary Authority announced the **lift of the**

RMB20,000 conversion limit imposed on Hong Kong residents' RMB deposits. The HKMA said that the removal of the conversion limit will make it more convenient for Hong Kong residents to participate in the Shanghai Hong Kong Stock Connect and other RMB financial transactions.

26. On 27th November, the Hong Kong Monetary Authority renewed the **currency swap** of RMB 400 billion with the People's Bank of China for another three years.

27. On 28th October, the Hong Kong Monetary Authority signed a **Memorandum of Understanding** on RMB business cooperation **with the Banque de France** to strengthen cooperation on RMB business development between Hong Kong and Paris.

Shanghai Hong Kong Stock Connect (SHKSC)

28. The pilot programme which enables overseas investors to invest in the Mainland's Ashare market through Hong Kong; and Mainland investors to invest in Hong Kong launched on 17 November.

29. After a rush northbound (from HK to China) on day one demand has been subdued, as less than 20 per cent of the daily quotas being filled (quotas are RMB 10.5bn southbound, RMB 13bn northbound). For more reporting from the BCG on the SHKSC, see here.

30. Despite slackened demand, most parties remain optimistic that trade will pick up over time. Financial Secretary John Tsang is confident that the newly launched scheme will be successful in the long term; and market participants also agree that more investor education work will require to grow investors' confidence into the scheme.

Contacts

Kathleen Poon | kathleen.poon@fco.gov.uk | +852 2901 3249