British
Consulate-General
Hong Kong

Hong Kong Economic Update – MAY 2014

Summary

Economy

- Hong Kong's economy grew 2.5 per cent (year-on-year) in the first quarter. This is the slowest quarterly growth in 18 months and is lower than the market expectation of 3 per cent. Nonetheless, Government and market consensus remain confident the Hong Kong's growth across 2014 will hit the 3-4 per cent Government target.
- Hong Kong's trade performance remained weak in the first quarter but may improve in the second half of this year.
- Growth in domestic demand remained firm, but decelerated.
- Hong Kong and the Association of Southeast Asian Nations (ASEAN) have agreed to pursue a bilateral Free Trade Agreement (FTA).
- The Competition Commission is developing guidelines for the implementation of the Competition Law in 2015.
- Hong Kong's property market has stabilised with a rise of 1 per cent in the first quarter. The government proposed some small relaxations on the double stamp duty for Hong Kong permanent residents buyers but this is not a sign for further relaxation.

Financial Sector

- Hong Kong banking sector remains resilient: good asset quality and strong capital adequacy ratio.
- Hong Kong is reviewing the taxation of corporate treasury activities to attract multinational corporations to set up their Corporate Treasury Centre (CTC) in Hong Kong.
- Offshore RMB business in Hong Kong remained active and strong. RMB deposits in Hong Kong increased 2.7 per cent from previous month to RMB 944.9 billion. Total remittance of RMB for cross-border trade settlement amounted to RMB602.4 billion.
- On 10 April, the Shanghai-Hong Kong Stock Connect (SHKSC) pilot was approved by the Central government and jointly announced by the Chinese Securities Regulatory Commission and the Hong Kong Securities and Futures Commission.

Economy

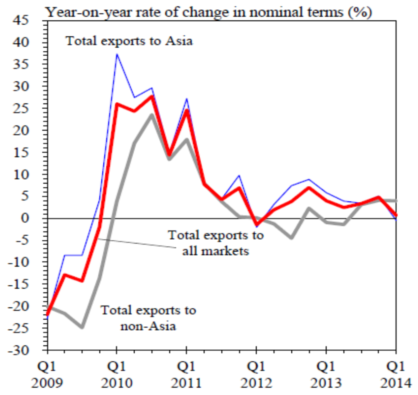
1. Hong Kong's economy grew 2.5 per cent (year-on-year) in the first quarter, a slower rate than the previous quarter (2.9 per cent). This is the slowest quarterly growth in 18 months and is lower than the market expectation of 3 per cent. On a quarterly basis, the economy grew 0.2 per cent this quarter compare to 0.9 per cent last quarter. The main drag came from the continued sluggish external demand and decelerating domestic consumption. Nonetheless, backed by improved global conditions as projected by the International Monetary Fund, the government remains confident the economy will maintain a 3-4 per cent growth rate over the whole year.

Merchandise trade may improve in the second half

2. Hong Kong's trade performance remained weak in the first quarter. Total exports of goods slowed from 5.7 per cent growth in the previous quarter to 0.5 per cent in the first quarter of this year. Causes include the slowdown in non-monetary gold, weak demand in advanced Economies (EU and US) and falling demand from Asian countries.

3. Whilst Asian markets continue to weight significantly on Hong Kong's exports, *Chart 1* shows that the fall in *total exports to Asian markets* was greater than the fall in *total exports to non Asia markets* in the first quarter, for the first time since 2009. Merchandise exports in the first quarter to major Asian economies were fairly mixed (see *Chart 2*). Total exports to the Mainland fell 2.9% (year-on-year) whilst other countries such as Singapore continued to grow solidly.

Chart 1



Source: Census and Stats Dept., HKSARG

4. Looking forward, the government expects that trade performance will improve during the rest of the year, backed by the International Monetary Fund's (IMF) projection of global growth at 3.6 per cent this year.

5. Meanwhile, exports of services continued to expand in the first quarter at a moderated pace of 3.1 per cent, down from 4.7 per cent in the previous quarter, year-on-year. Sluggish trade flows among the region led to a decrease in trade related services (-0.2 per cent) and transportation services (1.6 per cent). However, strong inbound tourism - thanks to continued growth of Mainland visitors, which grew 20 per cent in the first quarter to 11.4 million - has helped support travel services (7.9 per cent growth). Financial and business services growth (2.0 per cent) was backed by active fundraising activities (see point 20 below).

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

	2013				2014
Countries	Q1	Q2	Q3	Q4	Q1
China	8.5	6.3	2.8	2.8	-2.9
US	-5.0	-8.0	-1.0	-3.6	3.9
EU	-5.4	-2.5	2.7	2.4	1.2
Japan	-4.9	-5.5	-8.3	-6.2	-2.1
India	0.3	8.0	6.7	16.8	7.6
Taiwan	14.2	-12.1	-7.6	-13.9	-5.9
Korea	0.5	2.0	4.5	18.6	1.8
Singapore	5.2	0.2	-0.9	6.2	6.8

Source: Census & Stats Dept., HKSARG

Growth in domestic demand remained firm, but decelerated

6. Demand from households and businesses grew at a steady but decelerated pace. Private consumption expenditure grew 2.0 per cent (year-on-year) in the first quarter of this year compared to 3.6 per cent in the previous quarter. Overall investment spending increased 3 per cent. Government consumption expenditure also grew steadily at 2.4 per cent.

7. Retail sales in March fell another 1.3 per cent after a fall of 2.2 per cent in February this year. The main drag came from decline in sales of valuable items such as jewellery, watches and clocks (-8.9 per cent in value) and electronic goods and photographic equipments (-15.3 per cent in value).

8. As mentioned in previous reports, Mainland visitors per capita spending is declining. Visitor spending as a percentage of total consumer spending in local retail market has dropped from the peak of 27.6 per cent in the second quarter of 2013 to 7.9 per cent in the first quarter this year. This may in part be driven by the increasing proportion of same-day visitors, who according to Goldman Sachs analysis spend 3 times less per capita than overnight Mainland visitors. Official statistics show that there were 6.7 million same-day visitors (an increase of 21 per cent) compare to 4.7 million overnight visitors (an increase of 19 per cent) during the first quarter of this year.

9. Despite the decrease in retail sales in recent months, the government remains cautiously confident in Hong Kong's strong fundamentals: a full employment situation (unemployment at 3.1 per cent in April); stable inflation (consumer price inflation at 3.5 per cent in April and forecast at 3.7 per cent for 2014) and a growing flow of inbound tourists will continue to support domestic consumption.

10. Business sentiment remained positive, although small and medium-sized enterprises (mainly on retail, restaurants, and real estate sectors) remained cautious. The special stamp duty measures, a possible quota or tightening on the Individual Visit Scheme for Mainland tourists, higher rents, food and labour costs (e.g. proposed minimum wage rise to HK$38 per hour from HK$30), contributed to business uncertainty.

The 2014-15 Budget will soon be approved in the Legislative Council

11. After three weeks of filibustering, the Budget Appropriation Bill is expected to pass the Legislative Council by 4 June.

12. Chief Executive, CY Leung, urged legislators to stop filibustering following the latest IMD World Competitiveness Rankings 2013, which lowered Hong Kong's ranking from third fourth place. Whilst most commentators are confident that Hong Kong remains highly competitive, some agree that Hong Kong will need to improve in the

areas of research & development as well as education to maintain its competitiveness.

13. The government announced on 26 April that Hong Kong and the Association of Southeast Asian Nations (ASEAN) will pursue a bilateral Free Trade Agreement (FTA). Gregory So, Secretary for Commerce and Economic Development, said the FTA will enhance trade and investment flows between ASEAN and Hong Kong. ASEAN is Hong Kong’s second largest trading partner in terms of goods and fourth largest in terms of services.

14. Major areas covered in the FTA include tariff reduction / elimination, preferential rules of origin, services liberalisation, investment promotion and dispute settlement mechanism. A public consultation on the agreement was launched on 26 May in preparation for bilateral negotiations in July this year.

15. Since the bill passed two years ago, the Competition Commission (established in May last year) has developed guidelines for the implementation of the Competition Law in 2015. The Commission is seeking views from businesses and other stakeholders on implementation of guidelines until July this year. The ordinance aims to tackle two types of anti-competitive behaviour – price fixing and market sharing and the abuse of market power. SMEs have voiced concerns they may unknowingly break the law due to unfamiliarity of the ordinance. The Commission has reassured SMEs that it will provide all necessary support, and enforcement will initially be lenient.

Property Market

16. Hong Kong’s property market continued to adjust, as residential property prices fell 1 per cent during the first quarter. Property sales transactions dropped again, falling 34 per cent compared to the first quarter last year and 9 per cent compared to the previous quarter. Despite the fall, March property prices still surpassed the 1997 peak by 41 per cent and housing affordability ratio has edged up slightly to 56 per cent from 54 per cent last quarter.

17. On residential mortgages, loans drawn down increased from 9.7 per cent in February to 23.7 percent in March, and the number of mortgage applications in increased 30.8 per cent compared to the previous month. Mortgage delinquency ratio remained unchanged at 0.02 per cent and rescheduled loan ratios remained unchanged at 0 per cent. The number of mortgage loans in negative equity, whilst growing apace, remains small and the overall risk it poses is low.

18. On flat supply, the government continues to work towards its commitment to build 470,000 units over the next ten years: 8,000 private units began construction in the first quarter, the highest number since 2004; and 2,900 units completed. The construction industry projects a record high in residential flats commenced this year.

19. Chief Executive, CY Leung, said on 1 April that the property market is no longer “overheating”, and he announced data that shows that foreign buyers (mostly from

the Mainland) have dropped. Hence, he announced the suspension of the "Hong Kong Property for Hong Kong people" scheme (a 2012 initiative allowing exclusive purchase by Hong Kong permanent residents on selected new builds).

20. Whilst market consensus is that it is too early to expect major policy change on governmental tightening measures, the government proposed some small relaxations to the Stamp Duty (Amendment) Bill to the Legislative Council on 13 May. The two principal measures focused on double stamp duty measures, specifically extending the grace period from temporary sales agreements to time when the property is acquired and exemptions on one car parking space.

21. The government reiterated that this does not signal any relaxation of its tightening measure in the short-term as uncertainties (ie fund flow and interest rate direction) remain, nor will it include a sunset clause in the bill.

22. Looking forward, analysts cite the main influences on the property market as: interest rate uncertainties, moderated growth in China, continued increases in land and housing supply, and even a flavour of disagreement on political development in HK will all affect the housing market. Most market analysts expects price to fall between 10 – 15 per cent this year whilst some extreme projections are as high as 30 per cent by 2015.

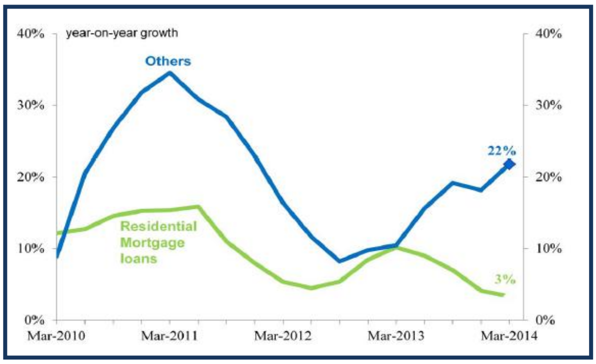
Financial

23. The Hong Kong stock market remained volatile. The **Hang Seng Index fell 5 per cent** in the first quarter, compared to the previous quarter. Market volatility was affected by possible increase of interest rates, signs of slower growth in the Mainland and the geopolitical risks around Eastern Europe. Whilst the market demonstrated signs of volatility, Norman Chan, Chief Executive of the HKMA said in April that so far Hong Kong is experiencing little capital outflow and its impact on the banking system remains small.

24. Fund raising activities continued but less active compare to previous quarter due to market volatility. The **Hong Kong Stock Exchange raised HK$46 billion (£3.7 bn) of funds through initial public offerings (IPO)** in the first quarter. HK Electric Investments' HK$24 billion (£2 bn), one of Asia's biggest IPO in the first quarter, alone contributed over 50 per cent of all funds raised through IPO. Mainland related stocks continued to dominate the stock market and accounted for 60 per cent of total equity fund raised.

25. **Hong Kong banking sector remains resilient**. Banks' total **capital adequacy ratio is high** at average of 15.9 per cent at end of 2013. HKMA said that all AIs should have no difficulty in complying with the statutory minimum requirement under the BASEL III framework. **Asset quality of the local banking sector was also good**: ratio of substandard loans to total loans and the delinquency ratio for

residential mortgages remained at a very low level (less than 1 per cent) in the first quarter.



26. On banking activities, total loans and advances slowed slightly and decreased by 1.2 per cent in March. Loan growth cooled but remained active during the first quarter: loans for use in Hong Kong rose 6.5 per cent in the first quarter. Such expansion was led by trade finance (12.4 per cent), loans to manufacturing (7.4 per cent), and loans for financial related activities (11.6 per cent). Affected by a quiet property market, loan growth for residential mortgages (1 per cent) and building, construction, property development and investment (2.8 per cent) remained quiet. HKMA remains confident that credit risk is low but will maintain close supervision on credit growth situation in banks.

27. IMF noted that an increase of credit growth to Mainland enterprises has increased Hong Kong banks' Mainland asset exposure to increase to 19% of total assets (USD2.5trn). IMF said this does not pose immediate risk to banks in Hong Kong. However, it warns that close monitoring is necessary, in the unlikely possibility that China experiences a shock.

Policy Development

28. The Financial Secretary has set up a task force to **review the taxation of corporate treasury activities under the Inland Revenue Ordinance** in order to attract multinational corporations to set up their Corporate Treasury Centre (CTC) in Hong Kong. The task force will come up with concrete proposals in 12 months. HKMA will also take on the role to promote HK as a destination for CTCs.

29. On 25 March, **Hong Kong and the United States (US) signed an agreement for exchange of information relating to tax**. This is the **first tax information exchange agreement (TIEA) signed by HK**. Professor KC Chan, Secretary for Financial Services, said signing of the TIEA with the US demonstrates Hong Kong's continued commitment to its international obligations on tax transparency. The agreement will become effective once it is passed by the Legislative Council.

30. In March, the Government launched the **consultation to introduce the new open-ended fund company structure, to expand Hong Kong's legal infrastructure for investment fund vehicles**. This aims to provide market participants with more flexibility in establishing and operating funds in Hong Kong. The government is hoping that the proposal will attract more mutual funds and private funds to domicile in Hong Kong.

RMB Business

31. Offshore RMB business in Hong Kong remained active and strong:

- In April, HK's RMB real time gross settlement system (RTGS) registered an average daily turnover of close to RMB700 billion (12 times the 2011 level); daily average turnover of RMB spot and forward transactions at US$20 - 30 billion.

- In March, RMB deposits in Hong Kong increased by 2.7 per cent to RMB 944.9 billion; total remittance of RMB for cross-border trade settlement amounted to RMB602.4 billion compare to RMB394.1 billion in February.

- In the first quarter, RMB bond issuance was especially active, surging by 43.4 per cent (compared to the preceding quarter) on the back of vibrant issuance by international corporate and financial institutions. Outstanding RMB loans rose 4.4 per cent in the first quarter (compare to the preceding quarter) to RMB121 billion.

- Ministry of Finance announced in April that it will issue RMB28 billion offshore RMB bonds in Hong Kong, its fifth issuance since 2009. The first batch of RMB16 billion was issued on 21 May and has received robust demand with 2.99 times overall coverage ratio for the transaction. The remaining RMB12 billion will be issued in the second half of this year. The bond will be listed and traded on the Hong Kong stock exchange.

- Hong Kong Exchange and Clearing (HKEx) launched new RMB denominated products this quarter, including the first deliverable RMB currency futures in the world on 7 April.

32. On 10 April, **the Shanghai-Hong Kong Stock Connect (SHKSC) pilot** was approved by the Central government and jointly announced by the Chinese Securities Regulatory Commission and the Hong Kong Securities and Futures Commission. The SHKSC is a pilot program which allows mutual stock market access between Mainland China and Hong Kong (Diptel1403175 reported on 16 April). The scheme, as Charles Li, Chief Executive of the Hong Kong Exchange and Clearing said "is a very significant breakthrough in the opening of China's capital market".

33. The pilot scheme is also significant to Hong Kong as it **reflects Hong Kong's strategic position in China's wider financial reform as well as in strengthening its position as a leading offshore RMB centre**. Hong Kong will act as a platform for foreign investors to invest in the Mainland stock market, which is looking to broaden its investor base through increased exposure of international and institutional investors.

34. Although the imminent impact may not be significant, the market generally welcome the new scheme as it offers an additional channel to invest into China (besides QFII and RQFII). Importantly, Market observers agree that this connect will be the first of many potential connections between HK and Mainland markets – for example, commodities or the bond market. The scheme is aimed to be launched in about six months' time (around October this year) after the preparatory work is finished.

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