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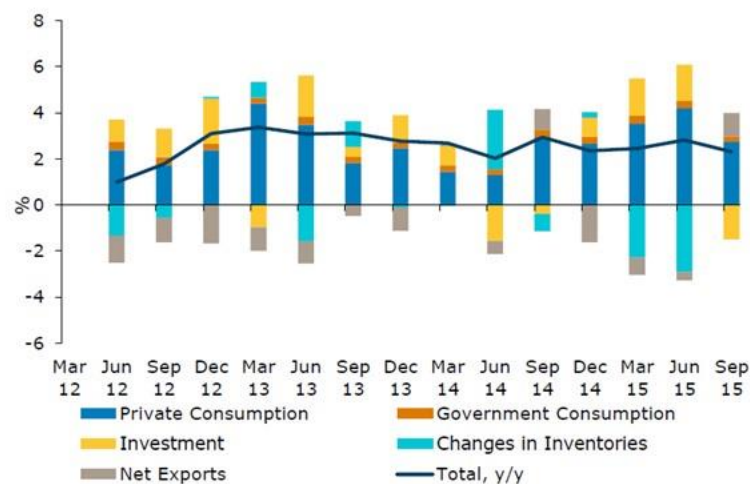
British
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Hong Kong Economic Update – November 2015

Summary

Economy

GDP Growth by Economic Activity



Source: ANZ Research

- Hong Kong's economy grew at 2.3 per cent (year-on-year) in the third quarter, better than market expectations of 2.0 per cent. The government now expects that growth will be around 2.4 per cent this year.

- Growth was dragged down primarily by weak investment outturn which declined sharply by 6.5 per cent year on year, from a 5.2 per cent gain previously. This was primarily due to lower machinery, equipment investments.
- External trade also slackened further with goods exports and imports declining by 3.2 per cent and 4.1 respectively in the third quarter, compare to a year earlier. Private consumption also slowed to 4.3 per cent but still remains as the key driver to growth. Both weak domestic and external demand reflects the impact of the slowdown in China.
- Despite better than expected growth, headwinds remain: businesses investment sentiment has been weakened due to the slackening global economic outlook and retail businesses have been affected by the drop in inbound tourism, stock market volatility, and strong US currency.
- Hong Kong's property market stabilised in the third quarter of this year with property price rises decelerating to 2 per cent (year-on-year), compare to an increase of 3 per cent in the second quarter. However, property market risk remains amid deteriorating housing affordability and overall property prices still exceeded the 1997 peak by 77 per cent. Overall market consensus is that there will be a slow and gradual correction in the residential market.

Financial Sector

- The Hang Seng Index (HSI) fell over 20 per cent between end-of-June to end-of-September and is now 5 per cent down from the start of the year.
- Strong performance during the first half of this year has supported Hong Kong's fund raising activities where Hong Kong was ranked first in IPO fund raising during the first three quarters of this year.
- Hong Kong banks remained resilient with capital adequacy ratio of authorised institutions stayed high at 17.5 per cent as at end-of-June 2015. However, the Hong Kong Monetary Authority (HKMA) said that there are signs that banking sector's asset quality is deteriorating due to marginal increase in classified (bad) loans.
- RMB business in Hong Kong's offshore market remained active but developed at a different pace due to recent market volatility and RMB depreciation.

Economy

- Hong Kong's economy grew at 2.3 per cent in the third quarter of this year, which is better than market expectations but at a slower pace from the 2.8 per cent recorded in the second quarter. The government said that weak goods and services trade coupled with slower growth in from domestic demand will continue to be affected by global uncertainties, particularly the slowdown in China. Given overall growth of around 2.5 per cent during the first three quarters, the government expects that growth will be around 2.4 per cent for this year as a whole, which falls within the forecast range of 2 – 3 per cent as projected in August earlier this year.

External demand weakened across all markets

- Hong Kong’s external trade slackened further with **total exports of goods declining 3.2 per cent** in the third quarter following a fall of 3.6 per cent in the second quarter, compared to a year earlier. Demand from advanced economies remained weak, exports to US, EU, and Japan fell on an annual basis. Meanwhile, exports to Asia also suffered amid lukewarm growth in the global economy. The government said that the third quarter saw the worst retrenchment since the global financial crisis in 2008. Demand from Korea, Singapore, and Taiwan dropped between 9.5 to 17.2 per cent during the third quarter. The spillover effect of China’s slowdown is also reflected in Hong Kong’s **imports of goods**, which also moderated and **declined by 4.1 per cent** during the third quarter, compare to a year earlier.

Total exports of goods by major markets (year-on-year rate of change in real percentage terms)

Countries	2015			2014	
	Q1	Q2	Q3	Q3	Q4
China	-0.2	-4.4	-3.5	2.4	-4.3
US	3.3	3.6	-1.4	0.2	3.8
EU	-3.5	-6.7	-6.0	-0.3	-2.3
Japan	-5.8	-4.0	-1.7	-5.2	-8.4
India	12.4	-3.1	2.3	35.6	6.1
Taiwan	-12.8	-20.3	-23.5	13.6	1.7
Korea	-5.7	-13.8	-19.1	4	-11.5
Singapore	0.4	-3.7	-8.7	0.3	0.6

Source: Census & Stats Dept., HKSARG

- **Exports of services also weakened and declined 1.3 per cent in the third quarter**, compare to last year. Weak demand in advanced economies also reduced regional trade and cargo flows, scaling back demand for exports of trade-related and transportation services. Decline in tourist arrivals, mainly those from the Mainland, which declined 7.3 per cent was the main drag to exports of travel services. Exports of financial and business services was also affected by the slow down of cross-border financial and fund raising activities due to volatile market in the summer.

Solid but slower growth on domestic demand

- Domestic demand grew at a slow but firm pace in the third quarter and remained the key driver to the economy. Private consumption expenditure grew at a solid rate of 4.3 per cent in the third quarter, compare to a year earlier, supported by stable job (unemployment at 3.3 per cent for the three months to September) and income (median monthly real income growth at 4 per cent, year-on-year) conditions. Meanwhile, government consumption expenditure also grew steadily at 2.6 per cent during the third quarter, thanks to ongoing large-scale infrastructure works. Steady expansion of private sector building and construction activities also helped support building and construction expenditure.

However, there are headwinds to this only key driver ...

- On the business front, investment sentiment was weakened by slackening global economic outlook. During the third quarter, overall investment spending in terms of gross domestic fixed capital formation has its largest decline and dropped 6.5 per cent (year-on-year) compare to an increase of 5.2 per cent (year-on-year) in the second quarter. Government said the decline was due to the drop of 13 per cent (year-on-year) in private sector machinery and equipment acquisition.
- On the retail front, drop in inbound tourism and the correction of the stock market in the summer, coupled with strong currency (due to strong US dollar under the peg system) has weakened retail sales performance. Retail businesses are now becoming much less optimistic on Hong Kong’s retail sales outlook. Overall visitors fell 6.4, the first decline since 2009 and Mainland visitors drop slightly more by 7.3 per cent in the third quarter. In addition, increased overseas travel and spending by Hong Kong people also weakened retail sales.

- During the first nine months of this year, total retail sales dropped 2.7 per cent (year-on-year) with the largest fall of 6.4 per cent in September. Government data shows that sales in luxury items remained weak particularly in watches and jewellery (-23 per cent), electronic equipments (-8 per cent) and clothing appeals (-12 per cent). Meanwhile demand for daily goods items such as food, alcohol drinks, and tobacco (+23 per cent) and commodities in supermarket (+2 per cent) grew, compare to the same period last year.

Property Market

- Hong Kong's property market continued to stabilise in the third quarter of this year with property prices rising at 2 per cent following a rise of 3 per cent in the second quarter of this year. Buyers' and investors' sentiment were heavily affected by the imminent rate hike in the US, global slowdown particularly China, and stock market correction in both Hong Kong and the Mainland. Trading activities, led by primary market transactions, fell 13 per cent during the third quarter compare to the second quarter.
- Although housing prices rose at a slower pace, housing market bubble risk remained. In September, Hong Kong's overall flat prices still exceeded the 1997 peak by 77 per cent with housing affordability ratio stayed at a high of around 64 per cent in the third quarter.
- Overall, maintaining a stable and sustainable housing market stands high on the government's agenda and the government remained committed to increase housing supply in the short, medium, and long run. According to the Housing and Transport Bureau, there will be a supply of 86,000 units over the next three to four years, the highest since 2004. Both government and market believe that steady increase in supply is essential to meet market demand and will not lead to excess capacity. Nevertheless, in face of increase supply and market uncertainties, market analysts expect that general housing prices will drop 10-15 per cent, with the correction concentrated amongst small to medium sized dwellings but most agree that a sharp and steep correction is unlikely.
- On mortgage financing, risk remains low. With the Hong Kong Monetary Authority's (HKMA) macro-prudential measures in place to ensure Hong Kong's financial stability, both mortgage loans applications (-18 per cent) and approvals (12 per cent) continued to decrease in September, compare to a month earlier. Despite marginal increase in outstanding mortgage loans, there is nearly no delinquency (0.03 per cent) and nil application for loan schedule. HKMA reiterates that the authority will remain cautious and stands ready to make any necessary adjustment to macro-prudential policies if necessary. Under a low interest rate environment, mortgage loan financing price reference continued to be dominated by HIBOR.

Policy Development

- The 18th Plenary of the Hong Kong / Guangdong Co-operation Joint Conference convened in early September, five co-operation agreements in the area such as intellectual property protection, enhancing cross-boundary e-commerce, education etc. The two governments also agree to strengthen co-operation with each other to seize the opportunities brought about by the "Belt and Road" initiatives and the Free Trade Agreement.
- The Hong Kong and Macao government announced that they will commence negotiations on the Hong Kong Macao Closer Macao Economic Partnership Arrangement (HK-Macao CEPA). The free trade agreement would enhance further economic co-operation and development between the two regions.

Financial

- The Hang Seng Index (HSI) has recorded intense volatility in the third quarter following a short-term rally in April. Investors' sentiments were hit by stock market volatility in the Mainland, slowdown in the Mainland economy, and the depreciation of the RMB. The HSI fell over 20 per cent between end-of-June to end-of-September dominated by stock selling whilst fund raising and other trading activities has turned very quiet during the quarter.
- Nevertheless, strong performance during the first half of this year supported Hong Kong's fund raising activities. Total equity capital raised during the first nine months of this year increased 39 per cent over a year earlier to HK\$851 billion. In terms of amount of funds raised through Initial Public Offerings (IPO), Hong Kong was ranked the first globally, raising a total of HK\$156.4 billion during the first nine months of this year.
- On the banking side, Hong Kong banks remain resilient with capital adequacy ratio of authorised institutions stayed high at 17.5 per cent as at end-of-June 2015. However, demand for credit moderated affected by economic uncertainties and financial market volatility. During the third quarter, loan for use both in Hong Kong and outside Hong Kong dropped 1.3 and 2.0 per cent respectively. Demand for trade finance dropped 12 per cent due to sluggish external trade; demand for loans to wholesale and retail trade also fell 2 per cent due to weak retail sales; loan demand from stockbrokers plunged the most by 53.4 per cent amid stock market volatility. The only area of growth came from property related loans, which grew around 3 per cent.
- However, the Hong Kong Monetary Authority (HKMA) said that there are signs that banking sector's asset quality is deteriorating. According to released data from HKMA, ratio of classified loan for retail banks has increased marginally from 0.43 per cent in September 2014 to 0.49 per cent in June 2015. The authority is also concerned that the increasing ratio was also contributed by Mainland related lending. Despite this marginal increase, HKMA will remain vigilant to market development and will step up supervisory efforts to ensure stability in Hong Kong's banking system.
- On Basel III implementation, HKMA is confident that authorised institutions in Hong Kong can meet capital requirement and implementation will be according to Basel's international time table.

Policy Development

- The profits tax exemption for offshore funds has been extended to private equity funds since 17 July 2015. Under the arrangement, transactions conducted by eligible offshore private equity funds in respect of securities of eligible overseas portfolio companies would be able to enjoy profits tax exemption. The exemption would help attract private equity fund managers to expand their business in Hong Kong and hire related professional services, thereby conducive to the further development of the asset management industry.
- HKMA is working closely with other government departments to establish Hong Kong as a regional corporate treasury centre (CTC). The initiative proposed in the 2015-16 Budget will allow deductions of CTCs' eligible interest expenses under profit tax, and reduce profits tax for specified treasury activities by 50 per cent. The industry consultation has launched in September this year and the Inland Revenue (Amendment) Bill is expected to be introduced to Legco before the end of 2015.

RMB Business

- Hong Kong's RMB business moderated during the third quarter of this year affected by Hong Kong and Mainland stock market volatility and the depreciation of the RMB:
- According to Standard Chartered's **Renminbi Globalisation Index (RGI)**, a weighted index of global offshore RMB activity, Hong Kong share of RMB business **rose** in September to 2,407 from 2,331 in August. Hong Kong's market share in the RGI remains at 61.7%.
 - **Total RMB deposits declined** by 9.7 per cent to RMB1,000.9 billion at end of September. However, deposits drop further to RMB895.4 billion as at end of October.
 - **RMB Real Time Gross Settlement (RTGS) system** transactions handled by banks in Hong Kong has exceeded RMB1000 billion.
 - **RMB cross-border trade settlement** transactions handled by banks in Hong Kong **surged** 30.6 per cent to RMB2,050.1 billion in the third quarter, compare to the previous quarter of this year.
 - **RMB bond issuance dropped significantly** from RMB35.5 billion in the second quarter to RMB9.2 billion in the third quarter, in the absence of sovereign bond issued in the last quarter. Bond issuance, however, is much slower than RMB70 billion in the second quarter of last year.
 - **Outstanding RMB loans surged** by 21 per cent to RMB285.4 billion at end of September compare to end of June.
 - Despite low take up rate (around 40 per cent (northbound) and 37 per cent (south bound) of total quota) operation of the **Shanghai Hong Kong Stock Connect** remained smooth and did not experience any disruption even during the intense market volatility in the summer.
 - Other products include the successful issuance of **Panda bonds**, fund raised for the support of general offshore capital works such as supporting Mainland corporations going global and projects related to the Belt and Road, by both Bank of China (Hong Kong) and by HSBC Hong Kong on September 29.

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