

Private Consumption Needs to Catch Up

Although Hong Kong's economic recovery remains intact, the primary driver of growth at present still comes from the external sector, while growth in private consumption lags behind. This mirrors the pattern seen in other Asian economies in the aftermath of the Asian financial crisis. Furthermore, competition from China continues to divert capital and jobs away from the region. Hence, the recovery has helped to mitigate, but not solve, the hollowing out of the domestic economy. To achieve more balanced and sustainable growth, continued strength from the property sector is essential.

Diverging performance from the external and domestic sectors

The Hong Kong economy posted a remarkably high 6.5% growth rate in the first half of this year, and trade is the major driver to the economic recovery. After registering double-digit growth of 15.3% in 2004, total exports of goods and services grew a solid 9.8% in the first half of this year. This is mainly because China, Asia's manufacturing powerhouse, has registered 30%-plus annual growth in exports since 2003. With trade between Hong Kong and the Mainland accounting for about half of Hong Kong's total trade, the city has undoubtedly become one of the leading beneficiaries of China's trade boom.

While the external sector has been performing well, the domestic economy has been lagging behind. Even though growth in private consumption remained steady in the first six months of 2005, its contribution to overall economic performance continued to fall. The ratio of household consumption to GDP fell to a low of 55.3% in the first half this year, after averaging 63% over the decade from 1990 to 1999. This indicates that the benefits of a strong external sector have been slow in spreading to the domestic column, and growth in private consumption has stayed behind that of the economy as a whole.

Moreover, private consumption has tended to favour goods over services. Goods consumption in the local market registered a 7.0% year-on-year increase in the first half of this year, higher than the average 5.7% annual growth between 1992 and 1997. This was a marked improvement, even excluding the increases in tourist spending. However, since most of the goods consumed in Hong Kong are imported, much of the benefit from the increase in the purchase of goods has been transferred to the pockets of foreign merchandisers. The value-added component of consumption of goods to the local economy is therefore considerably smaller than that of services.

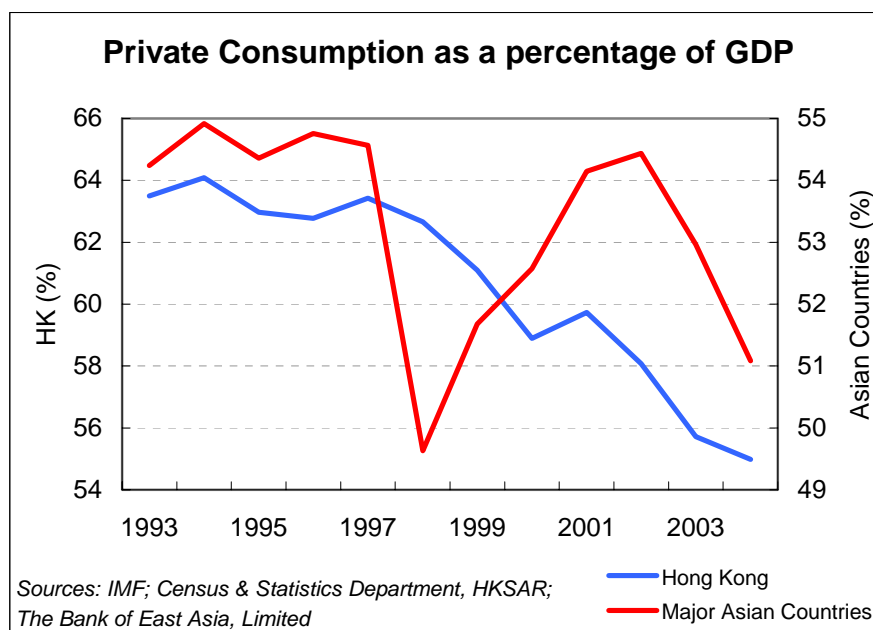
Comparatively, spending on services grew by a mere 2.4% in the first half, a figure even lower than the average 2.7% growth in the lacklustre years of 2001 and 2002. It is small wonder that those employed in the labour intensive services sector have yet to feel significant benefits from the economic recovery.

The trend is particularly evident if we examine the labour market. According to the General Household Survey, in the twelve months prior to June 2005 total employment grew by 61,800. The import/export industry registered the highest job growth. Even if manufacturing is included to account for firms' possible switch from manufacturing to trading, the two together still have produced 23,900 new jobs during the period. These sectors account for only 22% of total employment, but have been responsible for almost 40% of job growth.

Employment growth by industry between 2004Q3 and 2005Q2 (Quarterly increase)					
Industry	2004 Q3	2004 Q4	2005 Q1	2005 Q2	Total
	<i>Change in Employment (persons)</i>				
Import/Export Trades	5,800	-6,300	19,300	24,500	43,300
Manufacturing	-21,700	900	1,800	-400	-19,400
Wholesale/Retail	-2,600	7,300	9,400	-12,600	1,500
Restaurants/Hotels	11,200	-100	-8,900	1,900	4,100
Real Estate and Business Services	2,400	900	1,700	14,200	19,200
Construction	-100	8,000	-7,000	-2,900	-2,000
Community and Personal Services	-12,100	25,000	12,100	-11,400	13,600
Others	-3,200	10,200	-2,300	-3,200	1,500
Total	-20,300	45,900	26,100	10,100	61,800
<i>Source: Quarterly Report on General Household Survey</i>					

Regional trend: diminishing role of private consumption

The declining importance of domestic household consumption within the economy reflects a general trend in Asia. The share of private consumption to gross domestic product in countries such as Singapore, South Korea, Malaysia and the Philippines has declined significantly over the past decade. The Asian financial crisis shattered investor and consumer confidence, and Asian economies resorted to exporting their way out of recession. In the U.S., where the focus was on helping the country recover from the burst of the Internet bubble, interest rates were pushed to 50-year lows in an effort to encourage consumer spending. Low mortgage rates and an attendant rise in property prices created a "wealth effect" among homeowners. American consumers thus went on a spending spree, drawing in imports from Asia. Under the combined effect of the internal push and external pull, Asian exporters recorded spectacular growth in the past few years, giving tremendous momentum to the recovery in the region. Trade surpluses averaged 8.5% of total GDP in the post Asian crisis period, a sharp contrast to the trade deficits prior to 1997.



However, Asia's impressive trade performance has done little to lift the region's domestic consumption, which has remained feeble. Consumers and investors have yet to emerge from the shadow of plunging asset prices in the late 1990s. Furthermore, intense competition from China has damaged sentiment. The emergence of China as a regional manufacturing hub has affected the livelihood of workers in surrounding Asian countries, as jobs migrated to low-cost factories in the Mainland. As a result unemployment rates in the affected countries increased from an average of 3.7% in the mid 1990s, to 5.7% in 2004. While the business sector could benefit from export earnings, it is still haunted by the chilling experience of the financial crisis. Those willing to invest often opt for China to take the advantage of the lower cost and the huge potential market. As a result, large trade surpluses have not translated into a rise in domestic consumption and revival of the local economy.

Hong Kong, being part of this Asian economic community, could hardly escape from this trend. In fact, the situation in Hong Kong is more acute due to its close proximity to the Mainland. The persisting migration of both jobs and capital to the hinterland continue to shift economic activities away from the city, constraining domestic consumption.

The way out

To counter the leakage and achieve more balanced growth, efforts must be made to channel external earnings into the domestic economy. To this end, the property market can play an important role. As pointed out in the 2005 April edition of the Economic Analysis, there is a close relationship between local demand and activities in the property market. Despite the high interest rates before 1997, a rising property market continued to support private consumption and keep domestic demand strong. However, during the 'negative asset' era following the plunge of property prices in the late 1990s, consumers were reluctant to spend even in the midst of a low interest rate environment. Thus it could be seen that people reacted more adversely to negative net assets than either higher interest rates or taxes.

A thriving property market would stimulate activities in real estate, financial services, property development and construction. This would encourage hiring in these industries and bring significant improvement to the labour market. For instance, the pickup of the property market has added 17,200 jobs in construction, real estate and business services in the 12 months to June 2005. Higher asset values could also lift both consumer and business confidence. As property owners become wealthier, spending on both goods and services would increase. In addition, the business sector would be more willing to expand investment, given that they could use their premises as collaterals.

At present, favourable economic fundamentals should justify a stronger housing market. Despite a 41.4% rise in property prices since January 2004, followed by successive interest rate hikes starting from April this year, housing remains affordable. Mortgage payments for a 50 sqm housing unit currently account for 56.7% of median household income, which is still lower than the 20-year average of 65%. Therefore, further strengthening of the housing market can be supported without leading to a property bubble as seen in the late 1990s. On the contrary, it can help spread the benefits of the current recovery to the domestic side. Only when local demand shows a sustained pickup will Hong Kong redress the balance in economic growth and thus see broad improvement in the labour market.

Conclusion

Although Hong Kong's top line growth is strong, the failure of private consumption to match growth in external trade indicates that we are still feeling the effects of the hollowing out of the domestic economy. A strong property market can help to rebalance the economy, as rising property values will lead to retention of more export earnings at home, which will in turn stimulate domestic activity. Furthermore, as a small and open economy and an international financial centre, Hong Kong can use an expanding property market to attract capital inflow. From this perspective, careful control of land supply by the government plays an important role, as it helps to rebuild confidence in property investments in Hong Kong. A robust property market will spread the fruits of economic recovery to all parts of the economy.