BEA
The Bank of East Asia, Limited

Economic Analysis

January, 2013

A Publication of the BEA Economic Research Department

Hong Kong Economic Outlook in 2013

Hong Kong's economy was buffeted by external turbulence through much of 2012. The spreading European debt crisis undermined confidence in the global economic recovery. Growth in the United States decelerated, and exports from Asia plummeted. As a result, Hong Kong export growth slid to just 1.9% in the first eleven months of 2012. Real GDP is likely to grow by a meagre 1.3% in 2012. However, a number of developments suggest that we can be more upbeat as we look forward to 2013.

Improving Western Economies

With the help of a further dose of quantitative easing, the US economic recovery picked up steam in the fourth quarter of 2012. US corporations have repaired their balance sheets and hiring is on the rise. Non-farm payrolls rose by a monthly average of 159,700 between July and December 2012, leading to a 0.5 percentage point fall in the unemployment rate to 7.8%. In another positive development, property prices are rebounding. The S&P/Case-Shiller home price index rose by 4.3% in the 12 months ending October 2012, resulting to an improvement in consumer sentiment. The strong momentum of economic recovery could offset the impacts brought by fiscal tightening policies.

The outlook for Europe is somewhat less upbeat compared with the US. The European economies were haunted by both recession and the debt crisis in 2012. Nevertheless, the potential for surprises from Europe in the coming year has been mitigated by the containment measures adopted during 2012. The Outright Monetary Transactions policy has provided a line of support for the weaker European economies. The major creditor countries have also shown more flexibility with respect to restructuring of sovereign debt for their over-stretched neighbours. This should provide much needed breathing space for the debt-laden countries in the region.

The positive developments in both the US and Europe are leading to improving business confidence, and demand for imports is picking up. China's official manufacturing purchasing managers' index rose to 50.6 in December, comfortably in positive territory. The growth momentum should continue in 2013.

China's Economic Reforms

China made a number of difficult economic decisions in 2012. With the uncertain global economic environment, China twice lowered interest rates by 25 basis points in mid-2012. As China's exports plunged to low single-digit growth in both July and August, there were widespread expectations of further significant monetary and fiscal stimulus. This did not happen, upending the long-held assumption that solid economic growth would be the top priority ahead of China's leadership transition.

The focus of China's 12th Five-Year Plan is firmly on rebalancing the economy through boosting domestic consumption. We believe that the policy restraint demonstrated in the face of a slowing economy reflects the strong will of the leadership to stay the course on economic rebalancing. Some growth will be sacrificed for the sake of reform, and it is no coincidence that, for 2012 as a whole, China's economic growth likely fell below 8% for the first time since 1999.

The new leadership also appears to be committed to reforms. Measures to prevent property prices from surging will remain in place. Further reforms on pricing and taxation, including the expansion of value-added tax and new property taxes to more cities, are expected.

Hong Kong can benefit from these reforms, in particular the effort to upgrade the service sector. The service industry accounts for about 43% of China's GDP, much lower than the 70% range in developed economies. External expertise will be a key ingredient in the development of the service sector and Hong Kong, as an advanced service-based economy, has much to offer. It is targeted that all barriers on trade in services between the Mainland and Hong Kong to be removed by 2015, and companies should be planning their strategies now rather than later.

Mainland Demand for Hong Kong Services

One of the bright spots in the Hong Kong economy in 2012 was the resilient employment market. The unemployment rate hovered in the range of 3.2-3.4% for the first eleven months of the year, with total employment increased by 47,300 or 1.3%. This performance is remarkable, given the global economic slowdown and the increase in labour costs following the introduction of the minimum wage in May 2011. Between March 2011 and September 2012, median household income increased by 9.9%. Over the same period, total employment grew by 3.5%, or 124,700. A key factor is the persistent strength of Mainland demand for business and consumer services. Under China's 12th Five-Year Plan, Mainland companies are encouraged to develop overseas markets, and Hong Kong remains the preferred platform for Mainland companies planning to enter into the international arena.

In addition, Mainland tourists continue to have a major influence on local consumption. Mainland arrivals for the first three quarters of 2012 were almost double the total for the same period in 2009. Mainland tourist spending on shopping totalled HK$110.8bn in 2011, equal to 26.6% of total retail sales.

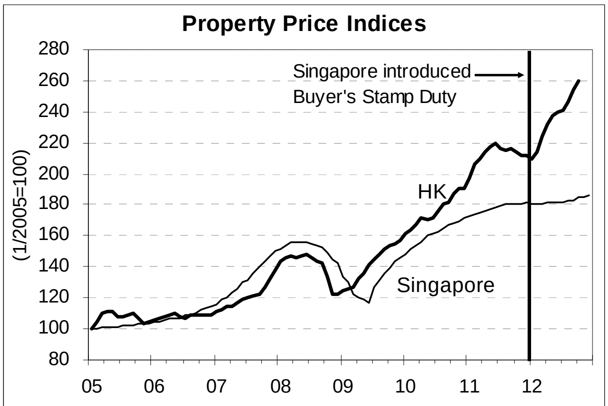
Employment in retail, accommodation and food, financial, real estate, professional and business services has benefitted the most from these developments, enabling the employment market to skate around the worst of the severe downturn in Western economies. These sectors account for 35% of total employment, but were responsible for 69% of the employment growth from mid-2008 to mid-2012. This development trend should persist in 2013.

Property Market

While the economy will see a smoother ride in 2013, the same cannot be said for the property market. The market is fuelled by historically low interest rates and housing supply, as well as capital inflows from the Mainland. Property prices rose by a further 20% in the first nine months of 2012, outpacing the 5% year-on-year increase in median household income in the third quarter. As a result, the price-to-income ratio for housing[1] has risen to 11.2 times, significantly above the 20-year average of 7.7 times. Perhaps most disturbing, the cost of housing with an area of 40 square metres or less jumped by 24.3% in the first three quarters of 2012, while rental values rose by 12.4%. Alarmed by these sharp increases, the Government introduced a range of new measures to stabilise the property market in October, 2012. They appear to have worked – for now.

Mainland buyers, in particular, have been deterred by the 15% Buyer's Stamp Duty on all transactions not in the name of a Hong Kong Permanent Resident. Mainland buyers accounted for 10.6% and 17%[2] of total property transaction volume and value, respectively, for the first nine months of 2012. The primary market is hardest hit, as Mainlanders accounted for 26% of sales volume in this segment in the first three quarters. In comparison, Mainlanders accounted for only 8% of secondary market transactions. The luxury segment is a special case: Mainlanders accounted for 29.5% of transaction volume for properties priced at HK$12 million or more.

Singapore's property market has also been affected by a surge in Mainland buying interest, and the city state introduced its own Buyer's Stamp Duty – at 10% – in December 2011. The experience of Singapore could provide a useful reference point for Hong Kong. Between June 2009 and December 2011, Singapore property prices jumped by 54.7%. However, following the introduction of the new stamp duty, prices rose by only 2.8% in the subsequent twelve months. Market studies[3] indicate that the share of foreign buyers (including permanent and non-permanent residents) dropped from 30% in 2011 to 21.3% in the first quarter of 2012. The share recovered modestly to 23.4% in the third quarter of 2012. Among foreign buyers, the share of Mainland buyers dropped from an average of 28.3% in 2011 to 21.7% in September 2012.



Sources: The Urban Renewal Authority, Singapore; Rating & Valuation Department, HK

While the measure proved effective in checking capital inflows to Singapore, it may have been responsible for the increase in Mainland investment interest in Hong Kong at the time. This may partially explain why Hong Kong property prices jumped by 20% in the first nine months of 2012, after having fallen by 4.4% between June 2011 and January 2012.

Hong Kong's luxury market may experience challenging times adapting to the new conditions in the months ahead. Meanwhile, since Mainlanders account for only 9.6% of transaction volume in the market segment of property prices lower than HK$12 million, the impact of the measures will be less on the small- and medium-sized market. Only increase in supply could adjust prices to a more reasonable and affordable level.

Conclusion

The continuing recovery in the US economy and lower volatility in Europe will translate into stronger demand for imports from Asia, including Hong Kong. Meanwhile, Mainland tourist spending and demand for business services from Mainland companies will continue to provide support to the domestic economy. Hong Kong's real GDP is projected to grow by 4% in 2013. Inflation will average at 4%.

Forecast of HK Major Indicators (yoy % change)		
	Real Growth Rate	
	2012	2013
1. Domestic Sector		
Private Consumption expenditure	4.2	4.5
Government Consumption Expenditure	3.3	3.0
Gross Domestic Fixed Capital Formation	8.7	8.0
2. External Sector		
Total Exports of Goods	1.2	6.0
Imports of Goods	2.4	7.6
Exports of Services	2.0	6.5
Imports of Services	1.8	4.5
3. Real Gross Domestic Product	1.3	4.0
4. Composite CPI	4.0	4.0
BEA Economic Research Forecasts		

[1] Ratio of price for a 45-square metres flat to annual median household income (those living in private housing)
[2] Centaline Property Research Report
[3] "Singapore Real Estate Highlights" by Knight Frank LLP