

**BEA**

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Hong Kong Economic Outlook in 2014

In the first eleven months of 2013, the value of total exports of goods rose at a modest 4% year-on-year. As the external environment improves, Hong Kong exports will experience a gradual pickup, providing the main impetus of growth in 2014.

Economic Environment Stabilising in Advanced Economies

The US economy is recovering steadily, and the job market is brightening. The unemployment rate dropped to 7% in November from 7.9% at the beginning of the year, while non-farm payrolls rose by a monthly average of 188,545 during the first eleven months of 2013, up from an average of 179,455 in the same period in 2012. Moreover, residential housing prices increased at an annualized rate of 13.6% in last October. This solid performance should persist in 2014, outweighing the headwinds of QE3 tapering and controversy over the debt ceiling.

Worries over the health of the eurozone have, on the other hand, yet to dissipate. The economy expanded by a disappointing 0.1% quarter-on-quarter in Q3 2013, indicating that the nascent recovery remains fragile. Moreover, the eurozone remains haunted by a high unemployment rate, reaching 12.1% in November. The Composite Purchasing Managers' Index ("PMI") has edged over 50 since July, suggesting economic conditions have stabilised. Overall, however, eurozone demand for Asian exports is expected to remain sluggish in early 2014.

Mixed Economic Outlook for China

On a year-on-year basis, China's export sector rose at a moderate 7.9% during 2013. Softer growth has led to slower income increases. Consequently, retail sales rose 13.0% during the first eleven months, the lowest figure since 2003.

The improving US economy shall boost China's exports sector in 2014. Manufacturing PMI readings from both HSBC and official sources have crossed the 50 threshold since last August, indicating that economic growth has gained momentum. China's exports are projected to grow by 10% in 2014.

However, it will take time before the pickup in manufacturing translates into stronger income and consumer spending growth.

Meanwhile, the Chinese government will take advantage of a more stable economic environment to tackle the Mainland's structural economic problems. During 2008-12, total loans jumped by 96.8%, outpacing the 67% increase in nominal GDP. High leverage has been compounded by the rapid expansion of shadow banking. A restrictive credit policy is expected to be implemented to contain loan growth. Local governments and industries with excess capacity, such as steel, will face pressure to scale down their projects.

The surging property market is another concern. Property prices jumped more than 20% year-on-year in major cities like Beijing and Guangzhou. Besides credit tightening, more austerity measures could be in the pipeline to keep the market in check. These measures will drag investment growth, diluting the positive impact of improving exports. The Chinese economy is expected to expand at 7.6% in 2014.

All in all, while demand from the EU and Mainland China will remain moderate, the US recovery is expected to accelerate and translate into higher demand for Asian exports. Growth in Hong Kong exports will improve to 7% in 2014.

Driving Force of Retail Sales is Subdued

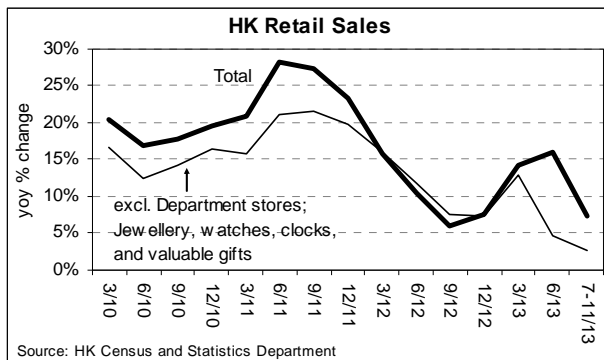
Despite the slow exports growth during 2012-13, Hong Kong's real private consumption registered robust growth of 3% in 2012 and 4.4% in the first three quarters of 2013. This was mainly due to the tight employment market. The unemployment rate remained low throughout this period, dropping to a low of 3.3% in November 2013.

Hong Kong's economy has been supported by economic forces from Mainland China. Catalysed by Chinese enterprises which consider Hong Kong their favoured platform for overseas investment, employment in business-related services¹ has experienced remarkable growth.

¹ Employment in business-related services, including finance, insurance, real estate, professional services, and business services.

The labour-intensive retail services² have enjoyed the fruit of blossoming Mainland tourist spending over the last several years. Mainland retail spending accounted for 29.2% of total consumer goods expenditure in Hong Kong in 2012, up from a 16.6% share in 2007. Mainland tourists have been an important cornerstone for the retail sales market, leading to a remarkable expansion of employment in retail services.

However, data show that the expansion of the retail sector has subsided in recent months, casting uncertainty over the employment outlook. On a year-on-year basis, while retail sales rose by a strong 15.2% in the first half of 2013, growth softened notably to 7.4% during July-November. One reason was the slower growth in income and spending in Mainland China. Annual growth of Mainland visitor arrivals slowed to 15.8% in Q3, down from a spectacular 24.2% rise in 2012. Furthermore, as a more frugal lifestyle is being promoted by the central government, Chinese tourist spending on luxury items in Hong Kong will be hampered. The surge in retail sales driven by Mainland tourist spending in recent years may be subdued.



Furthermore, domestic demand is also losing steam as seen in recent months. Deducting jewellery, watch, valuable gift, and department store purchases – all of which are mainly made by Mainland shoppers – retail sales grew at just 3.7% during July - November of 2013, significantly down from the 8.8% increase in the first half of the year. As a result, retail service employment suffered quarter-on-quarter declines in both the second and third quarters of 2013, the first consecutive quarterly drops since the first half of 2009.

Downbeat on the Property Market

The correction of residential property prices may further erode domestic demand. This will not only affect consumer sentiment, but also the employment market in related sectors, such as real estate and furnishing. With a low transaction volume in the property market, the number of real estate agents employed shrank by 2,700 quarter-on-quarter in Q3 2013. The situation will deteriorate further in 2014 as the property price correction continues. Hence, despite improving

employment conditions in export-related sectors, the overall unemployment rate is expected to edge slightly higher, reaching 3.5% sometime in 2014. This will slow the growth of private consumption to 3.2% in 2014, down from an expected 4.1% gain in 2013.

Following the introduction of demand-side cooling measures for the property market, transaction volume dropped markedly by 37.7% on a year-on-year basis to 50,676 in 2013. Property developers will be conservative in pricing strategies in face of subdued trading, attempting to speed up the selling of new residential projects to make up for sales losses in 2013. This will put pressure on overall property prices in the coming year. The beginning of QE tapering announced by the US Federal Reserve Bank precludes the end of the ultra-low interest rate era. It is expected that the US will raise the federal funds rate in the second half of 2015. With the prospect of rising funding costs, investors will sell properties at hand at an increased pace, further pushing prices downwards. Residential property prices are expected to fall by 10% in 2014.

Economic Outlook in 2014

Inflation has been relatively high, misaligning economic performance. The main culprits are the continued soar in food prices and housing rents, which together accounted for 59.1% of CPI weighting. Easing residential property prices and rentals shall alleviate inflation momentum, and inflation is expected to moderate at 3.7% in 2014.

We expect that investment will see a moderate increase as ongoing large-scale public infrastructure projects and government spending are outstripping sluggish private construction. This, together with a stronger performance for exports, should compensate for weaker private consumption growth. Hong Kong's real GDP is projected to grow by 3.5% in 2014.

Forecast of Major Indicators in Hong Kong (yoy % change in real terms)		
	2013	2014
1. Domestic Sector		
Private Consumption expenditure	4.1	3.2
Government Consumption Expenditure	2.9	3.5
Gross Domestic Fixed Capital Formation	2.5	4.0
2. External Sector		
Total Exports of Goods	7.3	10.5
Imports of Goods	8.2	9.6
Exports of Services	6.3	6.4
Imports of Services	0.8	1.0
3. Real Gross Domestic Product	3.0	3.5
4. Composite CPI	4.3	3.7

Source: Economic Research Department, The Bank of East Asia, Ltd.

² Employment in the retail sector, including retail, accommodation, and food services.