Hong Kong, China

Growth slowed in 2018 as the external environment became more challenging. Moderate growth should continue this year and next with domestic demand still resilient and the labor market tightening. Inflation will remain subdued, and the current account surplus will narrow further on weaker trade. Innovative policies are needed to raise the rate of labor force participation among women and older workers, toward alleviating the economic challenges posed by a rapidly aging population.

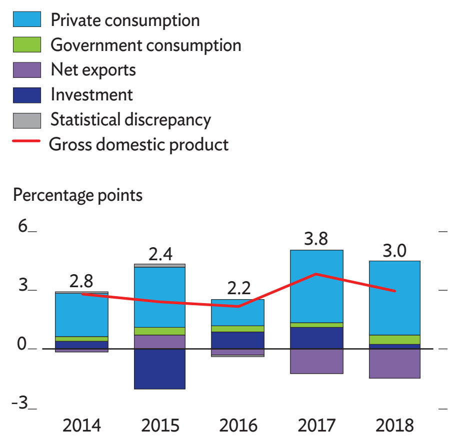
Economic performance

GDP growth moderated to 3.0% in 2018 from 3.8% in 2017 as downward pressure came from sluggish global trade, tightening external financial conditions, and persistent global trade friction (Figure 3.9.1). Domestic demand nevertheless remained resilient and served as the source of growth in 2018. Spurred by favorable job and income conditions, private consumption expenditure expanded by 5.6% in real terms and contributed 3.8 percentage points to GDP growth. Government spending also expanded, by 4.2%, adding 0.4 points to growth. Machinery and equipment acquisition picked up significantly, but building and construction saw a marginal decline, dragging down the investment contribution to growth to 0.3 points. Both export and import growth edged down, with net exports shaving 1.5 points off growth (Figure 3.9.2).

On the supply side, services remained the primary driver of economic growth, expanding by 3.4% last year. Manufacturing grew by 1.3%, while construction deteriorated by 0.2%. The residential property market remained buoyant in the first half of 2018 but began to cool in the second half as trade conflicts, global stock market corrections, and hikes in mortgage and lending rates dampened market sentiment (Figure 3.9.3).

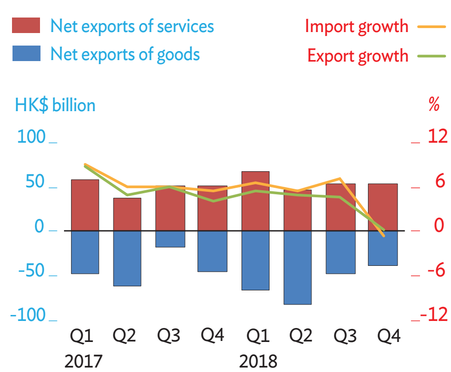
Consumer price inflation accelerated from 1.5% in 2017 to 2.4% in 2018, mainly because food prices increased by 3.4% (Figure 3.9.4). External price pressures edged up in the first half—fueled by robust global conditions, a depreciating local dollar, and higher oil prices—but largely held steady in the second half in light of subdued international prices and a

3.9.1 Demand-side contributions to growth



Source: Census and Statistics Department, https://www.censtatd.gov.hk/home/ (accessed 14 March 2019).

3.9.2 External trade



Q = quarter.

Source: Census and Statistics Department, https://www.censtatd.gov.hk/home/ (accessed 14 March 2019).

This chapter was written by Benno Ferrarini of the Economic Research and Regional Cooperation Department, ADB, Manila, and Michael Timbang, consultant, Economic Research and Regional Cooperation Department, ADB, Manila.

strengthening US dollar, to which the local dollar is linked. Netting out the effects of government one-off relief measures, underlying consumer price inflation rose from 1.7% in 2017 to 2.6% in 2018 as the economy sustained a growth rate above trend. Average residential property prices retreated from their peak in July but still rose by 1.8% in 2018, while newly let residential rents increased by 3.3%.

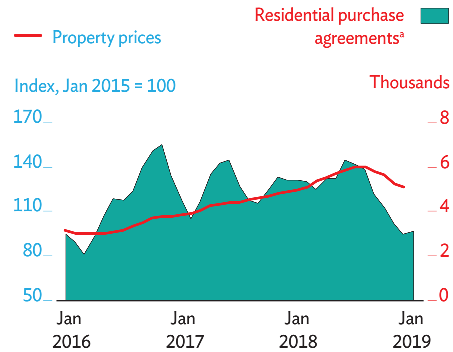
The current account surplus narrowed from the equivalent of 4.7% of GDP in 2017 to 4.3% in 2018. This reflected a higher goods trade deficit, albeit partly offset by rising net inflows of primary income and a higher surplus in services trade. Meanwhile, the overall balance of payments surplus narrowed sharply from 9.4% of GDP in 2017 to 0.3% in 2018 as net capital flows turned negative. Gross official reserves fell to $424.7 billion at the end of 2018, or cover for 7.5 months of imports.

The government revised its budget surplus estimate for fiscal year 2018 (FY2018, ending 31 March 2019) from 1.2% of GDP to 2.1%, mainly because expenditure was 5.6% less than budgeted (Figure 3.9.5). Revenue was also lower than the original estimate, by 1.3%, because of lower-than-expected receipts from land premium and stamp duties, which tend to be highly sensitive to market fluctuations.

Monetary conditions remained broadly accommodative in 2018. In tandem with the interest rate hike by the US Federal Reserve in December, the Hong Kong Monetary Authority raised its base rate by 25 basis points to 2.75%, marking its fourth adjustment in 2018. Domestic credit grew by 5.4%, and the broad money supply (M2) rose by 4.3%. The local stock market—the sixth largest in the world and the third largest in Asia—underwent a sharp correction last year amid trade conflicts and concern over US interest rate hikes that outpaced expectations. In December, the Hang Seng Index closed 13.6% lower than a year earlier and a sharp 22.0% down from its all-time high in January 2018 (Figure 3.9.6).

Hong Kong, China has been ranked the world's freest economy for 25 years in a row by the Heritage Foundation and, since 1996, by the Fraser Institute. Its economy was named in 2018 the most competitive in Asia, and the second most competitive globally, by the International Institute for Management Development. The economy ranked seventh in the *Global Competitiveness Report 2018* of the World Economic Forum and fourth in the World Bank's *Doing Business 2019*. Hong Kong, China has maintained its favorable business environment and its status as a regional and global trading hub, positioned among the world's top-ranked economies.

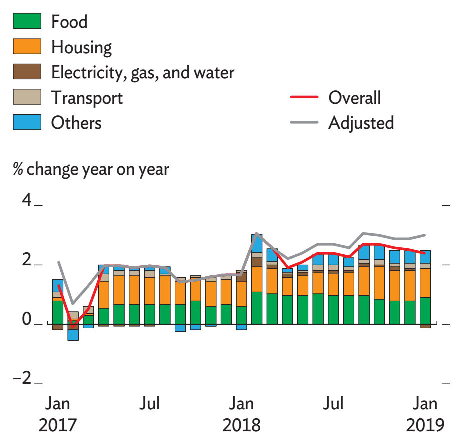
3.9.3 Property market indicators



[a] = 3-month moving averages.

Source: CEIC Data Company (accessed 14 March 2019).

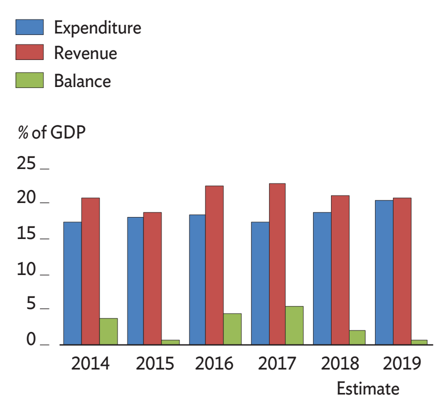
3.9.4 Monthly inflation



Note: Adjusted inflation is the rate once the effects of temporary government subsidies are removed.

Source: CEIC Data Company (accessed 14 March 2019).

3.9.5 Fiscal indicators



Note: Years are fiscal years ending on 31 March of the next year.

Sources: The Government of the Hong Kong Special Administrative Region of the PRC. The 2019–2020 Budget, and other years. http://www.budget.gov.hk; CEIC Data Company; *Asian Development Outlook* database.

Economic prospects

GDP growth is projected to slow to 2.5% in 2019 and 2020 (Figure 3.9.7). Growth moderation in the People's Republic of China (PRC) and several other key partners will weigh on exports from Hong Kong, China, such that net exports will add little to growth this year and next. Consumption will remain the engine of growth, supported by continued stable employment and strong incomes, though recent economic developments both at home and abroad have dampened confidence in the economy, reflected in softer asset prices and declines in retail sales. Private investment could weaken further this year, after a sharp decline in the fourth quarter of 2018, on deteriorating local business sentiment. The composite purchasing managers' index inched up slightly in January but remains in contraction territory. Business surveys saw sharp deterioration in sentiment, particularly in import/export trade and wholesale, reflecting the impact of ongoing trade conflict, and in real estate, mirroring the recent cooling in the property market.

On the supply side, services will continue to be the main driver of growth, supported by trade-related and professional services. Business sentiment in the sector fell markedly in mid-January, but retail, accommodation, and food services will likely be buttressed by continued strength in inbound tourism.

Inflation is forecast to decelerate slightly to 2.3% in 2019 and 2020 (Figure 3.9.8). The rising trend in rents starting early last year will continue to feed through, but recent consolidation in property markets will have a mitigating effect on consumer prices. Cost increases will be restrained as well by slower economic growth, higher interest rates at home, and the strong US dollar, while soft international commodity prices will keep external price pressures at bay.

The FY2019 budget surplus is forecast to dip to the equivalent of 0.6% of GDP. Budgetary revenue is slated to rise by 5.0% on higher expected receipts from land premiums. Budgetary expenditure is also projected to increase, by 13.0%, on higher outlays for social welfare, education, health care, family allowances, tourism, and infrastructure, as well as increased investment in land resource utilization, environmental protection, and promoting innovative and creative industries. Fiscal reserves are forecast to equal 39.4% of GDP by the end of March 2020.

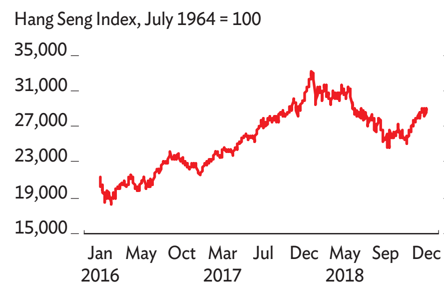
Trade is likely to offer little support to growth this year as slower increase in demand from the PRC and uncertainty spawned by escalating trade conflict with the US will dampen export growth. A strengthening US dollar could further limit export gains. Imports are also likely to be restrained by weakening domestic demand. The resulting goods trade deficit will be offset by an improving surplus in the services account as tourist numbers grow and demand for professional and

3.9.1 Selected economic indicators (%)

	2019	2020
GDP growth	2.5	2.5
Inflation	2.3	2.3
Current account balance (share of GDP)	3.5	3.3

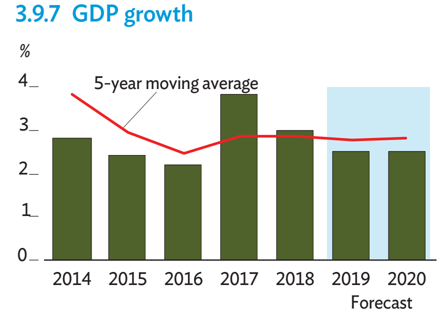
Source: ADB estimates.

3.9.6 Stock market



Source: Bloomberg (accessed 14 March 2019).

3.9.7 GDP growth



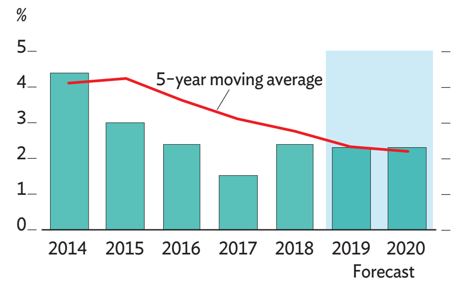
Source: *Asian Development Outlook* database.

financial services increases with new opportunities arising in the development of the Guangdong–Hong Kong–Macao Bay Area. Further, several trade and investment agreements, including those signed with the PRC and other key trade partners, may come into force this year. On balance, the current account surplus is forecast to narrow to 3.5% of GDP this year and further to 3.3% in 2020 (Figure 3.9.9).

The main risk to the outlook would be spillover from worsening trade friction. Full-blown escalation of the US–PRC trade conflict seems to mean the imposition by both economies of 25% blanket tariffs on all merchandise imports and, between the US and its trade partners globally, additional 25% tariffs on trade in automobiles and their parts and components. If this worse-case scenario occurs—and if Hong Kong, China sees half of its trade affected by the conflict—export growth is likely to fall by 0.2 percentage points, and GDP growth could lose an estimated 0.1 percentage points. Further, domestic demand, while still solid, may eventually succumb to heightened external uncertainties and weaker asset markets this year and next.

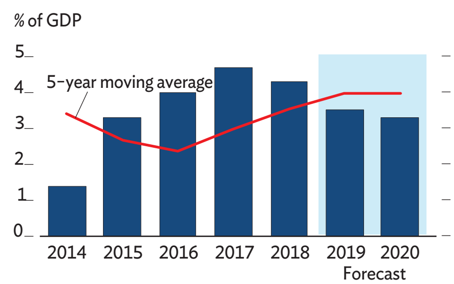
The other main risk would be an abrupt and steep increase in US interest rates, which could push up local interest rates. Tighter local monetary conditions would deepen the fall in residential property prices, which is already a downside domestic risk, and add to the debt burden, thus further weakening domestic demand. Nevertheless, Hong Kong, China remains well positioned to withstand external headwinds and counter these risks, buffered by ample fiscal reserves and benefiting from prudent economic management and a sound financial system.

3.9.8 Inflation



Source: *Asian Development Outlook* database.

3.9.9 Current account balance



Source: *Asian Development Outlook* database.

Policy challenge—sustaining labor supply as the population ages

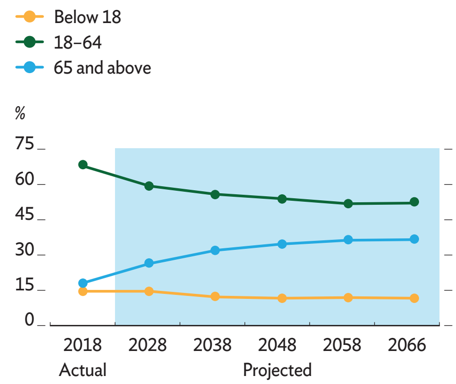
Hong Kong, China has a population that is aging more rapidly than in many other developed economies, including Japan, as fertility remains low and life expectancy rises. The Census and Statistics Department projects the share of the elderly in the population to nearly double from 17.9% in 2018 to 31.9% in 2038, while the shares of those aged 18–64 and under 18 both decrease (Figure 3.9.10). According to the International Monetary Fund, the rapidly increasing old age dependency ratio—defined as the ratio of residents drawing retirement benefits to working-age residents—can double public health spending, from the equivalent of 2.9% of GDP in 2016 to 6.0% in 2050, and spending on pensions, from 1.8% of GDP in 2015 to 3.9% in 2050. These projections indicate that population aging threatens to lower potential GDP growth by 0.75 percentage points annually, on average, during 2020–2050, putting further pressure on revenue and the fiscal balance.

Given the social implications, there is limited scope to gradually consolidate spending or raise adequate additional revenue to stem the demographic push toward structural deficits. The other main policy instruments available to the authorities for this purpose are to raise the rate of labor force participation and support innovation that keeps the elderly healthy and productive. There is certainly scope for raising female participation in the labor force, which, at 65% for ages 15–64 in 2017, was about 15 percentage points lower than for males. This gap can be narrowed through a range of actions: increased support for child care, more affordable child and after-school care, and the promotion of flexible work arrangements and part-time employment. The government has already embarked on policies that aim to retain older workers and thereby slow labor force depletion. As part of this policy, the Labor Department expanded its employment program for the middle aged by providing subsidies to employers that hire the unemployed or retirees aged above 60. In addition, the authorities are studying interventions successfully undertaken in Japan and Singapore: employer subsidies, support for creating short-term and flexible jobs, and statutory protection against age discrimination.

The government should also consider adaptive technologies that help counter the downside effects of an aging workforce. Such technologies allow people to work from home, help make the workplace more ergonomically correct and supportive, and facilitate medical advances that contribute to longevity and working lives that are longer and more productive. Yet other channels—through which technology can help seniors adapt and build their job skills, allowing them to be retained or brought back into the workforce—are advances in cloud-based job matching services and customized interactive training services, such as remote and virtual education and training for the elderly. Training programs should be developed for businesses to improve their management of age diversity and human resources.

The government should actively embrace labor market technological innovations more broadly and support them by funding research and development. The aim should be to develop human capital and resources with better skills, particularly in science, technology, engineering, and mathematics, especially in industries attuned to the current demographic shifts. With the work dependency ratio in steep ascent, now is the time to act decisively to accommodate these demographic changes and mitigate their negative impacts on the economy.

3.9.10 Population share by age group



Sources: Demographic Statistics Section, Census and Statistics Department; Wong, K. and M. Yeung. 2019. Population Ageing Trend of Hong Kong. *Economic Letter 2019/02*. Office of the Government Economist.