Government spending on capital works will be increased by 39% this year to $86.8b

Hong Kong's plan to get back in the growth groove

The latest Hong Kong Budget is providing a reprieve to besieged workers and businesses, whilst nurturing promising industries and millenials.

When Financial Secretary Paul Chan unveiled the 2017-18 Budget, he pronounced fresh measures to support battered sectors like tourism and the struggling small and medium-sized enterprises (SMEs), and also talked about the significant spending on infrastructure and education – a mix that the government hopes will help the Hong Kong economy snap out of its slow-growth stupor. Analysts forecast a better-performing year for the territory especially in light of stronger government support, but the near-term horizon is laden with challenges.

Mainland China, a top trading partner, continues to tread a sluggish growth trajectory. Retail sales will likewise remain suppressed this year after a brutal beating in 2016, although an expected stability in property prices and stronger support for workers should help boost domestic demand.

The government expects that these measures should boost gross domestic product for 2017 by 1.1%.

How well Hong Kong copes with the potential whiplash of 2017 will depend on its response to key threats. **Chua Han Teng**, senior analyst, Asia country risk and financial markets at BMI Research, identifies the most pertinent ones: the ongoing structural slowdown in China, an overvalued domestic housing market, and an uncertain external environment due to rising global protectionism.

"Hong Kong's economy will face downside pressures over the course of 2017 as slowing economic activity in the mainland will weigh on trade and retail sales," he says. "In addition, our long-held view for the housing market to decline will be negative for domestic demand as construction activity will be undermined whilst negative wealth effects will weigh on private consumption."

Meanwhile China's gross domestic product grew by 6.7% in 2016, continuing a steady decline in the past five years after climbing to 9.3% in 2011. The economic slowdown has led to a decline in mainland Chinese tourists travelling to and spending in Hong Kong, a trend which has pummelled the territory's retail and tourism sectors. Value of retail sales, in nominal terms, plummeted 8.1% in 2016, worsening from the 3.7% decline in 2015, according to the Hong Kong Development Trade Council (HKTDC).

Countering the mainland factor

The latest Budget announcements contained some measures to help counter the impact of the slowdown in China. For instance, the Hong Kong government will waive license fees of $137m for thousands of travel agents, hotels, guesthouses, restaurants, and hawkers to assist the distressed tourism industry.

To recall, tourist spending growth moderated in January with retail sales of jewelry, watches, clocks, and valuable gifts – viewed as a close proxy for tourist spending – declined by 3.9% year-on-year after rising 2.3% year-on-year in December. Still, even as tourists appear to be keeping their wallets closed, more of them have been flocking to the territory, a refreshingly positive trend for the downtrodden tourism sector, says **Sylvia Sheng**, China economist at Merrill Lynch (Hong Kong).

"Apart from an improvement in the overall tourist arrivals growth in recent months, there are also emerging signs of recovery in overnight visitors which will likely offer support to tourist spending," she says. "However, we think a strong Hong Kong dollar on the back of US dollar strength will likely pose challenges to tourist arrivals in the coming months."

The appreciation of the Hong Kong dollar has helped dissuade mainland China tourists from coming to and shopping in the territory in favour of other popular tourist destinations in Asia and Europe. Retailers have been hit hard, with sales plummeting, but the bleeding should lessen in 2017 on the back of local spending.

Chua Han Teng

Thomas Shik

"Looking ahead, we expect to see some stabilisation in retail sales growth in the near term," says Sheng. "Local spending growth will likely remain solid amidst resilient labour market conditions and expected stable property prices."

In January, retail sales growth came in slightly above market expectations. Retail sales volume contracted by 1.4% year-on-year in January, narrowing from the 2.9% year-on-year decline in December. Meanwhile, in value terms, January retail sales growth came in at -0.9% year-on-year versus the -2.9% year-on-year in December. Sheng attributes this mainly to stronger local consumption and seasonal distortions stemming from an early Lunar New Year.

Where Hong Kong might fall flat on its face this year is trade. "Hong Kong exports are not expected to fare much better in 2017 than in 2016, with value sales expected to show zero growth," says Sheng. "The rising trade tension triggered by US President Donald Trump's promised protectionist policies, possible shocks in the EU and Japan, untamed volatility of capital markets, a marked slowdown of the Chinese economy, and escalated geopolitical tensions pose the major downside risks to exports." HKTDC data show mainland China and the US were the top two largest trading partners of Hong Kong in 2016, with the former also the largest export market representing for 52.4% of Hong Kong's total exports in 2016.

Even as the government attempts to support the tourism industry and domestic demand, some analysts question the effectiveness of these efforts. Chua, for one, believes it is unlikely that the one-off measures in the new Budget will have a significant impact on the Hong Kong economy.

"These measures appear to be aimed at mitigating the impact of the economic slowdown for Hong Kong's more vulnerable residents, including extra handouts to the elderly and disabled," he says, referring to the government's plan to raise the Old Age Living Allowance and broaden asset and healthcare coverage. "In addition, given that the tax cuts to households and businesses are likely to be rather limited, we do not believe that it will lead to a significant rise in spending." The latest Hong Kong Budget outlined a plan to reduce salaries tax and tax under personal assessment by up to a maximum of $20,000 for the 2016-2017 fiscal year, impacting 1.84 million taxpayers and cutting government revenue by $16.4b (US$2.1b), based on HKTDC estimates.

But **Thomas Shik**, acting chief economist at Hang Seng Bank, holds a more sanguine outlook: "Thanks to the modest improvement in the outlook for advanced economies and the recent economic stabilisation on mainland China, Hong Kong's growth momentum has gathered steam over the recent months. The pace of the year-on-year decline in retail sales volume has narrowed and trade growth has returned to positive territory after about two years of decline."

Growth prospects

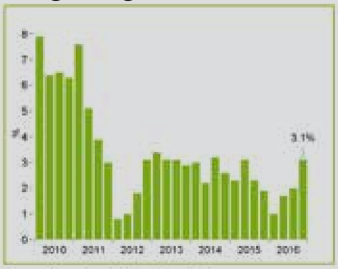
"Assuming a stable global environment, we expect the growth momentum to continue. Before the release of the Budget, we projected that Hong Kong's growth should accelerate to 1.8% this year from 1.4% last year. Now given the stronger-than-expected growth for the whole of 2016, we are considering an upgrade of our 2017 full-year growth forecast," says Shik.

One possible risk lies in the fact that global growth remains relatively low, which can easily dampen prospects for the territory's small and open economy. "It is not surprising to see that Financial Secretary Paul Chan unveiled a new round of relief measures to support the economy including cutting salaries tax and profits tax and waiving rates," says Shik. "The government expects that these measures should boost gross domestic product for 2017 by 1.1%."

Wenda Ma, economist at HKTDC, reckons the measures will strengthen Hong Kong's competitiveness and liveability. Government spending on capital works will be increased by 39% this year to $86.8b from $62.4b in 2012-2013, which is expected to contribute 4.7% to Hong Kong's GDP.

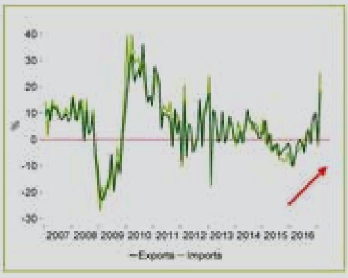
Another $1b will be earmarked for youth training and post-secondary local student education. Promising sectors such as transshipment, cross-boundary e-commerce, air cargo, and startups will receive greater support. These initiatives are viewed as investments for the future.

Hong Kong GDP growth



Sources: Macrobond, Hang Seng Bank

Hong Kong trade growth



Sources: Macrobond, Hang Seng Bank

Contributions to Hong Kong GDP growth

Sources: Macrobond, Hang Seng Bank

Hong Kong retail sales volume growth

Sources: Macrobond, Hang Seng Bank