



For now the economy has gained some breathing room

## Hong Kong economy to see subdued growth in 2017

Real gross domestic product growth is forecast to reach 1.3%, whilst a more optimistic view expects a 1.8% expansion but with upside risks.

When Hong Kong's economic report card revealed better-than-expected growth in the third quarter of 2016 and Financial Secretary Paul Chan Mo-po signalled even higher fourth quarter results, the good news lent cause for celebration. But those cheers will be short-lived amidst challenges both in the domestic and global fronts that will hamper full recovery. Analysts seem optimistic that there will be a bit more room for the economy to recuperate, but uncertainties abound and business outlooks are deeply dour.

The Hong Kong economy has gained breathing room as monetary headwinds temporarily ease, but **Duncan Wooldridge**, economist at UBS, says a strong rebound is not in the cards. Instead, the territory will see subdued growth in 2017 and 2018, with real gross domestic

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product (GDP) growth forecast to only reach 1.3% and 1.4%, respectively.

### Restrained growth

"Whilst Hong Kong's near-term macro has become less bad, we don't expect much recovery ahead. Growth is likely to remain subdued and chug along an L-shaped path in 2017 and 2018," says Wooldridge, referring to the previously higher 2 to 3% GDP growth range the territory posted from 2013 to 2015.

He also expressed skepticism that the battered retail and hospitality sectors will bounce back since demand is not likely to improve significantly, even taking into consideration dipping domestic costs. "Whilst these sectors are indeed finding a floor, as the supply sides become more favourable and the relative Hong Kong dollar

appreciation pauses, any recovery thereafter still critically hinges on better end-demand," says Wooldridge. "However, tourist spending is still hindered heavily by continued RMB depreciation and tighter rather than looser Chinese visa policy."

The silver lining for the Hong Kong economy is that the headwinds caused by tighter monetary conditions have lessened since the latter half of 2016: The US dollar, which had been appreciating, retreated somewhat in the third quarter of 2016, allowing the Hong Kong dollar to stabilise in real exchange terms; and expectations for US rate hikes lessened after the "Brexit" vote in late June.

"The stabilisation in monetary conditions since the second half of 2016 has allowed the city to temporarily muddle through," says Wooldridge, adding that even if growth will be restrained, domestic spending should at least pick up in 2017 if wealth effects from property turn more constructive.

**Sylvia Sheng**, China economist at Merrill Lynch (Hong Kong) likewise expects Hong Kong's economic growth momentum to remain modest in 2017, which would help keep domestic inflation pressure in check. "Looking ahead, we expect inflationary pressure to remain moderate in the near term," says Sheng. "On the external front, import price inflation will likely remain contained amidst a strong Hong Kong dollar on a trade-weighted basis on the back of US dollar strength."

### Optimism and uncertainties

Meanwhile, a more optimistic Hang Seng Bank expects Hong Kong's economy to expand by 1.8% in 2017 as recovery in advanced countries gains pace and mainland China stabilises. This growth forecast comes with a couple of notable upside risks, namely a stronger low base effect and a stimulus package from the Trump administration.

"The low base effect may be bigger than we anticipate as retail sales and trade have both persistently declined for the past two or three years," says **Thomas Shik**, acting chief economist at Hang Seng Bank. "Economic

confidence on global growth may further improve following the planned announcement of economic stimulus plans by the Trump administration later this year.”

Ongoing uncertainties surrounding the Hong Kong economy, including potential changes in international trade policy and the mainland’s economic transition, may dampen growth. **Julia Wang**, economist at HSBC, notes that significant changes to US trade policy under the Trump administration is a key downside risk, along with the sluggish pace of global recovery. Hong Kong will need to brace for impact when trade conflicts do break out. “Should our base case view of the avoidance of an outright trade-war play out, our economists predict stronger growth in the US and continued stability in China. This should have a positive impact on Hong Kong’s economy,” says Wang. “However, in the scenario of rising protectionism abroad, Hong Kong’s economy stands to be impacted negatively.”

## SME dour outlook

On the home front, majority of small and medium enterprises (SMEs) do not expect the economy to improve in 2017. The Standard Chartered Hong Kong SME Leading Business Index (SME Index) revealed that only 10% of SME respondents expect better economic growth. The remaining majority was equally split between expecting deterioration and a status quo.

Released jointly by Standard Chartered Bank and the Hong Kong Productivity Council, the SME Index fell to 41.9 in the first quarter of 2017 from 42.5 in the fourth quarter of

2016, 50 being neutral. This was the first drop after two consecutive quarters of improvement from the record-low 40.4 reached in the second quarter of 2016, indicating that companies have not been able to shake off their pessimistic sentiment, says **Kelvin Lau**, senior economist, HK at Standard Chartered Bank (HK) Limited. “SMEs are bearish on Hong Kong’s economic outlook,” says Lau. “Resilient hiring sentiment was not enough to turn things around.”

SME sentiments on sales and profit margin also dropped to their second-weakest levels in more than four years. Still, he reckons the cautiousness reflected in the sales and profit margin sub-indices related only to short-term business performance, which contrasts with continued confidence in the territory’s long-term business outlook.

## Sector expectations

Looking at the SME index by industry, manufacturing fell to 39.2, the second-lowest on record, from an already-weak 40.3 prior. On the other hand, import/export/wholesale trade rebounded in the first quarter of 2017, seen by Lau as a reversion following its underperformance throughout 2016. Finally, retailers were not any more upbeat than more externally oriented respondents, with the 38.9 reading for retail barely above its third quarter of 2016 low. As a consolation for retailers, Wang says retail sales have been falling at a slower pace in recent months as tourist arrivals have shown signs of stabilisation, although sales of consumer durables and luxury items remain weak.

In terms of business performance,

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21% of SMEs anticipated expansion, by an average 10%. This contrasts with 29% of respondents expecting contraction, by an average 11%. Lau notes that one in five respondents said Trump’s election as US president had weakened their business confidence. Most businesses also expressed worries about possible changes to US trade policy (57%), followed by intensifying foreign exchange volatility (23%) and an uncertain rate-hiking outlook.

## Property focus

Whilst the Hong Kong economy seems to have gathered some strength in 2016, challenges remain in 2017, and all eyes will be on how well the property sector copes, says Wang. The property market has staged a notable recovery since early 2016 when prices corrected from an all-time high reached in September 2015 whilst transaction volumes also improved. This helped lift Hong Kong’s growth to 1.9% in the third quarter of 2016, up from 1.7% in the second quarter.

But Wang warns that the Hong Kong property market could be doubly impacted by local tightening measures and the likelihood of a more aggressive rate hike cycle in the US. She cites the increase in the double stamp duty on residential property to a flat rate of 15%, from a sliding scale of 1.5%-8.5% previously, as likely impacting the recovery in the housing market.

“Furthermore, our US economists have now pencilled in a more aggressive path of Fed tightening, amidst expectations of more fiscal stimulus and higher growth in the US,” she says. “Should this materialise, Hong Kong will face higher mortgage costs which is likely to bring more challenges for the housing sector in 2017.”

## Growth momentum has improved in 2H 2016



## Expected economic performance: 2017 vs 2016

