Hong Kong

The Covid-19 crisis worsens the ongoing recession

The Covid-19 pandemic strikes an economy that has already been weakened by several quarters of decline in merchandise exports, tourism, private consumption and investment. Since February, the government has launched a major fiscal stimulus plan representing about 10% of GDP. The plan includes direct support measures in favour of corporates and households. Additional structural measures will be needed going forward, in order to fuel a sustainable rebound in private demand and bolster medium-term economic growth prospects. Thanks to abundant fiscal reserves and minimal debt, the government has comfortable manoeuvring room to pursue an expansionist policy for several years to come.

Another rude test

Economic growth has plummeted over the past two years. It dropped from 4% year-on-year (y/y) in H1 2018 to 1.9% in H2 2018 and 0.6% in H1 2019, before contracting by 2.8% in H2 2019. In Q1 2020, Hong Kong is expected to report its fourth consecutive quarter of negative quarterly growth in real GDP. The recession is likely to extend into the second quarter. Once the international environment improves, economic activity should begin to recover gradually, supported by stronger growth in mainland China and a major fiscal stimulus plan. Yet it could also continue to be hampered by persistently sluggish private-sector demand.

In 2019, and certainly also in Q1 2020, the contraction in real GDP was due to the sharp decline in both domestic demand (excluding public spending) and exports of goods and services. Private consumption plummeted in H2 2019 (-3.1% y/y, compared to +0.9% in H1 and +5.4% in 2018), disrupted by protest movements, the sharp decline in tourism inflows and the deterioration of the labour market. The situation abruptly worsened in February after confinement measures were enforced in mainland China and Hong Kong. Between August 2019 and January 2020, retail sales fell by more than 20% y/y each month, before collapsing by 47% in February (chart 2). Tourist inflows dropped to fewer than 200,000 visitors in February whereas Hong Kong still hosted 3.2 million visitors a month on average between August 2019 and January 2020 (down from 5.8 million visitors a month in H1 2019). Activity in the tourism sector is expected to remain at a standstill for several more weeks or even months. The impact on the economy will be significant: spending by tourists (78% of which were from China) in local retail shops accounts for about a third of Hong Kong's retail sales, and tourism accounts for an estimated 4.5% of GDP.

The downturn in the labour market was moderate in 2019, but is expected to worsen in H1 2020, restraining the rebound in private consumption. Employment and real wages dipped slightly in H2 2019. The unemployment rate rose from 2.8% in mid-2019 to 3.3% at year-end 2019, before hitting 3.7% in February 2020. Last but not least, the equity market correction (the Hang Seng index plunged 16% in Q1 2020) and the decline in real estate prices (-6% since mid-2019) should fuel negative wealth effects that will weigh on household consumption in the short term.

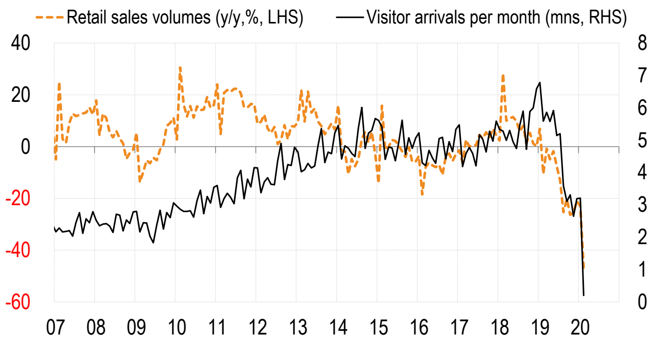
1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	2.9	-1.2	-2.5	3.9
Inflation (CPI, year average, %)	2.4	2.9	2.1	2.4
Budget balance / GDP (%)	2.4	-1.3	-10.0	-5.8
Current account balance / GDP (%)	3.7	3.5	2.5	3.0

* Fiscal Year from April 1st of year N to March 31st of year N+1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Tourist arrivals and retail sales: free fall



Source: CSD, Hong Kong Tourism Board

Investment collapsed in 2019 (-12% vs. +2% in 2018), pulled down by the erosion of business sentiment and economic growth prospects. The situation is likely to have deteriorated further in Q1 2020 due to the decline in economic activity and corporate losses. Private investment should remain depressed in the quarters ahead.

The contraction in tourism, global trade and China's external trade led to a decline in Hong Kong's exports and imports of goods and services in 2019. These trends will continue in 2020. Merchandise exports (99% of which are re-exports) were down 4% in 2019, and declined another 12% y/y in the first two months of 2020. In net terms, however, external demand made a positive contribution to real GDP growth (of 2.3 percentage points) in 2019, after making negative contributions in the three previous years.

Fiscal policy is increasingly expansionist

The government adopted a clearly expansionist fiscal policy in 2019 to address the contraction in private demand and the deterioration in business sentiment and household confidence. The 2019/20 budget included tax cuts, increased social welfare spending, and new investments in infrastructure, innovation and the development of technological hubs. Faced with the shock engendered by the coronavirus epidemic, the government announced two new, large stimulus packages in February and then in early April. The plans mainly call for one-off measures to curb the decline in domestic demand in the short term. In the future, the government will also need to round out its fiscal policy with more structural measures that aim to improve the social welfare system and improve access to housing, which would bolster private consumption and strengthen medium-term growth prospects.

The fiscal stimulus plan for 2019/20 accounted for 1.3% of GDP. The new stimulus packages introduced since February account for 10% of GDP. They aim, first, to strengthen Hong Kong's capacity to combat epidemics with the creation of a new Anti-Epidemic Fund (HKD 30 bn, or 1% of GDP) and, second, to support corporates and households in order to offset their revenue loss, boost domestic demand and encourage a rapid rebound in activity. The measures include: 1) cash payout of HKD 10,000 (nearly USD 1,300) to each permanent resident aged 18 or above, for a total of HKD 71 bn (2.5% of GDP); 2) tax and fee reliefs and other one-off relief measures (public services, rent for low-income housing…) for a total of HKD 81 bn (2.8% of GDP); 3) an employment subsidy scheme aimed at helping employers to pay wages for a period of six months (HKD 80 bn, or 2.8% of GDP); 4) relief measures for a list of specific sectors hit by the epidemic (tourism, construction…) for a total of HKD 21 bn or 0.7% of GDP; and 5) temporary job creation (HKD 6 bn, or 0.2% of GDP).

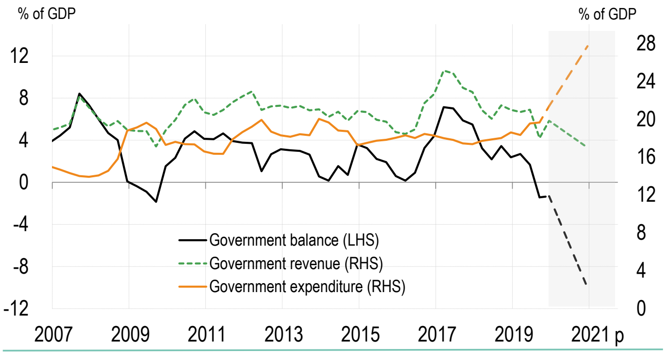
Hong Kong's monetary policy has also been loosened. Given the Currency Board arrangement, the Hong Kong Monetary Authority follows decisions of the US Fed. As a result, the base rate was cut from 2% to 0.86% in March. The authorities have also introduced lending programmes for SMEs (with low interest rates and state guarantees) and eased the prudential standards of banks to encourage them to cover corporate and household financing needs in the short term.

Public finances are solid enough to weather the shock

The government is expected to report a deficit of 1.3% of GDP in fiscal year 2019/20 (ended 31 March 2020): this would be its first deficit since 2003. In fiscal year 2020/21, the deficit could swell to 10% of GDP. The deficit should narrow thereafter as economic growth recovers and the government adjusts its fiscal policy. Even so, the government expects public finances to continue to report deficits over the next five years.

In fiscal year 2019/20, government revenue contracted by 5% and represented less than 20% of GDP (preliminary estimate), as tax revenues were hit by the recession, the equity market correction

3- Fiscal balance will now remain in deficit



Source: Hong Kong Treasury, BNP Paribas

and the property market downturn. Government expenditure increased by 15%, with an acceleration in Q1 2020 due to the first measures of the new stimulus package. In fiscal year 2020/21, revenue should decline significantly, while spending will continue to rise and reach a record level close to 28% of GDP, vs an average of 19% of GDP over the past five years (chart 3). The government has substantial manoeuvring room to absorb some slippage in its deficits in the short and medium term. Thanks to a solid tradition of fiscal discipline, it has reported surpluses over the past 15 years, despite the volatility of fiscal revenues (which rely on taxes, stamp duties and land premium). As a result, the government has managed to build up very comfortable fiscal reserves. In fiscal year 2019/20, reserves accounted for 39% of GDP and 23 months of fiscal spending (compared to 13 months in 2004/05). These reserves will be used to finance part of the upcoming deficits, which means they will diminish in the years ahead. Fiscal reserves should narrow to less than 15 months of fiscal spending by the end of fiscal year 2020/21, which still provides a very comfortable safety buffer. The central government could also opt for bond issues. It has a minimal debt burden, which is more than covered by assets: its 2004 international bond issue matured in 2019; and the bonds issued as part of a local market development programme (which are not used to finance the budget) account for less than 5% of GDP.

In contrast, corporate debt is very high (226% of GDP at end-September 2019) as is household debt (79%), which makes them a source of vulnerability in the current environment. Some will find it increasingly difficult to meet loan payments despite the relief offered by the authorities and creditors. Banks' average performance is likely to deteriorate in the months ahead, but the Hong Kong financial system as a whole is solid. Banks have sufficiently strong equity capital and liquidity to weather the shock.

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