HONG KONG

SHOCK FOLLOWS SHOCK

The economic growth recovery has been unbalanced since the health shock in early 2020 and has rapidly lost steam. It was then interrupted in the first quarter of 2022, due to a very sharp rise in the number of Covid-19 infections and deaths linked to the Omicron variant. The epidemic wave is starting to recede, but Hong Kong will now have to face the effects of a slowing global trade, rising commodity prices and the tightening of US monetary policy. Despite these unfavourable conditions, sovereign solvency remains very robust and the government keeps a strong capacity to continue an expansionary fiscal policy.

After two years of contraction, Hong Kong's economy grew by 6.4% in 2021. However, its recovery started to run out of steam in Q2 2021, and activity came to another sharp stop in Q1 2022 due to a major resurgence of the pandemic. Real GDP returned to its pre-Covid level of end-2019 last year, but it is unlikely to regain its end-2018 level (i.e., prior to the protest movements) until the second half of 2022.

A STUTTERING RECOVERY IN 2021...

The Covid-19 shock in early 2020 hit an economy that was already in recession. After several quarters of contraction, private consumption, investment, tourism and goods exports all collapsed in H1 2020. Activity – with the exception of tourism – then recovered rapidly, supported by a large fiscal stimulus package, an easing of monetary conditions and the strong acceleration of foreign trade. However, the recovery has remained unbalanced and has rapidly lost steam, before being interrupted in Q1 2022.

While foreign trade recovered strongly after the shock in Q1 2020, boosted by the very solid performance of Chinese exports, domestic demand lagged behind despite the very accommodative policy mix. The investment ratio, which fell from 21.6% of GDP in 2018 to 17% in 2020, barely improved in 2021 (reaching 17.5%), held back by the territory's loss of attractiveness and worsening economic prospects. Private consumption (65.2% of GDP in 2021, down from 68.4% in 2018) faced significant constraints, notably including border closures (purchases by non-residents, primarily from China, represented nearly half of retail sales before the health crisis), a degraded labour market and low consumer confidence. The labour market has not regained its position from before the crises of 2019 and 2020, with the hardest-hit service sectors also being the most labour-intensive, such as restaurants and hotels. Between Q4 2018 and Q4 2021, real wages grew by less than 1% and total employment fell by 4.8%. The total population and the active population also fell over the same period, by 1.1% and 3.8% respectively. The unemployment rate climbed from 2.7% in December 2018 to a peak of 6.8% in February 2021, then fell back to 3.5% in January 2022 before starting to rise again (to 4.2% in February).

... INTERRUPTED BY THE OMICRON WAVE IN Q1 2022

Up until the end of 2021, Hong Kong was successful in controlling the Covid-19 pandemic, albeit at the cost of significant restrictions (notably at the border). However, the health situation has deteriorated rapidly since the arrival of the Omicron variant in late December 2021. The number of infections soared out of control, especially due to insufficient vaccination rates. By 6 April 2022, 86% of the population had received two vaccine shots, from just 65% at end-2021; and the vaccination rate was only 61% for those aged between 70 and 79 and just 35% for the over-80s. The number of new cases jumped from less than 100 in the last week of December to 450,000 in the first week of March (in a population of 7.4 million), and the mortality rate also rocketed[1] .

Between January and mid-March, the authorities introduced very stringent restrictive measures in Hong Kong. Mobility indicators, which had returned to pre-crisis levels by the end of 2021, collapsed and in early March were running at their lowest levels since the pandemic began.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth, %	-1.7	-6.5	6.4	1.6	3.6
Inflation, CPI, year average, %	2.9	0.3	1.6	3.0	2.3
Budget balance / GDP, % (1)	-0.6	-9.4	-1.4	-3.5	-2.0
Government debt / GDP, %	0.3	1.0	2.1	3.2	4.0
Current account balance / GDP, %	5.8	6.9	11.2	4.2	4.7
Forex reserves, USD bn	441	492	497	500	505
Forex reserves, in months of retained imports	41	51	44	38	38
Réserves de change, en mois d'imports	14.9	16.3	13.1	12.3	11.7

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CONSUMERS REMAIN DEPRESSED

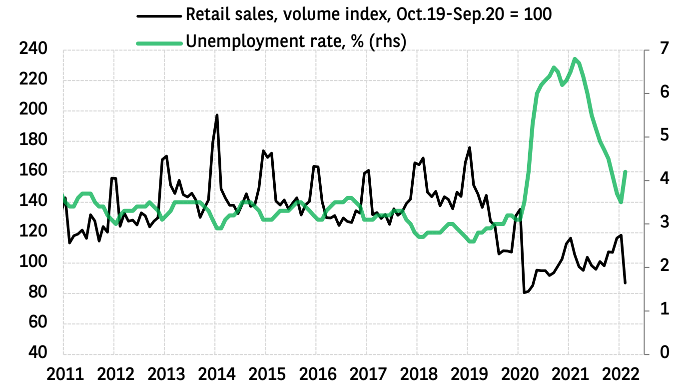

CHART 1

SOURCE: CSD

1 The average number of daily deaths per million population was below 0.1 in 2020 and 2021, but reached a record level of 38 in the second week of March. It had fallen to 9 a month later, but this is still the highest rate in the world at present. By way of comparison, this death rate peaked at 2.5 in Singapore in 2021 and at 10 in the US. Total Covid-related deaths in Hong Kong climbed from 213 at the end of 2021 to 9,069 on 15 April.

Retail sales fell sharply once again. Since mid-March, this wave of the epidemic appears to have eased and mobility conditions have started to improve. They are likely to see a very gradual return to normal over the next few months given the tough Covid-19 strategy.

INTERNATIONAL CONDITIONS HAVE WORSENED

Hong Kong is now also facing other challenges, linked to the deterioration of international conditions. First of all, Hong Kong will suffer the indirect repercussions of the war in Ukraine through its effects on global trade and on commodity prices. Its direct trade with Russia and Ukraine is very limited, at 0.2% and 0.7% respectively of total imports and exports. However, because of its role as a regional trade hub, Hong Kong is vulnerable to the expected slowdown in world trade and disruptions to supply chains. These disruptions are expected to be exacerbated over the next few weeks by the consequences of the pandemic wave on industrial production and transport of goods in China. Therefore, in the short term, a slowdown in exports (of which 98% are re-exports) will add to Hong Kong's weak domestic demand.

Meanwhile, Consumer Price Inflation (CPI) is set to accelerate, driven by rising global commodity prices and supply difficulties. Pressures on food prices (which represent 27.4% of the consumer basket) have increased recently, with average food price inflation accelerating to 3.1% y/y in December-February from 2.2% over the previous six months. However, CPI is likely to remain moderate; it is projected to average around 3% in 2022, vs. 1.6% in 2021. It will be contained by the lack of wage pressure, weak domestic demand and slow growth in rent (rent makes up 40.3% of the CPI index). Moreover, government subsidies for energy and other utility bills, planned for this year, will limit households' loss of purchasing power.

The acceleration of monetary tightening in the US is another risk factor that could affect Hong Kong's economic growth in the short term. Because of its Currency Board regime, Hong Kong's monetary policy follows the policy decisions of the US Federal Reserve. Monetary tightening in the US is likely to continue at a rapid pace in order to contain fast-rising inflation. The US policy rate, which had been held at 0.25% since the onset of the Covid-19 shock in early 2020, was increased to 0.5% on 16 March and is likely to get close to 2% by the end of 2022. Hong Kong's base rate will follow suit; it was increased from 0.5% to 0.75% in March. However, inflation rates and economic cycles differ between the two economies. In Hong Kong, the increase in inflation will not counterbalance the expected rise in nominal interest rates in 2022, meaning that a greater tightening in monetary conditions.

FISCAL POLICY LEEWAY REMAINS VERY COMFORTABLE

Fiscal policy will continue to support the economy in 2022. The recessions of 2019 and 2020 and the pandemic have caused a rapid deterioration of fiscal balances, but the solvency of the public sector and Hong Kong's external financial position remain very solid.

The fiscal balance became negative in the 2019/20 fiscal year (April 2019 to March 2020) for the first time in fifteen years. The deficit then jumped to 9.4% of GDP in 2020/21, following a fiscal stimulus package worth 12.3% of GDP. In 2021/22, some of the support measures have been partially renewed (representing some 3% of GDP). The deficit has fallen back rapidly (it is expected to be less than 2% of GDP), helped by the economic recovery. In 2022/23, the government will maintain its expansionary fiscal policy. Its latest budget, announced at the peak of the latest Covid-19 wave at the end of February, sets out a stimulus package worth around 6% of GDP. The deficit is thus likely to increase again and should exceed 3% of GDP in 2022/23.

INCREASING INFLATION, INCREASING INTEREST RATES

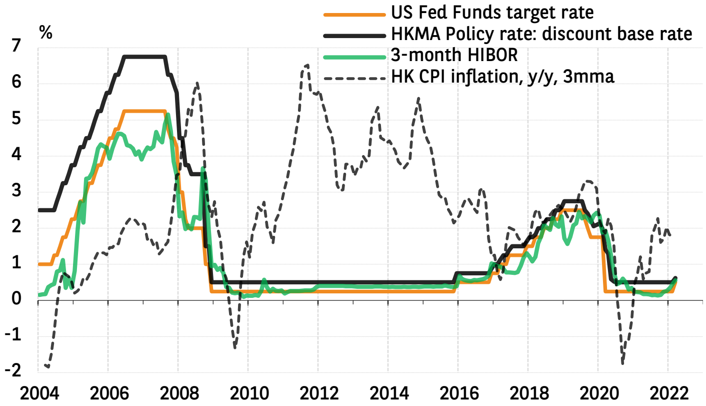

CHART 2 SOURCE: CSD, HKMA, US FEDERAL RESERVE

The government has implemented various measures such as increases in spending on health and vaccination (1% of GDP in 2020/21, 0.2% in 2021/22 and more than 2% in 2022/23) and measures aimed at supporting employment (3.4% of GDP in 2020) and creating temporary jobs (0.2% of GDP in 2021). It has also offered direct support to enterprises (subsidies, tax breaks, support for SMEs and sectors in crisis such as tourism) and to households, including cash payments to residents in 2020/21 (2.6% of GDP) and the distribution of consumer vouchers (1.3% of GDP in 2021/22 and an expected 2% of GDP in 2022/23), as well as various cost reductions (fees for public services, rents, etc.). The government is also projecting to develop a number of infrastructure projects. In the medium term, structural measures will also be necessary, to enhance social protection and housing affordability, and improve consumer confidence and demand.

The government has considerable fiscal leeway to introduce such support measures. It has drawn on its fiscal reserves to finance the deficits since 2020 and will continue to do so. Reserves fell from HKD 1,190 billion in March 2020 (43% of GDP and 23 months of government spending) to HKD 862 billion in December 2021. However, this has not affected the government's solvency: fiscal reserves still stand at around 30% of GDP and can cover 16 months of spending. In addition, government debt is very limited (and it is negative in net terms) and only a tiny portion is actually used to cover its budget financing needs (1% of GDP in 2020).

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