HONG KONG

STILL RECOVERING

The difficult recovery in economic activity experienced over the past two years reflects all of the constraints on the Hong Kong economy. Monetary policy, which must follow the United States' monetary policy, was restrictive until September 2024, with particularly painful consequences, as inflation in Hong Kong remained moderate and domestic demand, conversely, needed support. The economic cycle is much more in sync with mainland China's economic cycle. In the very short term, economic growth is expected to accelerate, supported by ongoing monetary easing and the expected strengthening of Chinese demand. In the medium term, Hong Kong's prospects hinge on its continued economic and financial integration with mainland China.

IN 2024, ACTIVITY ONLY JUST RETURNS TO ITS 2018 LEVEL

In Q3 2024, economic activity was down quarter-on-quarter (-1.1% q/q, seasonally adjusted), after modest growth in Q2 (+0.3% q/q) and a stronger start to the year (+2.5% q/q in Q1). The poorer-than-expected Q3 performance is mainly due to the slowdown in exports of goods and the continued decline in private consumption. Moreover, since the start of the year, activity has been hit by the restrictive monetary and financial conditions and weak domestic demand in China – which in particular has dampened confidence and taken a toll on tourism-related sectors in Hong Kong. This has significantly compounded the difficulties experienced by Hong Kong's economy in recovering from the successive shocks caused by the protest movements in 2019, the institutional change since 2020 and the 2020-2022 pandemic crisis.

Over the first three quarters of 2024, economic growth stood at 2.6% year-on-year (y/y), driven by net exports of goods and investment. Meanwhile, private consumption and net exports of services made negative contributions to real GDP growth (*chart 1*). Assuming that there is a strong acceleration in the final quarter and growth of +2.8% over the entire year, real GDP is expected to only just hit its 2018 level in 2024. Private consumption, investment and trade in goods and services will not have got back to their 2018 levels (in real terms) in 2024, while public spending is expected to be around 25% higher.

MULTIPLE CONSTRAINTS

Major obstacles have restricted the recovery in domestic demand since the end of the health crisis. First of all, while the government has kept a relatively accommodative fiscal policy stance, monetary and credit conditions have been tightened, in line with the monetary tightening cycle in the United States (as Hong Kong has a currency board system). The Hong Kong policy rate rose from 0.5% in March 2022 to 5.75% in August 2023, and then remained at this historically high level until mid-September 2024 – even though the post-COVID recovery was struggling and inflationary pressures remained very moderate. Annual average consumer price inflation has been close to 2% since 2022.

These very restrictive monetary conditions have affected private consumption and investment through various channels, including the continued decline in bank lending (- 3.6% y/y at end-2023 and - 3.1% y/y in September 2024), the rising debt servicing burden for households and companies, and the falling value of property and financial assets (*chart 2*). In September 2024, the volume of property transactions (over a 12-month cumulative period) was 40% below its 2021 level, and average house prices were down 27% compared to the end of 2021 (and down 13% y/y). What's more, the negative wealth effects of these falling house prices were compounded by the stock market correction, as the Hang Seng index lost 22% between December 2021 and September 2024 (but has rebounded recently).

Domestic demand, the property sector and financial markets have also been penalised by the low level of confidence among residents and foreign investors, the contagion effects of the property crisis in China (particularly via the financial difficulties of property developers) and the weak demand of Chinese consumers. The number of tourists visiting the territory (8 out of 10 come from China) has recovered slowly since 2022 and was still 30% below its Q3 2018 level in Q3 2024.

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	6.5	-3.7	3.3	2.8	2.7
Inflation, CPI, year average, %	1.6	1.9	2.1	1.9	2.2
Budget balance / GDP, % (1)	0.0	-6.6	-5.7	-5.5	-5.0
Government debt / GDP, %	5.9	7.8	8.2	7.0	8.2
Current account balance / GDP, %	11.8	10.2	9.1	10.6	8.6
Forex reserves, USD bn	497	424	426	423	420
Forex reserves, in months of retained imports	47.7	42.6	38.3	38.3	37.0

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

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

HONG KONG: CONTRIBUTION TO REAL GDP GROWTH

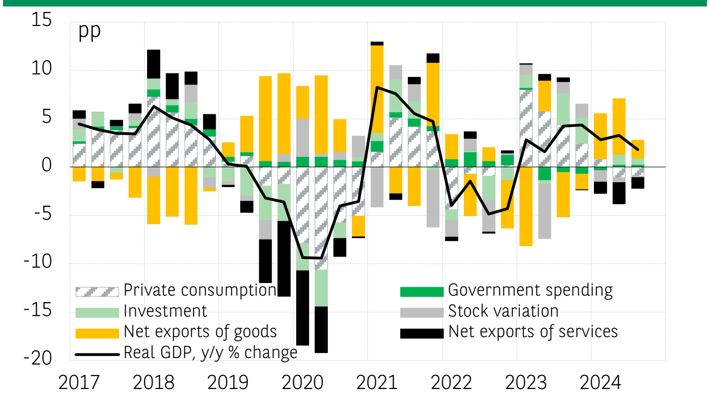

CHART 1 SOURCE: CENSUS AND STATISTICS DEPARTMENT, BNP PARIBAS

This is largely due to the cautious attitude of Chinese households and the appreciation of the HKD against the RMB from spring 2022 to summer 2024. Conversely, outbound tourist numbers from the Hong Kong territory have been above their 2018-2019 level since last summer. Overall, Hong Kong retail sales have posted a very fragile recovery since 2022 (more than a third of retail sales came from tourist spending in 2018). Over the first nine months of 2024, they tumbled even further (-9% y/y in volume terms) and were still 30% below their 2018 level.

In addition, as Hong Kong is a transit and re-export hub for goods (re-exports account for 99% of its exports and 92% of its imports), its foreign trade activity is affected by fluctuations in global demand and trade flows to and from mainland China (which accounts for 56% of its exports and 44% of its imports). As a result, after falling in 2023, the contribution of net foreign trade in goods has recovered, buoyed by the strong exports from China and other industrialised Asian countries in the early months of 2024. However, it declined during the summer, and this trend could continue in the short term, against a backdrop of rising customs barriers.

AN ONGOING MONETARY CYCLE CHANGE

Conversely, domestic demand and exports of services may increase slightly in the coming quarters. On the one hand, economic policy will become more accommodative. On the monetary side, an easing cycle started in mid-September and will continue at the pace set by the US Federal Reserve: the policy rate was cut to 5% on 8 November and further cuts are expected by the end of 2025. On the fiscal side, the government is seemingly opting to delay the adjustment process and maintain a moderately supportive policy. Last month, the authorities also announced a further easing of prudential rules to boost demand for loans and housing.

On the other hand, tourism-related activities could benefit from renewed interest among Chinese consumers, provided that their confidence is strengthened by the new support measures implemented by Beijing, and that the Chinese yuan appreciates against the US dollar and the HKD. However, the yuan appreciation seen in August-September has stalled, and it is uncertain in the short term given the inflationary risk of the measures proposed by Trump and the risk of new trade tensions between the US and China.

A FUTURE BOUND UP WITH MAINLAND CHINA

There are therefore high downside risks to our short-term economic growth forecast (2.7% in 2025). In the medium term, we expect real GDP growth of 2.4% per year on average (2026-2029), compared to 2.8% per year over the 2014-2018 period. Growth prospects are still being supported by Hong Kong's solid macroeconomic fundamentals: external accounts and public finances are robust, and large foreign exchange reserves and fiscal reserves provide the authorities with a strong financial capacity to tackle any economic difficulties, support the territory's development and address structural challenges (such as improving the social security system and housing supply, adapting to climate change and the low-carbon transition). Hong Kong also has a strong and well-regulated financial system and competitive service sectors.

However, a number of factors are impairing the potential growth of Hong Kong's economy. Firstly, there are demographic trends: the population is ageing (the proportion of the population above 65 years old has risen from 17% in 2018 to 22.8%, with Hong Kong becoming a "super-aged" society); the working-age population fell to 5.06 million individuals in mid-2024 (-5.2% since 2018), i.e. 67.2% of the total population; and talent is leaving the territory (due to emigration of residents and relocations of headquarters of multinational companies).

HONG KONG: MONETARY CONDITIONS AND ASSET PRICES

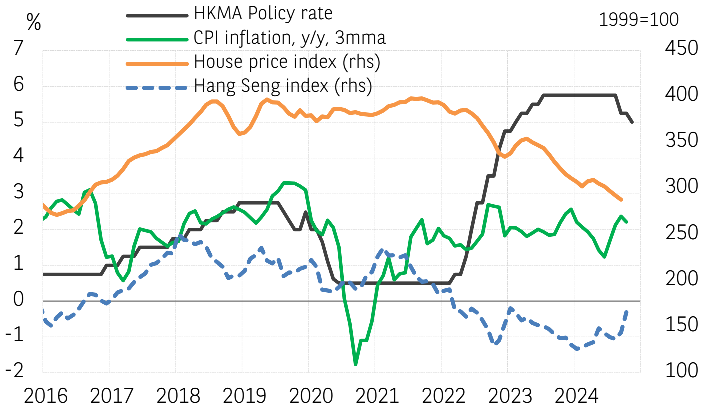

CHART 2 SOURCE: HKMA, CSD, BNP PARIBAS

Secondly, the institutional change since 2020, the increased political risk and the loss of the Hong Kong Special Administrative Region's "geopolitical neutrality" are dampening confidence among local and foreign investors. This has contributed to the difficult recovery in investment following the 2019-2020 and 2022 periods of contraction (in real terms, investment will be around 10% below its 2018 level in 2024). The investment ratio plummeted to 15.8% of GDP in H1 2024, compared to 21.6% in 2016-2018, which does not augur well for future economic growth. In addition, perceptions of a deteriorating doing business environment could weaken the bases of Hong Kong's success as an international trade and financial hub, built on the free movement of goods and capital and a stable and transparent legal and regulatory framework. Hong Kong is one of the five main global financial centres, but its finance and insurance sector (the economy's largest sector, accounting for 21% of GDP) has been contracting for two years.

Hong Kong is likely to continue to play a crucial role as a services hub and a financial centre, becoming even more focused on China's needs. Firstly, Hong Kong plays a key role in internationalising the RMB; it is the main offshore RMB liquidity pool and the main offshore RMB transaction centre (handling more than 70% of RMB SWIFT payments). Moreover, Hong Kong is a major financing hub for Chinese companies (which account for more than ¾ of its market capitalisation). Finally, the rising number of "connect schemes" over the past decade has made financial transactions and portfolio investment flows between mainland China and Hong Kong easier. In addition, Hong Kong is still the transit point for 60% of total direct investment (DI) flows to and from mainland China. This role could grow going forward: while DI flows into China have been declining since 2022, Chinese companies are expected to increase their direct investments in the rest of the world.

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