The Budget increased total government expenditure without harming the fiscal position, and both short and longer-term issues were addressed.

The Budget does not appear to be a game changer in terms of its near-term impact, but it is another step in the right direction as regards tackling the structural challenges that Hong Kong will be facing in the longer term.

The GDP report for Q4 created some concern, as domestic demand - traditionally a primary driver of growth – softened, and there was also a significant decline in investment expenditure. At the same time, exports of goods and services recorded a declining trend, with little sign of recovery in the short term.

With mounting external uncertainties and softer-than-expected domestic demand growth, we have cut our 2016 full-year GDP growth forecast from 2.4% to 1.8%, with risk tilted towards the downside.
Hong Kong 2016-17 Budget

Hong Kong Financial Secretary, John Tsang Chun-wah, Hong Kong 2016-17 Budget today (24 February 2016). Total government expenditure was increased without harming the fiscal position, and both short and longer-term issues were addressed.

Strong fiscal position

Total government expenditure is estimated to increase by 14.0% (in nominal terms) and 11.5% (in real terms) relative to the previous Budget. The marked increase in total government expenditure is not expected to send the fiscal position into deficit, although the fiscal surplus is expected to shrink to HKD11.4 billion from an estimated HKD30.5 billion in the previous financial year (Exhibit 1). Despite the increase in the total government expenditure, the estimated fiscal surplus should continuously support the very strong fiscal position of Hong Kong, with the fiscal reserve expected to be around HKD859.0 billion by the end of March this year (Exhibit 2).

Expansion of short-term relief measures

The Government's annual economic growth projection for 2016 of 1% to 2% largely explains the implementation of measures to relieve the burden of taxpayers, on top of targeted measures to help the tourism industry and small and medium enterprises. These measures were similar to those in the 2015-16 Budget, except that there is no longer a one-month public housing rent waiver (Exhibit 3).

Exhibit 1: Budget balance

Source: CEIC, 2016-17 Budget, Hang Seng Bank

Exhibit 2: Fiscal reserves

Source: CEIC, Hang Seng Bank
Although there is a 14.3% increase in the relief package in nominal terms in this Budget relative to the previous one, we expect the direct impact from this latest relief package to be relatively mild, as consumption has not been significantly influenced by similar initiatives in the past.

With the anticipated future structural fiscal deficit expected to become evident as early as 2018-19, it would not be a surprise to see a tightening up of relief measures in the coming fiscal years.

**Future investment**

Apart from the short-term relief package which focuses on managing cyclical fluctuations, the Budget announcement also included some measures and initiatives to maintain and boost Hong Kong’s longer-term competitiveness and
productivity growth, which we view as rather encouraging, especially as regards nurturing innovation section and finding new markets section.

One area of particular growth potential is the taking advantage of technologies – such as mobile communications, artificial intelligence and financial technologies (which is widely known as Fintech) – outlined under the nurturing innovation section. Some key measures of Fintech include:

- The Hong Kong Monetary Authority (HKMA), the Securities and Futures Commission (SFC), and the Office of the Commissioner of Insurance to set up dedicated Fintech platforms
- Cyberport to provide 3000m² of dedicated space and launch a designated programme
- InvestHK to set up a dedicated team to help relevant enterprises
- Implement steering group’s suggestions to promote Fintech

Another area of considerable interest is the coverage given to the Belt and Road Initiative in the finding new markets section. We have already discussed the role that Hong Kong can play in this large-scale project by the Chinese Government to further integrate itself into the world economy, and what it might mean in terms of a boost in exports of financial services, in our recent monthly report⁴. Some key measures in the Budget include:

- Issue a third sukuk (in other words, Islamic bond)
- HKMA to establish an office to facilitate the financing of infrastructure projects
- Greater promotion of Hong Kong’s capital markets and develop green financial products
- Lead a business mission to Central Asia.

Some other key measures would also support the Hong Kong’s longer-term economic development. These include:

- Science Park to allocate HKD8.2 billion to promote smart production and research

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- Earmark HKD500 million to set up Innovation and Technology Fund for Better Living
- Inject HKD2 billion to launch a Midstream Research Programme for universities
- Set up a HKD2 billion Innovation and Technology Venture Fund
- Allocate HKD4.4 billion to expand Science Park in stages
- Cyberport to earmark HKD200 million to invest in start-ups
- Inject HKD20 million into Film Development Fund to subsidise expenses of locally-produced Cantonese films for distribution and promotion on the Mainland
- Launch Art Development Matching Grants Pilot Scheme
- Expand tax deductions for capital expenditure incurred in the purchase of more categories of intellectual property rights

Ageing population

While it is clearly not possible to address all Hong Kong's issues in one Budget, this Budget included consideration of both short-term and longer-term issues, with the aforementioned measures boosting growth potential and forward planning tackling the future structural Budget deficit against the backdrop of the ageing population:

- Establish the Future Fund with an initial endowment of HKD220 billion for greater returns through long-term investment
- Set aside HKD200 billion for 10-year hospital development plan
- Top up housing reserve that has a current balance of HKD74 billion to support long-term public housing development
- Earmark HKD50 billion to improve retirement protection for elderly in need
- Allocate HKD10 billion to set up a fund to generate investment returns for public-private partnership programmes in healthcare services.

Summary

Overall, the 2016-17 Budget does not appear to be a game changer in terms of its near-term impact, but it is another step in the right direction as regards tackling the structural challenges that Hong Kong will be facing in the longer term.
Q4 GDP Growth Slows

Hong Kong’s real gross domestic product (GDP) growth slowed to 1.9% in the fourth quarter of last year, down on the downwardly revised 2.2% in the third quarter (Exhibit 4). This came in above our forecast of 1.8% but below market expectations of 2.2%. On a seasonally adjusted quarter-on-quarter basis, real GDP growth decelerated to 0.2% in the fourth quarter compared with the downwardly revised 0.6% in the third quarter. The annual GDP growth for 2015 was 2.4%, down from an upwardly revised 2.6% in the previous year.

This GDP report is being viewed with some concern. Unlike in previous quarters, the main contributor to this growth rate was external demand, which contributed 2.1%, while domestic demand dragged down growth slightly by 0.2% (Exhibit 5). Caution should be exercised in drawing any conclusions about the reasons behind the positive contribution of net exports of goods and services to growth, as both exports and imports, which recorded declines in the third quarter, continued to decline on a year-on-year basis in the fourth quarter by 0.9% and 1.8% respectively.

Dimming Economic Growth Outlook for 2016

The level of external uncertainty looks set to remain relatively high in 2016, with headwinds coming from concerns over moderating growth rates on the Mainland, interest rate normalisation in the US, the increase in global financial market volatility...
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and the emergence of demand-side factors pushing down crude oil prices. In addition, the adverse spillover effects from external economic uncertainties appears to be greater than expected, weighing on domestic demand, even though this may be somewhat supported by private consumption expenditure growth amid stable labour market conditions and weak inflation.

With the mounting external uncertainties and the softer-than-expected domestic demand growth, we have cut our 2016 full-year GDP growth forecast from 2.4% to 1.8% (Exhibit 6), with risk tilted towards the downside.

Exhibit 6: Economic prospects for 2016

<table>
<thead>
<tr>
<th>2016 Forecast</th>
<th>Hang Seng Bank</th>
<th>Hong Kong’s government</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (%)</td>
<td>1.8</td>
<td>1.0 to 2.0</td>
</tr>
<tr>
<td>Nominal GDP (%)</td>
<td>3.3</td>
<td>2.5 to 3.5</td>
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</tbody>
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