Summary

Hong Kong has become increasingly integrated with the economy of mainland China. Headline numbers of trade and financial flows seem to suggest that mainland China is now playing a dominant role in driving Hong Kong’s economic cycles. Yet, these headline figures have masked the underlying driving forces behind the cross-border flows in goods and services. Indeed, a good chunk of production on the Mainland goes to serving final demand from foreign countries, particularly the US, rather than domestic demand.

This paper studies the relative importance of mainland China and the US in driving Hong Kong’s economic cycles. In principle, the trend and cyclical components of Hong Kong’s output growth may be driven by different external forces. We identify the permanent and transitory component of income in the three economies based on the permanent income hypothesis, and with the use of a simple state-space model. We use structural vector autoregression models to analyse how permanent and transitory shocks originating from mainland China and the US affect the Hong Kong economy, and how such influences evolve over time.

Our findings suggest that at the business cycle frequency, Hong Kong is still more synchronised with the US than with mainland China. On the other hand, Hong Kong and mainland China share a strong co-movement in terms of long-run trend growth, likely reflecting the on-going progress of economic and social integration between the two economies.