

HONG KONG: A SHIP IN ROUGH SEAS

By Daniel Po-min Chan

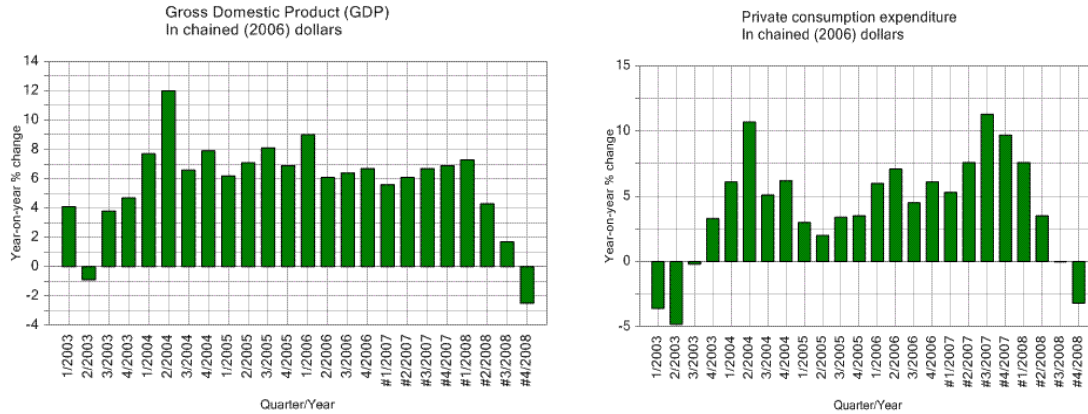
As the financial crisis persists, prospects for global economic growth have deteriorated tremendously over the last few months, given the fact that de-leveraging in the international financial sector has continued and consumer confidence has plunged. As financial conditions continue to present serious downside risks, forceful fiscal and monetary policy responses in many countries are trying to contain the risk of a systemic financial meltdown. However, there are many reasons to remain concerned about the potential impact of these measures on the financial crisis. The process of de-leveraging could be more intense and protracted than previously expected.

For instance, the risk of Eastern European loans is now coming to light as the global economic recession forces western banks to pull back, refuse to renew loans or “roll over” the credits. That helps explain why Hong Kong Monetary Authority Chief Executive Joseph Yam has warned about the possibility of a "second wave" in the continuing global financial crisis. He said it might be more even damaging in emerging markets, as the financial tsunami has sent many of them into deep recession.

The Hong Kong Economy Feels the Heat

With a deteriorating global economic environment, Hong Kong's primary economic engines – property, finance and international trade – are all losing momentum. In 2008's closing months, Hong Kong saw its first quarter of negative year-on-year growth figure since the SARS outbreak six years ago. Output dropped 2.5% year-on-year in the last quarter of 2008 on the back of slumping domestic demand (which fell 6.9%), leaving full-year 2008 gross domestic product growth of a mere 2.5%, against our previous forecast of 4.4% growth. Looking ahead, the persistent global credit crunch and economic downturn will make 2009 an extremely challenging year for Hong Kong, due to fragile consumer and investment confidence, slumping exports, a mounting unemployment rate and falling consumer spending. Economic growth for 2009 may contract by 3.5%.

Figure 1: Hong Kong Real GDP and Consumption Growth



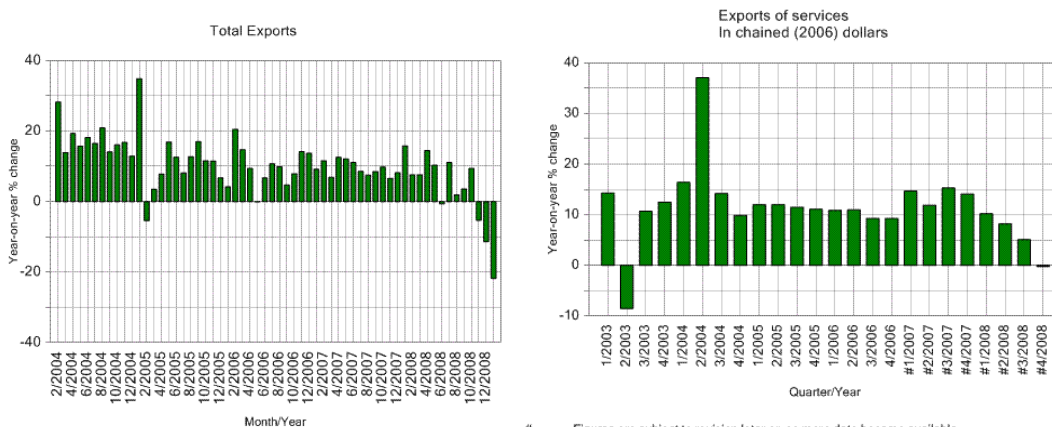
Figures are subject to revision later on as more data become available. Figures are the latest data released on 25 February 2009.

Figures are subject to revision later on as more data become available. Figures are the latest data released on 25 February 2009.

A Grim Outlook for Exports

Hong Kong's total exports registered double-digit declines of 21.8% in January 2009, the worst performance since 2001 when the United States was in recession. Total exports to the US and major European markets recorded significant declines, while shipments to mainland China and major Asian economies also contracted sharply. In coming months, Hong Kong's exports of goods and services are likely to weaken further on signs of deepening global recession. However, with the implementation of multibillion-dollar rescue measures by various governments and authorities, there is a hope that the economy could be bottoming out by the end of this year or early next year.

Figure 3: Export growth

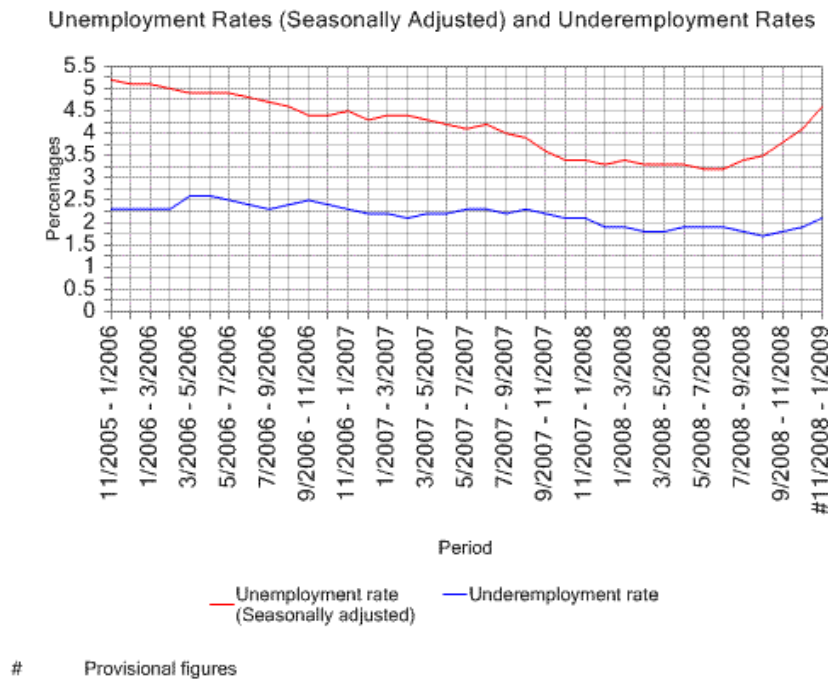


Figures are subject to revision later on as more data become available. Figures are the latest data released on 25 February 2009.

Rising Unemployment Lies Ahead

In the labor market, the unemployment rate in November 2008 – January 2009 increased sharply to 4.6% (levels last seen at end-2006) from 4.1% in October – December 2008, leaving 157,700 people unemployed. Since the labor market began to weaken in September 2008, job losses have been widespread across most employment sectors. Against this backdrop, preserving jobs is a top priority in this year's budget; the government announced initiatives intended to create about 62,000 jobs and internship opportunities, equivalent to 1.6% of the total workforce. Nevertheless, the impact of these projects is unlikely to be felt until the latter part of the year. It is highly likely there will be a continual rise in the unemployment rate through the year, exceeding 6% or even 7% by December.

Figure 4: Unemployment rate



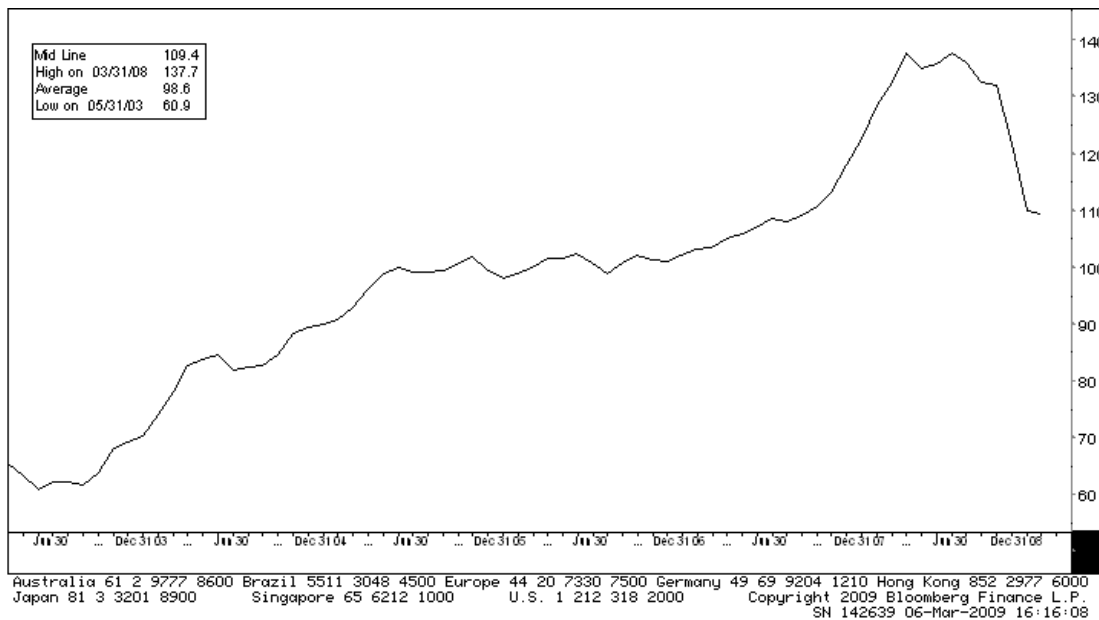
Holiday shoppers and tourists helped boost January retail sales to register a strong growth of 7.4% (against 1.1% rise in December) as the Lunar New Year fell in late January rather than in early February as it did last year. After netting out the effect of price changes, the sales volume actually rose 5.4% (against a 0.5% contraction in the previous month). Due to economic recession, more local people stayed home and spent locally instead of

traveling overseas. Looking ahead, however, economic outlook is bleak, as the full impact of the global financial tsunami on local consumer spending is not yet fully reflected by the macro numbers due to the typical time lag of changes in labour market conditions.

The Property Market Remains at Risk

The significant deterioration of economic conditions has caused banks to react conservatively with respect to mortgage lending policies, a major factor that discourages the present property market. The performance of the residential market in December 2008 already showed dramatic price and volume decreases in the aftermath of the financial tsunami. Despite a mild increase of bargain hunting, total take-up figures plummeted by more than 65% year-on-year in December 2008. In addition, the pace of the downward price adjustment accelerated and residential prices were about 18% below the peak prices of March 2008. Looking ahead, despite recent signs of stabilizing home prices in January, optimism in the residential sector is unwarranted because further deterioration of economic fundamentals means a market recovery is unlikely. Residential prices could fall another 10% to 20% in 2009.

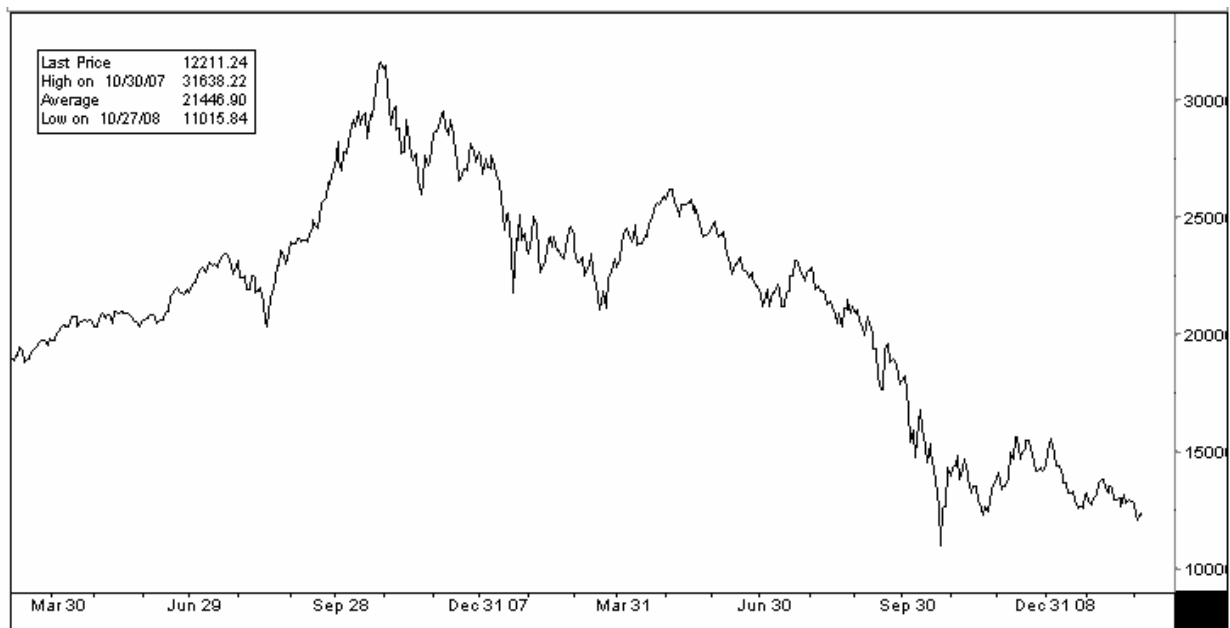
Figure 5: HKU All Residential Price Index (Jan 2000=100)



Stock Market remains at Low Tide with Volatility

In the stock market, the Hang Seng Index experienced high volatility, declining by over 60% from its October 2007 peak to 12,211 on March 5, 2009. The past upsurge had resulted from the August, 2007 announcement by China's State Administration of Foreign Exchange that it would allow direct individual investments in Hong Kong securities. However, a delay in this scheme, poor performance in the A-share market (partly due to the launch of a series of macroeconomic control measures in mainland China) plus concerns over more credit losses, continues to dampen market sentiment in the second half of 2008. More importantly, the recent release of several lower-than-expected mainland corporate earnings, followed by analysts' downgrades of key stocks, has highlighted fears that firms in China are being hit by the cooling global demand. Any sudden contraction in global liquidity or a stampede to redeem funds could lead to liquidations by international investors and fund outflow, given the relatively fragile investor confidence.

Figure 6: Hong Kong Hang Seng Index (6 Mar 07 – 5 Mar 09)



The Hong Kong Budget only Stresses Preserving Employment

The 2009/10 budget with its HK\$39.9 billion (US\$5.1 billion) deficit, equal to 2.4% of GDP, is not designed to boost an economy that remains export-oriented with a big leakage effect. Instead, the Hong Kong government stresses preserving employment, saying it will create more than 62,000 jobs, which is about 1.6% of the labor force. Compared to the unemployment rate at the height of SARS, which was 8.5%, the government is trying to slow the rise of the unemployment rate by preventing consumption from deteriorating too quickly. However, the proposed infrastructure works still lack concrete details and schedules, and their effects will take time to become evident. Thus Hong Kong's economy will continue to contract this year as the external environment continues to deteriorate sharply. The government's prediction of 2% to 3% economic contraction this year might be overly optimistic, and Hong Kong more likely will experience a full-year contraction of 3.5% or even more in 2009.

The China Factor is Hong Kong's Lifeline

At the end of the day, being a small and open economy, Hong Kong will remain vulnerable to changes in the global environment, like a ship in rough seas. However, it does enjoy the advantage of strong support (such as through the Closer Economic Partnership Arrangement) from the mainland when seeking to overcome various difficulties and hardships.

In the global economic downturn, Chinese economic growth has also moderated in the fourth quarter, registering 6.8% annual growth rate for the period (for China, this comparatively low level was last seen in 2001); for the full year, the GDP growth was 9.0%, down sharply from 13% in 2007. Nevertheless, with the aggressive loosening in monetary policy in the latter part of 2008—which involved one year lending rate cuts totaling 216 basis points, reserve requirement ratio cuts amounting to 250 basis points and the elimination of loan quotas—plus the announced four trillion yuan (US\$584 billion) fiscal stimulus plan, the economy still has continued to decelerate. For example, it experienced a 17.5% export decrease in January, and this year's GDP growth is expected to fall to 7.5%, below the government's reaffirmed projection of 8%. Looking ahead, the global financial crisis will inevitably continue to impact China, which will experience falling export orders and foreign investments, not entirely offset by huge infrastructure spending and large stimulus plans in 10 selected industries.

It is expected that China will make every effort to stabilize its economy by using its enormous foreign exchange surplus. Premier Wen vowed to accelerate measures to ease Hong Kong's economic woes in his annual report to the National People's Congress in March, and it's hoped this will help Hong Kong cushion the impact of the global sub-prime crisis on its own economy through trade, the benefits of CEPA and a liberalized yuan settlement policy involving local and mainland financial institutions. At minimum, Hong Kong should show some positive benefits during the current financial crisis when compared to other Asian economies.

Daniel Po-min Chan is a senior investment strategist at DBS Bank (Hong Kong), where he analyzes the economies and investment environment of the greater China region.