Economic Analysis

April 2002

A Publication of the BEA Economic Research Department

US Recovery: Trends to Watch

The recession in the US that began in March last year may have been the shortest downturn recorded in recent US history. US consumers have shown tremendous resilience in leading America out of the post 9-11 slump, but recovery in corporate earnings is essential for the US economy to continue to prosper. US companies are expected to expand their investments in the Mainland in search of profits, and Hong Kong will definitely benefit from this trend.

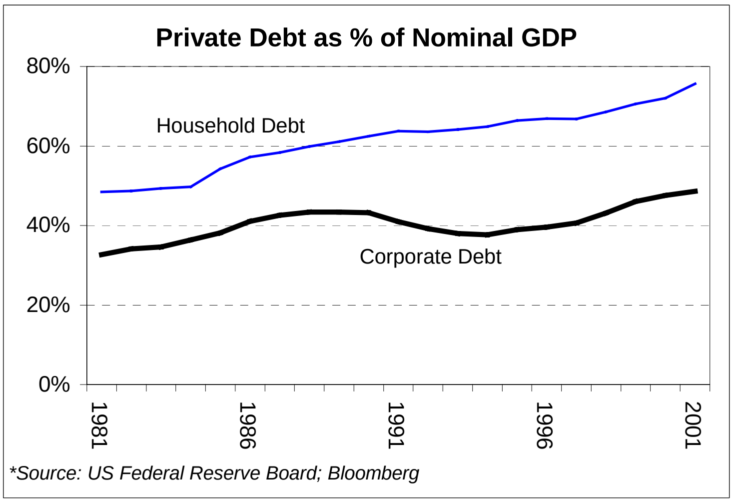
Corporate America in trouble

The 10-year-long expansion of the US economy gave rise to speculation that the concept of business cycles had become obsolete. As a result of the Internet stock bubble, there was excessive optimism regarding the demand side in the US. Companies were eager to expand, and they were not afraid to build their businesses on leverage. According to the US Federal Reserve Board, corporate debt in the US doubled between 1993 and 2001.

However, when the tech bubble finally burst, the debt burden and inventory build-up represented an imminent risk to the US economy. In a swift response, the US Federal Reserve Board came to the rescue with drastic cuts in interest rates over the past year. The move has not only lightened the debt service burden on Corporate America, the cheaper credit has also diluted the negative wealth impact of falling stock prices on household spending. Combined with the government's fiscal stimulus package, consumer spending has held up extremely well throughout last year to provide the much-needed support for corporate earnings. Although unemployment has risen, it has not matched levels reached in previous recessions. Alan Greenspan had engineered a soft landing and kept the US economy from crashing down.

High private debt will moderate the pace of recovery

With the recovery being confirmed, attention now turns to the pace of growth. A recent survey among US economists suggested that, after a spurt of strong growth in the first quarter, US economic growth would resume a more moderate pace for the rest of the year. We believe that the country's high debt level is one of the factors contributing to this view. Early this year, Mr. Greenspan said, "…although household spending should continue to trend up, the potential for significant acceleration in activity in this sector is likely to be more limited than in past cycles." [i] Deep interest rate cuts last year boosted not only household spending, but also household debt levels. As consumers are already overstretched, further acceleration in consumption by taking on more debt will be difficult.



*Source: US Federal Reserve Board; Bloomberg

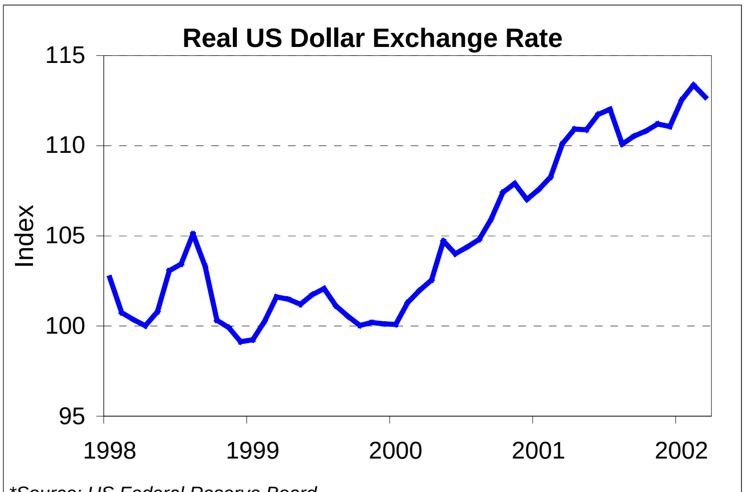
The same is true for US corporate debt, which stands at historically high levels. The drastic cuts in interest rates last year have eased the burden of corporate and household debt but not eliminated it altogether. The country's high private debt levels will constrain the ability of individuals and companies to expand their spending and investment through borrowing in the near term.

Businesses look abroad to boost earnings

Facing the prospect of rising interest rates, there is a great urgency for Corporate America to find ways to boost earnings and make its debt load more manageable. With the expected modest recovery in US domestic demand and a continuing lack of pricing power, more US companies are now turning abroad for solutions.

Seeking cheaper sourcing abroad is one way to improve the bottom line. American firms have been outsourcing their lower value-add activities to other countries, while retaining the more sophisticated business processes at home. Following the global trend of trade liberalization, there are now more opportunities abroad for US firms to exploit. At a time when consumers are price-conscious, cheaper sourcing abroad becomes critical for companies to maintain their profit margins.

From this aspect, sustaining the strength of the US dollar will be vital to the US economy. In fact, despite the economic slowdown and the terrorist attacks, the US dollar has been performing very well. In real terms, the greenback appreciated by 13% from the beginning of 2000. A strong greenback will dampen US exports, but cheaper imports would significantly reduce costs for domestic business. As domestic demand accounts for 65% of the nation's GDP, compared to 11% for exports, the benefits clearly outweigh the costs of slower exports. This partially explains US policymakers' relatively higher tolerance of a mounting current account deficit at the moment. Furthermore, a strong US dollar would secure America's position as a magnet for capital. Capital inflows would be able to counter the trade deficit resulted from the influx of imports, and more importantly, provide cheaper credit to finance the US debt.



**Source: US Federal Reserve Board*

Besides seeking cheaper sourcing abroad, exploring overseas markets is another trend that helps to create business value. Leveraging on their advanced management culture and high technology expertise, US companies are reaping success overseas in both trade and investments. Furthermore, tapping high growth regions like China will give upside potential to future business earnings. This provides the much-needed growth opportunities, convincing investors and creditors to tolerate near-term slower growth in earnings.

Implications for Hong Kong

Since the US corporations will benefit from cheap imports and open access to overseas markets, a liberalized trade environment will work to their advantage. US businesses have been the prime supporter of the global trade liberalization process. They were among the most vocal lobbyists behind China's accession to the World Trade Organization (WTO), eyeing the low production cost and the new urban affluent class in the Mainland. Common economic interests on both sides of the Pacific will provide the environment to foster closer Sino-US business cooperation.

Hong Kong's role as the springboard for US ventures into the Mainland will become more prominent under the cosier Mainland and US relationship. This is essential to our economy in the years to come, as Sino-US trade accounts for over half of our merchandise trade while over 200 US companies locate their regional headquarters in the territory. For the near term, a strong US rebound in the first half will end the slide of Hong Kong's external trade sector. However, the possible moderate growth of the US in the latter part of this year means that we will have to be patient before declaring a full recovery.

---

[i] *Source: Testimony of Chairman Alan Greenspan, Federal Reserve Board's semiannual monetary policy report to the Congress, before the Committee on Financial Services, US House of Representatives, February 27, 2002.*