Economic Analysis

January, 2005

A Publication of the BEA Economic Research Department

2005: Weathering External Storms

As a small and externally oriented economy, Hong Kong's course in 2005 will be largely determined by the external environment. Looking out to the horizon from early January, it appears as though we will be buffeted from two sides. On the one side, growth prospects will be dampened by a slowdown in external trade growth, due to reduced demand from the United States and neighbouring Asian countries as these economies slow. On the other, growth will be boosted by the growing number of Chinese tourists and the massive capital inflows induced by RMB speculation. Weighing the two, it is likely that the positive influence of China will triumph over the adverse effect of a slowdown in external trade. Therefore, we expect that the recovery will be sustained in 2005.

US tightening cycle and high oil prices

Hong Kong's external trade is tied to the global economy, which in turn is highly dependent on the performance of the US economy. This year, US growth will be restrained by the current tightening cycle and high oil prices.

In order to reload the monetary weapon, we believe further rate rises are on the cards. It is because if the current round of interest rate hikes fizzles early, it would pose a problem for the future development of the US economy. The Fed will be left without a monetary policy reserve to stimulate the economy the next time growth slows. Looking back, the fed funds rate was reduced by 6.75 percentage points in the 1990 recession, and by 5.5 percentage points after the bursting of the Internet bubble. Therefore, in order to re-prime the monetary weapon, the fed funds rate should be lifted by a similar amount. Otherwise, the Fed would inevitably fall into a "zero interest rate trap" when the next slowdown occurs. We anticipate that the fed funds rate will be raised by 125 basis points in 2005.

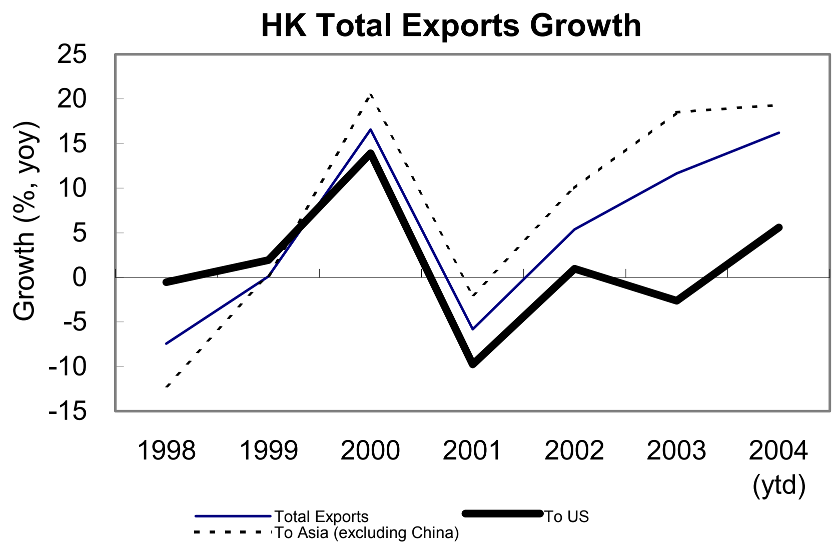
High oil prices are another factor that threaten US growth. Strong demand for crude oil from China has pushed up prices, helped by limited worldwide reserve capacity and tension in the Middle East.

According to a World Bank report, the price of crude oil will decline to US$36 per barrel in 2005. This is welcome relief after prices hit US$55 per barrel in late 2004. But it is still much higher than the US$30 per barrel in 2003. Even this relatively modest rise would be enough to slow US growth by half a percentage point this year. In addition, rising interest rates will curb US demand for imports. Hong Kong's external trade growth would decelerate accordingly.

The Asian Sorrow

Asia is one of the most significant destinations of exports from Hong Kong, and thus regional prosperity will be an important determinant of the territory's external sector. The export-led Asian economies are likely to suffer in 2005 as they are affected by the US slowdown. Moreover the US growing current account deficit has forced the US dollar to fall. The current account deficit in the first three quarters last year was US$72.54 billion higher than the same period in 2003. The appreciating Asian currency would hamper exports and thus the growth of the region. As a result, the external trade sector of Hong Kong would be affected as growth in Asia slows.

To make matters worse, some Asian economies are themselves vulnerable to rising oil prices. The situation is particularly severe in South Korea, Thailand and the Philippines, whose net oil imports accounted for about 5% of their gross domestic product in 2003, much higher than those of China and the United States. The oil burden could cripple the economic performance of the region if prices rise too high. Slower growth in Asia will reduce imports from Hong Kong.



Source: Census & Statistics Department, HKSAR

Implication of the elimination of textile and clothing quotas

Another point worth mentioning is the impact of the elimination of the textile and garment trade quotas on Hong Kong's external sector. The end of the 30-year quota system will all but end the complicated cross-border labelling game, which saw exports of textile and clothing products account for about 60% of Hong Kong's domestic exports in 2003. The lifting of the quota system will encourage Hong Kong manufacturers to relocate their remaining production facilities across the border. Though manufacturers could benefit from the cost reduction and greater access to foreign markets, it would be a blow to the workers in the industry. Furthermore, the declining exporting activities will be detrimental to Hong Kong's trade sector. Thus, at one fell swoop, half of Hong Kong's manufacturing exports will be eliminated.

In fact, the end of the quota system may have a more profound implication on the external trade in Hong Kong, as it could trigger confrontation between China and other countries. The double-digit exports growth on the mainland in recent years has aroused worldwide concern. The free trade in textile and garment products could intensify the already heightened tensions, as it is generally recognized that China will be the largest beneficiary of the new arrangements.

For instance, China made 16% of the United States clothing imports at present and the World Trade Organization sees that share soaring to more than 50%. Other countries will possibly protest against the country's dominance and introduce various safeguard measures against Chinese exports. Since trade between the mainland and Hong Kong accounts for a large share of Hong Kong's total trade, the slowdown in China's exports will adversely impact our external sector as well.

Impetus from China

Although Hong Kong's external trade will be dragged down by reduced external demand, the domestic economy will remain robust as it will be supported by the growing number of mainland tourists and the influx of capital due to market speculation on RMB revaluation. The combined positive effect should compensate for the slower growth in the external sector.

The number of mainland visitors coming to Hong Kong has tripled over the past five years, from 4 million in 2000 to an expected 12 million in 2004. Mainlanders' appetite for traveling has been fuelled by rising household income, which has doubled over the last decade. The increase in wealth has enhanced both the purchasing power and will to spend of mainland inhabitants. With the amount of RMB that can be brought out of China recently raised from $6,000 to $20,000, and the opening of the Disney theme park in September 2005, Hong Kong will remain one of the most attractive destinations for Chinese tourists. The thriving tourism industry will thus continue to provide stimulus to the domestic economy.

Further stimulus will come from the massive capital inflows generated by speculation on RMB revaluation. High liquidity in the local interbank market has left Hong Kong no option but to keep interest rates steady even when the Fed tightens.

Moreover, continued downward pressure on the US dollar would make Hong Kong's asset markets more attractive to foreign investors. Low interest rates, coupled with the falling greenback, will provide a favourable environment for the revival of the property market. Housing remains quite affordable by historical standards: mortgage payments for a 50 sqm housing unit currently account for about 40% of the median household income. As renting becomes more expensive than servicing a mortgage, renters would switch to home purchases and investors would increase their participation in buy-to-let activities. The property market should continue its spectacular performance this year.

Continued recovery

Slowing consumer demand in the United States induced by higher interest rates and a depreciating dollar will ripple through to the rest of the world through decelerating global trade. The reduced world demand, especially from the United States and Asia, will moderate Hong Kong's total export growth from 15.9% in 2004 to 8.5% in 2005.

The property market will be supported by strong fundamentals, together with the falling US dollar and the continued capital inflow in the first half of this year. Inbound tourism will remain robust, given the Mainlanders' growing appetite for travel. The thriving property market and the vibrant tourism flows will be the driver of the domestic economy. Inflation will rise and is expected to reach 1.5%, as retailers regain pricing power amid strong demand from both local consumers and tourists. A strong showing of the domestic economy will generate a considerable number of jobs and unemployment could fall further to 6% in 2005. The rosy domestic demand will be able to help Hong Kong weather the storms in the global economy, helping GDP growth to reach 4.5% this year.

However, a note of caution must be sounded. Speculation on RMB revaluation might retreat under the adamant stance of Chinese authorities on exchange-rate policy. This may cause a sudden reversal in fund flows and trigger a quick rise in Hong Kong interest rates, with a distinct chilling effect on asset markets.

Forecast of Major Indicators (%)		
	Real Growth Rate	
	2004@	2005@
1. Domestic Sector		
Private Consumption Expenditure	7.0	4.5
Government Consumption Expenditure	0.5	-1.0
Gross Domestic Fixed Capital Formation	7.7	4.0
2. External Sector		
Total Exports of Goods	15.9	8.5
Domestic Exports	1.5	-6.0
Re-exports	17.0	9.5
Imports of Goods	16.1	9.1
Exports of Services	16.0	11.0
Imports of Services	10.8	6.0
3. Real Gross Domestic Product	8.0	4.5
@ BEA Economic Research Forecasts		