Economic Analysis January, 2006

A Publication of the BEA Economic Research Department

2006: Stoking the Engines of Domestic Growth

The Hong Kong economy recorded another year of stellar growth in 2005. However, heading into 2006, a number of downside risks are appearing in the external sector. Higher interest rates in the U.S. will cool the American housing market, which in turn will force American consumers to end their profligacy at retail outlets. This will reduce demand for Hong Kong's exports in our largest overseas export market. Furthermore, Hong Kong's re-exports will face more headwinds as the Chinese government directs growth from export-oriented investment to private consumption under the country's 11th Five-Year Plan. Nevertheless, we expect that reviving domestic exports and a strengthening labour market will help compensate for the weakened external inputs, and guide the Hong Kong economy to another year of solid growth.

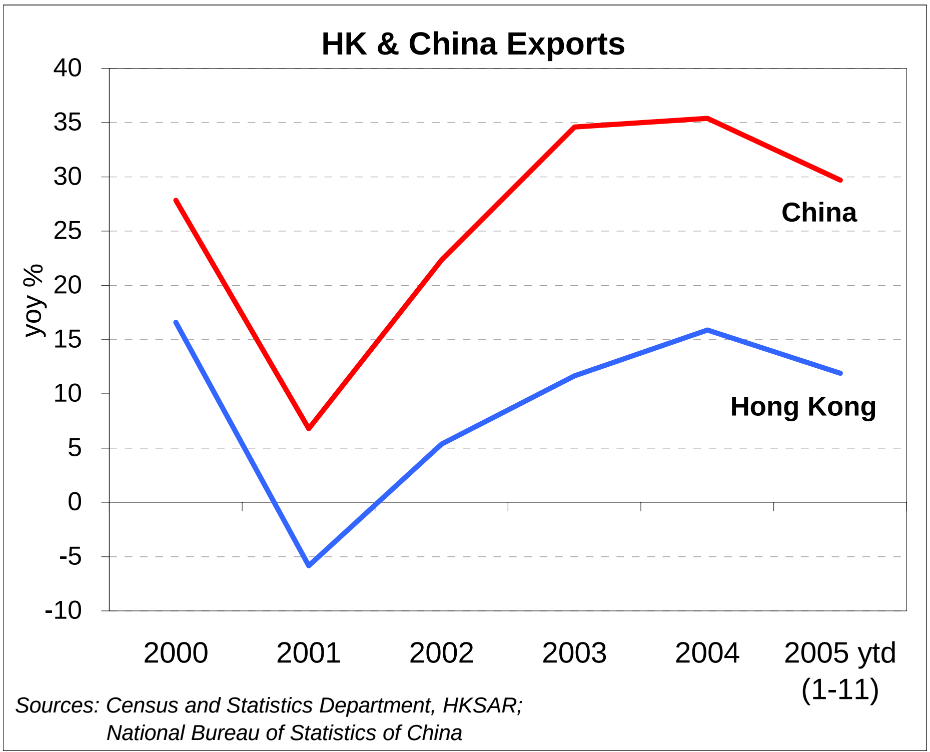
Higher U.S. interest rates

The external sector has been a potent driver for the city's economy during the current round of recovery, with exports of goods and services soaring by 10.6% in the first nine months of 2005. But the export locomotive is about to lose steam in 2006. Even after hiking interest rates by 225 basis points and claiming that monetary policy was no longer "accommodative", the Federal Reserve reiterated that further "measured" monetary tightening would be needed to balance growth and inflation. Nevertheless, the minutes of the December Federal Open Market Committee meeting revealed that the Fed governors believe that inflation will remain benign in 2006, despite higher energy prices. And incoming Fed chairman Ben Bernanke will focus on inflation when directing monetary policy. We therefore expect that the federal funds rate will peak at 4.75% in the first half of 2006.

The impact of higher U.S. interest rates is already being felt, as the chill winds of monetary tightening blow across America's housing market. According to data from the Federal Reserve, in the third quarter of 2005 mortgage payments as a percentage of personal disposable income rose to the highest level since 1980. Moreover, the National Association of Realtor's home affordability index for first-time buyers fell to its lowest level in more than 15 years. There are already signs that deteriorating market fundamentals are discouraging home purchases, causing existing home inventory to build in recent months. Given that surging home prices and a refinancing boom have fuelled consumption over the past four years, a slowdown in the housing market will quickly be reflected in reduced consumer spending and less imports from overseas. Hong Kong's external sector will feel the pain as American consumers turn more frugal.

China Changes Direction

For years, Hong Kong's external sector has been supported by robust exports from the Mainland. However, the 11th Five-Year Plan, approved at the fifth plenary session of the 16th Central Committee of the Communist Party of China, will result in a profound change in the mix of China's growth that will undermine the performance of Hong Kong's re-exports. The previous 10th Five-Year Plan that emphasized on expanding exports and investment has led to breakneck growth in both areas. Between 2000 and 2004, annual growth in exports and investment averaged 24.8% and 18.0% respectively, outstripping the country's economic growth by a wide margin. Starting from 2006 to 2010, however, the Chinese government will direct growth from export-oriented investment to private consumption. This will reduce the country's reliance on exports and investment in driving economic growth.



The process of China switching to a consumption-oriented economy will be gradual. Yet because of the close tie in trade between Hong Kong and China, even a mild slowdown in China's exports and investment could weaken Hong Kong's re-export sector. In the meantime, Hong Kong's re-exports will continue to encounter the headwinds imparted from Guangdong, where the ongoing structural shift from light to heavy industries is squeezing out opportunities for Hong Kong's manufacturers of light-industrial components. Heavy industries accounted for 56% of all industrial output in the province in 2004, compared with just 32.5% in 1990. All things considered, Hong Kong's re-export businesses will undoubtedly face more challenges ahead.

Reviving Domestic Exports

While the re-export sector is about to lose some traction, domestic exports are starting to gather momentum. The steady ascent from a 7.1% year-on-year decline in 2003 to a 6.6% increase in the first eleven months of 2005 is evidence that manufacturing relocation to the mainland is coming to an end. Furthermore, the continued strength of China's sourcing demand and the integration focus of the Closer Economic Partnership Arrangement (CEPA) have fostered a supportive environment for domestic exports. Applications for certificates of Hong Kong Origin have been especially strong for products such as electrical and electronic products as well as textile clothing. In the first eleven months of 2005, domestic exports to China soared by 17.8%, much faster than the 3.1% recorded in all of 2004.

Looking forward, the Mainland's new clothing and textile trade pacts with the European Union and the U.S. should help remove uncertainties surrounding the textile industry and provide a more predictable business environment for domestic textile manufacturers. There are already signs that clothing orders have returned; after contracting by 35.7% in the first seven months of 2005, domestic exports of apparel and clothing apparel rose by 13.4% in the following two months. The continued revival of domestic exports should keep Hong Kong's merchandise exports growing at a solid 9% in 2006.

Improved Domestic Fundamentals

Compared with the uncertainties surrounding the external sector, things are looking more upbeat on the domestic front, which is being propelled by a buoyant labour market. Since peaking at 8.6% in July 2003, the unemployment rate has fallen in line with the economic recovery. Unemployment fell to

5.3% in November 2005, the lowest level in over four years. Total employment since 2003 has increased by 250,000, comparable to previous rounds of recovery. More important, workers are starting to earn more in a tightening labour market. Government data shows that nominal payrolls grew by an average of 3.4% in the first three quarters of 2005. With staff turnover rate high and the recovery on a firmer footing, companies will be more inclined to lift wages.

Rising wages will lend support to private consumption. As pointed out in the October 2005 edition of Economic Analysis, a pickup in private consumption will be vital if the economy is to achieve more balanced and sustainable growth. Specifically, it would help spread out the recovery to more areas of the economy, spurring job growth in sectors such as wholesale and retail, financial services, real estate, and business services. And it is expected that the pickup in domestic exports will lead to more jobs in the manufacturing sector, making the job market's recovery even more broad-based. Hence we forecast that the unemployment rate will fall below 5.0% by the end of 2006, and private consumption will increase by 4.5%.

For the moment, consolidation in the property market triggered by the sharp rise in interest rates over the past six months remains a drag on consumption. Low rates at the beginning of 2005 encouraged a rapid run-up in house prices. However, since the introduction of the three refinements on the linked exchange rate mechanism in May 2005, interest rates in Hong Kong have rebalanced against their U.S. counterparts and are trending upward. With some life still remaining in the current round of U.S. monetary tightening, interest rates in Hong Kong are set to go higher in 2006, putting more pressure on the property market. Nevertheless, demand for new units remains solid, and the continual improvement in the labour market and resulting rise in wages should keep home purchases affordable. As interest rates in the U.S. peak in the first half of 2006, the recent consolidation should end accordingly. We believe that rising wages will propel a second-half revival in the property market, with property prices increasing by less than 5% for the whole year.

Consumer prices have been heading steadily upwards in 2005 and the trend is expected to continue this year, driven by renewals of private residential rental contracts at higher rates. While retailers may pass the cost of higher rents to consumers, moderating food prices in the mainland should keep overall price levels in check. The Composite CPI should therefore rise by 2.5% in 2006.

Conclusion

The economy has made a resounding rebound from the lows during the 2003 SARS outbreak. Buoyed by robust external trade, growth has been strong for two years in a row. Yet the double-digit export growth is unlikely to repeat in 2006 amid a souring external environment, in which American consumers turn frugal and the Chinese economy becomes less export-oriented. On the other hand, a rejuvenated domestic export sector and a strengthening labour market will supply growth momentum to the economy. Overall, we believe that the Hong Kong economy will expand by 5.2% in 2006.

However, previous experience with the SARS outbreak has taught us that the economy can be derailed by unforeseen risks. Arguably the most dangerous one on the horizon is an outbreak of avian flu in the form of human-to-human transmission. Fortunately, we are better prepared than we were for SARS. Governments around the world have been building up their capabilities to handle such a crisis. It is expected that scattered reports on individual infected cases will continue to emerge, and this will generate volatility in the financial market. Yet as long as governments continue to step up their efforts to fight the disease and the public stays alert, an avian flu pandemic may be forestalled.

Forecast of Major Indicators (%)		
	Real Growth Rate	
	2005@	2006@
1. Domestic Sector		
Private Consumption Expenditure	3.8	4.5
Government Consumption Expenditure	-2.5	-2.0
Gross Domestic Fixed Capital Formation	2.0	1.0
2. External Sector		
Total Exports of Goods	11.0	9.0
Domestic Exports	1.0	2.0
Re-exports	11.7	9.4
Imports of Goods	8.3	8.1
Exports of Services	8.0	6.0
Imports of Services	2.9	3.0
3. Real Gross Domestic Product	7.0	5.2
4. Composite CPI (yoy % change)	1.2	2.5
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