Economic Analysis

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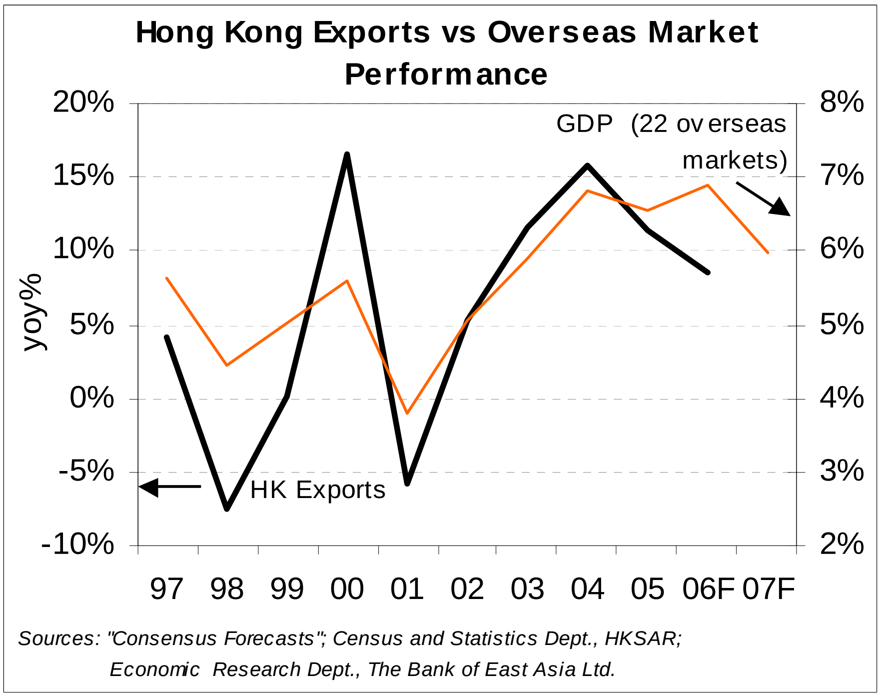
The Economic Outlook for Hong Kong in 2007

Hong Kong's economy has registered remarkable growth for three consecutive years. Trade and financial services have been the twin engines fueling the economic growth. Both sectors maintained strong double-digit growth for the entire period, increasing their combined share of the GDP to 46.7% in the first half of 2006. However, the trade sector has shown signs of moderation since the second quarter of 2006, while the financial sector has continued to pick up momentum. The pattern of divergence should continue in 2007.

Squeeze on Exports

Hong Kong's export growth decelerated to an estimated 9% in 2006, after posting average growth of 14% from 2003 to 2005. However, the slower growth is not the result of weaker demand from overseas markets. On the contrary, the average economic growth rates of Hong Kong's major export markets have strengthened from levels in 2005. This out-of-phase development has deviated from the pattern since 1997, where stronger overseas demand has always led to higher export growth, and vice versa.



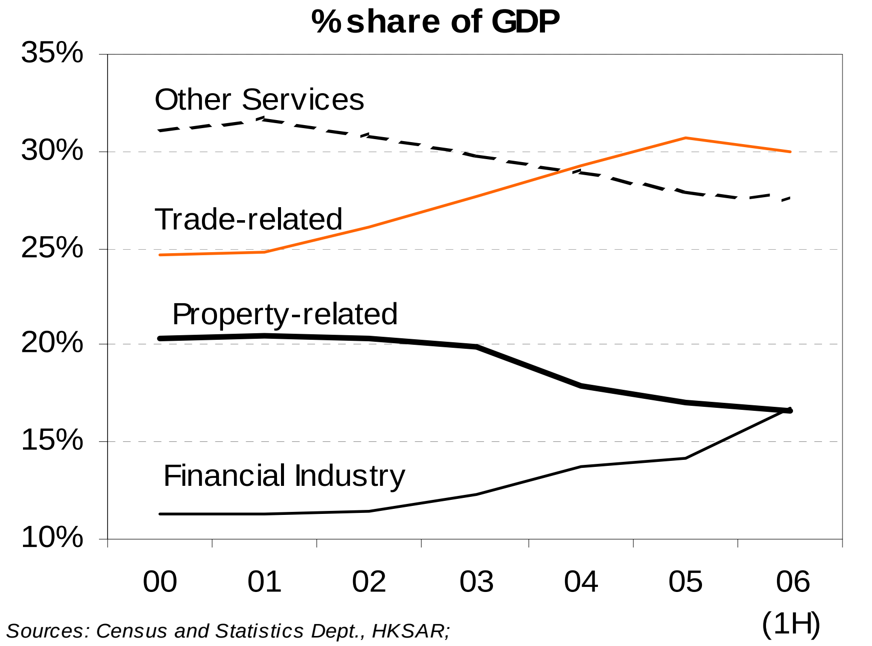
One factor that has contributed to the deviation is China's tighter export policy. In alignment with China's new policy of reducing resource consumption and pollution, a series of measures targeting the export sector have been introduced. These include tighter pollution controls, a decrease in export tax rebates, and adjustments in the Prohibited Commodity Catalogue for Processing Trade. The policy shift has suppressed manufacturing activities on the Mainland, and Hong Kong's manufacturers operating in the Guangdong region are the most adversely affected.

The same policy stance is likely to be adopted in 2007. Furthermore, China's Commerce Minister Bo Xilai has made narrowing the trade surplus the country's top priority as a means of tempering growth of foreign exchange reserves this year. Hence, China's export growth will decelerate from its current rapid pace, which in turn will affect Hong Kong's re-export business.

Meanwhile, following the consolidation of the US housing market, the subsequent decline in property prices will slow US consumer spending in 2007, and hence reduce people's appetite for imports. Many of our export markets are also expected to experience moderation in growth in 2007. As a result, Hong Kong exporters will face both weaker overseas demand and a more rigid export policy on the Mainland. Growth in merchandise exports is projected to slow to 7.4% in 2007 in real terms.

Booming Financial Sector

The financial industry faces a very different landscape. Its contributions to the GDP increased from 11% in 2001 to 16% in the first half of 2006, surpassing the respective contributions from property-related sectors for the first time ever. Growth is mainly driven by activities in the stock market, as indicated by its close correlation with activities in the financial industry.



Sources: Census and Statistics Dept., HKSAR;
Economic Research Dept., The Bank of East Asia Ltd.

The Mainland factor has played an important role in this development. Having been a member of the WTO for five years, China has a heightened awareness of the need for Mainland companies to raise capital in order to compete with growing foreign competition. Hong Kong's stock market has therefore not only established itself as the most efficient channel for Mainland companies to raise funds, but has also played an important role in the reform of the Mainland stock market. By listing in Hong Kong, Mainland companies are subject to more stringent supervisory regulations. In addition, the Hong Kong market provides credible company research reports and pricing information. These strengthen the confidence of Mainland investors in acquiring shares of these companies when they return to the Mainland stock market.

The strategy has proven to be successful. Twenty-one Mainland companies have listed in Hong Kong in 2006, raising a total of HKD292 billion. The return of quality H-share companies to the Mainland market also largely boosted the investors' interests, leading to a 130% jump in the Shanghai stock exchange index. Furthermore, the successful reform of the Mainland stock market is crucial to the development of private consumption, a key policy objective of the 11th Five-Year Plan. The wealth effect of rising financial asset prices is the most effective way to encourage individuals to spend.

Hence, the model should continue to be adopted in 2007, and an increasing number of Mainland companies listing in Hong Kong is expected. Due to the close correlation between the growth of the financial industry and the stock market, another year of busy IPO activity will provide support to the expansion of the industry.

Continuing Recovery of Private Consumption

In tandem with economic recovery, growth of private consumption accelerated to 4.8% in 2006, up from 3.4% in 2005.

Due in large part to the strong economic growth in the past three years, the unemployment rate dropped to 4.4% in December 2006, almost half of its peak in 2003. Trade-related sectors, business services, as well as community, social and personal services have been the major job generators. Although the slowdown in external trade this year will restrain employment growth in trade-related sectors, stronger domestic demand should counter any adverse effect. The unemployment rate should hover in the 4-4.5% range. Increased job security has provided strong fundamental support to improving consumer confidence.

Meanwhile, falling real interest rates have also contributed to stronger consumer spending. The appreciation of the Rmb in 2006 has translated into higher costs of imports from China, while the pricing power of retailers has been on the rise across the board as the employment market continues to improve. Hence, inflation should trend higher, and is expected to reach 2.7% in 2007. Despite rising inflation, interest rates are likely to be reduced by around half a percentage point. The US Fed may ease its monetary policy in the second half to battle any adverse effects resulting from the consolidation of the property market on the economy. The subsequent fall of Hong Kong real interest rates would encourage individuals to further spend and invest. Growth of private consumption should accelerate to 5.5% in 2007.

Outlook: Growing Significance of the Financial Industry

The Mainland factor will underpin the growth trend of Hong Kong's financial industries. China's foreign currency reserves jumped by 30% to USD1,066 billion in 2006, and have injected excess liquidity into the banking system. As a result, it has become increasingly urgent for the central government to ease restrictions on capital outflow to relieve the build-up of reserves. The latest extension of the limit of foreign currency that Mainland citizens may exchange, from USD20,000 to USD50,000, is an effort in this direction. Hong Kong, as an international financial centre, is the natural doorway for this capital outflow, and should benefit from this development.

In the meantime, China's commodity consumption has surged in recent years, and this has translated into a strong demand for commodity futures trading. For instance, fuel oil futures transactions in the Shanghai market jumped by 30% in 2006. However, as China's capital account is not fully open, Mainland traders must place orders overseas in order to gain international liquidity. This could create habitual inertia for Mainland investors to perform financial activities in overseas markets, which is not in China's best interest. This concern has led to suggestions that futures markets should be developed in Hong Kong, which offers investors access to international liquidity, and at the same time, addresses national security considerations.

This all suggests that the evolvement of the Mainland's financial systems has created numerous opportunities for Hong Kong as an international financial centre to offer more than the flourishing IPO business. Hence, the financial industries will continue to play an increasingly important role in the economy. In 2007, the strength of the financial sectors and private consumption should offset moderation in export growth, and the GDP is forecast to grow at a healthy 5%.

Forecast of Major Indicators (yoy % change)		
	Real Growth Rate	
	2006@	2007@
1. Domestic Sector		
Private Consumption Expenditure	4.8	5.5
Government Consumption Expenditure	0.1	0.5
Gross Domestic Fixed Capital Formation	8.1	4.5
2. External Sector		
Total Exports of Goods	9.3	7.4
Domestic Exports	10.7	-1.5
Re-exports	9.2	8.0
Imports of Goods	9.3	7.8
Exports of Services	8.6	7.0
Imports of Services	5.6	5.0
3. Real Gross Domestic Product	6.5	5.0
4. Composite CPI	2.0	2.7
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