

## 2008: Hong Kong in the midst of US-China decoupling

With broad-based growth in both the external and domestic sectors in 2007, Hong Kong's economy is expected to record its fourth consecutive year of above-trend growth, with the final GDP figure likely to come in at around 6%. Looking forward to 2008, two major events – the presidential election in the United States and the Olympic Games in Beijing – look set to shape the direction of the US and Mainland economies in the coming year. Caught in the middle, Hong Kong's open economy will be buffeted by both sides.

### More difficult times ahead for the US

The correction in the US housing market intensified during 2007, with housing starts, building permits and new home sales all dropping by over 45% from their peaks. Existing home sales saw the steepest plunge since 1989. Events finally came to a head with the dramatic collapse of the subprime mortgage market.

The spillover effects of the subprime crisis on other asset markets – especially mortgage-backed securities and asset-backed commercial paper – hit US financial institutions hard, triggering a global credit crunch and financial market turbulence in July and August 2007.

And there is still more bad news to come.

The housing market is yet to bottom out and some two million mortgage loans are expected to reset to higher rates and larger monthly payments during the coming two years. This is likely to further drive up delinquency rates and foreclosures. Although the markets took some solace from the US government-led rescue plan to freeze interest rates on subprime home loans for five years, the rescue will only apply to a limited number of loans and cannot be regarded as a general panacea.

Whether the US will fall into recession or not will hinge on the performance of the equity markets in the coming months. So far, the Dow Jones Industrial Average has only slightly corrected by 7.8% from the all-time high reached in October 2007, as weakness in the housing and financial sectors has been offset by soaring profits at US multinationals in the remaining sectors that are reaping the benefits of the outsourcing process and a robust global economy.

This may help explain why US consumers refuse to give up their spendthrift ways, as rising equity wealth is to some extent offsetting falling home values. During the first three quarters of 2007, US consumers drove personal consumption spending up by 2.6%, compared to the same period last year.

In order to keep the economy out of recession, the US Federal Reserve will therefore need to shift its focus from combating inflation to coddling the equity markets. As long as the financial markets remain stable, the US economy could escape 2008 with a slowdown instead of a full-blown recession. It is expected that the fed funds rate will be lowered by 75 basis points in the first half of this year.

Still, Hong Kong cannot rest easy. Under either scenario – slowdown or recession – US demand will weaken in 2008. Hong Kong's prospects in terms of external trade will remain clouded. The US presidential election provides the perfect excuse to ramp up pressure on China on trade issues one more time. Given the weak political position of the current US Administration and the continuing rise of the US merchandise deficit with China (the deficit is projected to grow to US\$ 255 billion in 2007), it would be foolhardy to expect the US government to remain silent.

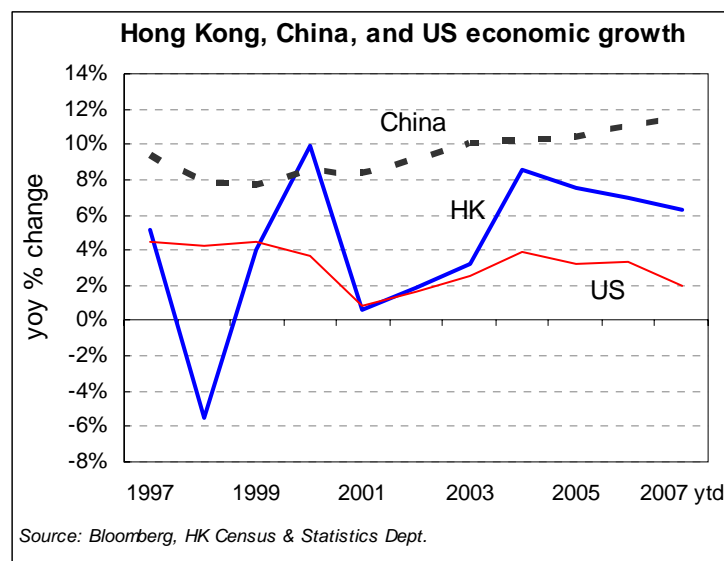
Meanwhile, the Chinese government is doing everything in its power to engineer a stable macroeconomic environment in the run-up to the Beijing Olympic Games. The last thing the government wants is another spike in exports, leading to a widening trade surplus and further liquidity pressures within the domestic economy. Therefore, export restraint will be the order of the day.

Given the above-mentioned external factors, the real growth of Hong Kong's export is likely to decelerate from an expected 7.2% in 2007 to 6.0% in 2008.

### Strong Mainland growth momentum will underpin Hong Kong

While the US economy is facing increasing risk, the Mainland economy continued to grow briskly in 2007 with average growth of 11.5% over the first three quarters. Aided by the record-setting pace of China's stock market in 2007, domestic consumption will soon be taking over from exports as the driver of Mainland growth. If this trend can continue, China will likely be shielded from the downturn in the US economy next year.

This decoupling story would benefit Hong Kong, as the SAR is becoming increasingly integrated with the Mainland economy. In fact, Hong Kong's economic growth has outpaced that of the US by a wide margin since 2004, in spite of its close affinity with the US economic cycle. This widening gap is undoubtedly due to the buoyancy of the Mainland economy.



In fact, the surge in Mainland visitors since the implementation of the Individual Visit Scheme in 2003 has greatly boosted Hong Kong's retail sector. In 2008, it is expected that the favourable impact of capital outflows from the Mainland will further stimulate the development of Hong Kong's financial sector.

With continuing hot money inflows and a stubbornly high trade surplus, the Mainland's foreign exchange reserves exceeded US\$1.43 trillion in September 2007. Although the People's Bank of China issued large amounts of treasury bills and raised the reserve requirement ratio for commercial banks 10 times in 2007, the growth in M2 money supply remains high above the government's target rate of 16%. Excess liquidity has not only fueled an asset bubble, it has fed fixed asset investment. The much-feared spectre of an overheating economy is looming larger. This has highlighted the need to further liberalize the capital account to relieve the pressure coming from the build up in foreign exchange reserves.

Meanwhile, the 17<sup>th</sup> Communist Party Congress, held in October 2007, gave some indication that further liberalization has high-level support. For the first time, the final report of the Party Congress stated that "conditions will be created to enable more citizens to have asset income". With its proximity to the Mainland and world-class financial infrastructure, Hong Kong is well-placed to support any diversification of the Mainland's savings. Demand from Mainland investors should therefore continue to support the further development of the financial industry in Hong Kong in the future.

### Negative real interest rates will further boost the property market

Amid upbeat domestic fundamentals, inflationary pressures are trending higher. Netting out the effect of the rates concession from April to September, the Composite CPI rose by 2.4% year-on-year in the first 11 months of 2007, exceeding the annual rate of 2.0% in 2006.

The main contributors to rising inflation were increases in food and private rental housing costs. Since the Mainland's rocketing food prices are unlikely to retreat until the second half of 2008, there is little prospect of relief from inflationary pressures in the near term.

Moreover, wage rises amid a tightening labor market, along with the positive wealth effect from the vibrant stock market, have propelled consumer spending. Retail sales accelerated to 12.4% in the first eleven months of 2007. This sharp growth has been a godsend to wholesalers and retailers, providing them much stronger pricing power.

Furthermore, the residential property market made a strong comeback in 2007. Property prices jumped by 13% by October compared to the start of the year, while rents increased by 11.9% in the same period. This suggests that the housing component will remain a potent force behind inflationary trends, given its nearly 30% weight in the Composite CPI and the recent upward trend of rents.

Inflation in Hong Kong is thus forecast to head towards 3.5% this year. Given the Federal Reserve's need to steer the US economy away from recession, further US rate cuts are likely. Hong Kong banks will have little choice but to follow suit, pushing domestic deposit interest rates below the 2% mark. This will bring down the mortgage costs and result in negative real interest rates, which will further boost property and other local asset plays.

## Conclusion

The US subprime crisis has greatly squeezed the availability of credit in global financial markets, forcing central banks from Canada to the United Kingdom to join the US Federal Reserve's lead in cutting interest rates. Together with the Mainland's effort to restrain exports to reduce pressures arising from the swelling trade surplus, this does not bode well for Hong Kong's external demand next year.

Although Beijing's monetary policy is shifting from "prudent" to "tight" to guard against the risks of economic overheating, the Mainland government will not introduce a heavy dose of medicine to cool the domestic markets before the Olympic Games.

Therefore, the Mainland stock market should continue to exert a positive influence on Hong Kong's market, even though volatility may increase substantially with the US subprime related risks. Caught between a cooling US and a warming Mainland, Hong Kong should remain a safe island in the storm, with the economy likely to grow at a steady 5% rate in 2008.

Forecast of Major Indicators (yoy % change)		
	Real Growth Rate	
	2007@	2008@
1. Domestic Sector		
Private Consumption expenditure	7.0	7.5
Government Consumption Expenditure	2.0	2.0
Gross Domestic Fixed Capital Formation	5.3	4.5
2. External Sector		
Total Exports of Goods	7.2	6.0
Domestic Exports	-25.3	-30.0
Re-exports	9.2	7.5
Imports of Goods	8.3	7.4
Exports of Services	10.9	8.5
Imports of Services	7.0	5.0
3. Real Gross Domestic Product	6.0	5.0
4. Composite CPI	2.0	3.5
@ BEA Economic Research Forecasts		

*The viewpoints expressed in the Economic Analysis do not necessarily reflect those of Management of this Bank. Reprinting of any figures or statements contained herein is permitted provided that proper attribution is given to the Economic Analysis and/or the BEA Economic Research Department. Please direct any inquiries to Economic Research Department, Tel: 3608-5020, Fax: 3608-6171, or GPO Box 31, Hong Kong.*