

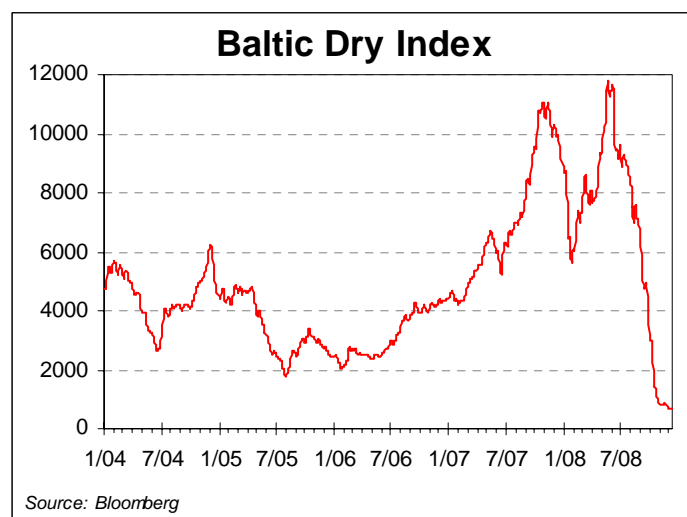
Hong Kong Economic Outlook 2009

The financial tsunami swamped the global economy in mid-September, resulting in a plunge in export orders that will lead to a very difficult first half of 2009 in Hong Kong. The economic path in the second half will largely depend on whether the US can break free from the credit squeeze and negative equity problems that are now gripping its economy.

The sorry state of the US economy

The US economy has gone from bad to worse in recent months. Falling housing prices and transaction volumes remain the prime concern. As of the end of September, 11.7 million mortgage owners, or 12.8% of the total residential housing properties, had mortgages that were greater than the value of their homes. The worsening negative equity situation is motivating an increasing number of homeowners to walk away from their properties. The increased supply of property under foreclosure will only reinforce a vicious circle of lower housing prices and a worsening negative equity problem. The increase in household net debt due to falling home asset values has caused US households to focus on paying back debt and trimming down spending. This will accelerate the contraction of consumer demand.

Meanwhile, since the financial meltdown in mid-September, the US money market has dried up and banks show little interest in lending. America's consumer sector has been particularly hard hit, making life increasingly difficult for retail businesses. Cash flow holds the key to survival, so retailers have slashed prices to move merchandise and boost their cash positions. Many have also delayed placing new orders, focusing instead on running down their inventories to low levels. This explains the sharp drop in the number of buying orders placed with Asian exporters. The Baltic Dry Index has dived in recent months, highlighting the sharp decline in global manufacturing activity.



It is all but certain that there will be a further contraction in the US economy in the first half of 2009. To turn things around, the US central bank has injected US\$800 billion and lowered Fed Fund rate to near zero percent level in an effort to unlock credit markets, while the newly elected US President vows to introduce an aggressive stimulus programme in an effort to jumpstart the economy. These initiatives should start to bear fruit by mid-2009, and prevent further deterioration in the financial markets and the broader economy.

A difficult six months ahead for the Hong Kong economy

Events in the US will have a profound impact on Hong Kong's economy. The reluctance of US retailers to commit to new orders, due to the credit squeeze and weak consumer demand, has created a crisis situation for Hong Kong manufacturers and exporters. The 2.2% drop in China's exports in November, following a 19% rise in exports in October, gave us the first hard numbers on how bad the situation has become. Furthermore, imports dropped by a startling 18% in November. As a significant portion of China's imports are semi-finished products, manufacturing materials and equipment, the sharp fall in imports suggests that the pipeline for export orders is running dry. Hong Kong exporters will face extremely difficult times ahead.

While the weak external demand is very similar to that during the Asian Currency Crisis, the domestic environment is very different. Interest costs are much lower than they were a decade ago. One-month Hibor is below 2%, as compared to an average of 7.8% in 1998. Also, while we then had to deal with the popping of the property bubble, our domestic economy is now in healthier form. The housing affordability index stands at about the 20-year average. As such, the relatively more solid fundamentals should allow the SAR government to draw deep into its pocket to present a strong fiscal stimulus package.

Looking ahead, the credit crunch should improve by mid-2009. Meanwhile, inventories at US retailers will fall to very low levels. A more normal level of demand from the US should return by then. Hence, surviving the drought in the first half of 2009 is a life-or-death challenge for Hong Kong exporters. In response, the SAR government has extended HK\$100 billion in loan guarantees to non-listed companies. This assistance will be critical to help companies survive the difficult months ahead.

In Hong Kong, we are likely to see an economic contraction in the first half, under the weight of the export slump. The return of import demand from the US should lead to a rebound in the trade sector in the second half. Nevertheless, for the year as a whole, exports are projected to contract by 1%. The fall in trade will slow employment growth, and the unemployment rate is likely to reach 5% in the second half of the year. This will lead to a reversal in private consumption growth to -0.6%. Meanwhile, government's aggressive effort to boost public construction should offset the fall in private investment. Capital formation is forecast to increase 1%. These will result in zero GDP growth for 2009, while inflation should subside to 2.5%.

If the Obama administration fails to arrest the worsening negative equity spiral, US spending may dive further and drive more consumer industries out of business. Under this scenario, US sourcing demand from Asia will be much softer in the second half. Hong Kong's GDP growth will fall to -3% in 2009 under this worse case scenario. Unemployment rate could climb to as high as 6%.

US path to recovery will likely be long

Looking further down the road, the economic challenges remain going beyond 2009, as the US economy is unlikely to recover to its previous form soon. One reaps what one sows. The housing bubble has lured US household to take on excess debt in recent years. From mid-2002 to mid-2008, mortgage and consumer loans rose by 73.8% to US\$13.8 trillion, while disposable income increased by a much slower 36.2%. With the bursting of the bubble, households must choose between loan default and repayment to unwind the debt.

In the case of the Asian Currency Crisis in 1998, many Asia companies could not roll over foreign currency loans and choose the path of default. This resulted in extreme financial and economic stress, but also shortened the adjustment timeframe. The region was back on its feet by mid-2000. While the US government may spend now to avoid deeper economic pain, this decision will prolong the time needed for adjustment.

Therefore, the US is likely to follow the economic adjustments of Japan and Hong Kong during their post-bubble burst era. The Japanese economic bubble burst in 1992, and the adjustment lasted until 2003. Discounting the additional damage caused by the Asian currency crisis, Japan took eight to ten years to repair the damage caused during bubble years. Meanwhile, it took six years for Hong Kong to recover. Due to cultural and structural differences, American households will probably be more willing to walk away from their debt than their Japanese and Hong Kong counterparts. Hence, the adjustment period could be shorter; nevertheless, it is unlikely to be less than four years. This implies that the US will not fully recover until 2012, and the economy will continue to suffer huge government debt, and sluggish consumer and investment spending. This overhang will continue to pressure the Hong Kong economy for the next few years.

Forecast of Major Indicators (yoy % change)		
	Real Growth Rate	
	2008@	2009@
1. Domestic Sector		
Private Consumption expenditure	2.1	-0.6
Government Consumption Expenditure	1.5	3.0
Gross Domestic Fixed Capital Formation	2.1	1.3
2. External Sector		
Total Exports of Goods	2.7	-1.5
Imports of Goods	3.0	-2.2
Exports of Services	5.1	1.6
Imports of Services	2.9	0.5
3. Real Gross Domestic Product	3.1	0
4. Composite CPI	4.5	2.5
@ BEA Economic Research Forecasts		

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