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Hong Kong Economic Outlook 2010

A Dramatic Turnaround

Economic activity grounded to a near standstill in the early part of 2009, in the wake of the most severe financial crisis since the Great Depression. At the time, many predicted that the Hong Kong economy would experience a collapse worse than that suffered during the Asian Financial Crisis, given the world-wide impact of the current turmoil.

Then, in a dramatic fashion, the monetary and fiscal stimulus packages introduced by governments around the world took hold. Credit markets became unstuck; economic activity rebounded.

In Hong Kong, the upturn was accompanied by a huge inflow of "hot money". The wave of cheap capital has – at least for the moment – overwhelmed the cold current of low export demand, giving rise to a novel economic phenomenon in the SAR. How this unstable mix evolves will determine the direction of Hong Kong's economic prospects in 2010.

Hong Kong exports were down 16.3% year-on-year in the first three quarters of 2009. The percentage decline in exports for the full year is likely to be the largest on record since data collection began in 1952. As the export sector accounts for close to one quarter of Hong Kong's total economic value add, the downturn has had a significant impact on economic performance. Unemployment rate surged from 3.5% in October 2008 to 5.2% in March 2009, while GDP growth nose dived to a 7.8% contraction in the first quarter.

However, as global financial markets stabilized in the second quarter, Hong Kong's asset markets staged a strong and sustained recovery. As of the end of October, equity prices had jumped by 96.6% from their low point in March, while property prices had risen by 24.2% in the first 10 months.

Companies have been quick to take advantage of the surge in liquidity, raising HKD 107bn through initial public offerings in the first ten months of this year. Furthermore, rising asset prices have boosted overall economic confidence. Despite a double-digit year-on-year decline in the value of exports in the third quarter, private consumption rose. Further, the surge in property prices has sent investment growth back into positive territory.

Headwind Facing the Asset Markets

While Hong Kong's economic recovery should be sustained in 2010 on the back of stronger global demand, the run-up in asset prices in 2009 could become a concern in the new year. The miraculous run is mainly the result of the aggressive credit expansion on the Mainland, and ultra-low interest rates in the United States. Any move to tighten the loose monetary policy will dictate the performance of Hong Kong asset market in 2010.

Economic Policy on the Mainland

Although China's exports will recover next year in line with the stabilizing global economy, for the foreseeable future the country is unlikely to attain the 20% annual export growth it enjoyed prior to the crisis. Just as in 2009, public and private investment will be needed to sustain growth at hoped-for levels.

Therefore, monetary policy will remain accommodative in 2010. Lending will remain strong, with new bank lending projected to total Rmb 6 trillion for the whole of 2010. While this is down from the estimated Rmb 9.5 trillion new loans in 2009, it is still high by historical standards.

Furthermore, given the rapid expansion in credit last year, some tightening is seen as beneficial for the long-term health of the economy. Banks will exercise more stringent credit screening, in order to keep bad loans off their books.

One area that will receive close attention will be the housing market. During this past year, there have been reports of land hoarding and excess borrowing by local property developers. Actions have already been taken to address these issues, and additional measures are expected in the coming months.

Further, sectors with excess capacity, such as steel, cement, etc, will come under increasing pressure to consolidate and improve efficiency. These policy adjustments are likely to have a cooling effect on Mainland and Hong Kong asset markets.

Uncertainty Surrounding US Interest Rates

The outlook for US interest rates is murky at best. The November employment report contained the good news that unemployment rate had fallen by 0.2% to 10%, while the decline in the nonfarm payroll narrowed to 11,000. With the prospect that the worst may be over for the employment outlook, there has been speculation that the US will raise interest rates earlier than initially expected.

However, experience from the previous downturns in 1991-93 and 2001-03 shows that it takes 9-12 months (See Chart) following the first positive monthly growth in nonfarm payroll for the unemployment rate to fall on

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a sustained basis. Also, the monthly increase in nonfarm payroll reached the 150,000-200,000 range in both cycles before the central bank started to raise interest rates. This is to ensure the labour market has strengthened to a level that is able to withstand the effect of interest rate hike. Furthermore, since the current unemployment rate is far above the 5% level experienced during the full employment period from 2005 to 2007, there is still a long way to go before unemployment falls to levels that would favour a rate hike.

Another wrinkle came from the announcement released after the Federal Open Market Committee meeting in November, which suggested that inflation would be a key barometer of the need for any monetary tightening.

However, the outlook on inflation remains benign, given the ongoing debt reduction process by US households. Total US household debt has fallen for five consecutive quarters, while the saving rate has increased to 4.4% from near zero prior to the crisis.

This has also brought profound changes in consumer behaviour. Per capita spending during the Thanksgiving season this year was lower than even the dismal season last year. Shoppers are now more cost conscious, and are more likely to compare prices and shop over the Internet. As a result, consumption-related businesses are focussing their efforts on cost control in order to maintain profits. This has adversely affected hiring.

As long as companies put off hiring new workers, the recovery will be muted at best. Furthermore, given mounting US government debt, policymakers are likely to favour growth over caution in order to restore the country's financial health. Hence, there is good reason to doubt market expectations that the US will begin to raise interest rates in the second half of 2010.

If the US delays raising interest rate until 2011, the market could interpret this as positive news, thereby further stimulating the Hong Kong asset market. This is critical as the timing of the next cycle of monetary tightening will have a significant impact on the Hong Kong asset markets. It is expected that, once the cycle begins, the US Fed Funds Rate will rise by three percentage points or more within 18 months. Locally, the property market will experience the greatest impact. In spite of the recession, during the past two years property prices have risen by 20%. The only factor keeping prices affordable has been the ultra-low interest rate environment. Mortgage interest rates are some 2.48 percentage points lower during the period, resulting in a drop of 19.2% in the monthly instalment payment per dollar of outstanding mortgage loan. When interest rates go up, the cost of mortgage payments will rise, putting pressure on both local households and on the larger asset markets.

Projections for Hong Kong Economy in 2010

The sharp contraction in exports during the first three quarters of 2009 has created a low base of comparison that should lead to a strong technical rebound in 2010. However, weak US consumer demand will limit Hong Kong export growth to 8%. With the recovery in the export sector, employment growth should return to positive territory. The unemployment rate is expected to fall to the 4%-4.5% range.

On the other hand, since asset markets are likely to face a headwind in 2010, uncertainty will limit growth in private consumption and investment to 4% and 5%, respectively. Overall speaking, GDP growth is projected to stand at 5% in 2010. With the general pick up in economic activity, retailers will gradually regain pricing power. The inflation rate is expected to climb to 3.7%, while the underlying inflation rate will be at 2.5%.

Forecast of Major Indicators (yoy % change)		
	Real Growth Rate	
	2009	2010
1. Domestic Sector		
Private Consumption Expenditure	0.2	4.0
Government Consumption Expenditure	3.5	3.5
Gross Domestic Fixed Capital Formation	-5.0	5.0
2. External Sector		
Total Exports of Goods	-11.0	8.0
Imports of Goods	-10.5	8.6
Exports of Services	-4.0	8.5
Imports of Services	-4.5	7.8
3. Real Gross Domestic Product	-3.0	5.0
4. Composite CPI	0.6	3.7
BEA Economic Research Forecasts