BEA

The Bank of East Asia, Limited

Economic Analysis

January, 2011

A Publication of the BEA Economic Research Department

Hong Kong Economic Outlook 2011

The Hong Kong economy enjoyed a remarkable recovery in 2010. Stronger performance of the US and European economies led to a rebound in global trade from the depressed level experienced in 2009. As a result, Hong Kong exports jumped 23.8% in the first 11 months of 2010. Meanwhile, during the first 11 months of the year, residential property prices increased by 20.8% and transaction volume by 19.3%. This provides further support to the domestic economy. Real GDP is estimated to have grown by 6.5% for the year.

The figures might have painted a rosy picture, but there were many obstacles to overcome along the way. The Greek debt crisis spooked the markets in the first half of 2010. Fear broke out again in the third quarter, as attention shifted to the escalating debt problems of the so-called PIIGS countries – Portugal, Italy, Ireland, Greece and Spain. The fourth quarter brought a rebound, as the quantitative easing measures adopted by the US Federal Reserve boosted markets around the world. The feared double-dip recession never materialises; instead, Asian governments had to take action to guard against hot money inflows and the subsequent risk of asset bubbles.

It will not be a smooth ride, but recovery will continue in the West

Despite the roller-coaster year experienced in 2010, we remain cautiously optimistic about Hong Kong's 2011 economic outlook.

While the European debt crisis is still bubbling, the recent Irish episode attracted far less market attention than the Greek debacle earlier in 2010. The Dow Jones index fell by 10.7% in the month following the onset of the Greek crisis, but barely reacted when Ireland got into trouble. There is now widespread belief that Germany and France, however reluctant, will always bail out Euro zone members that get into trouble. Hence, while aftershocks may disrupt the market from time to time, they are unlikely to be severe enough to trigger a recession. The Euro zone economy is expected to grow by 1.4% in 2011, slightly slower than the 1.6% growth in 2010.

Meanwhile, the US has maintained expansionary fiscal and monetary policies in order to sustain the economic recovery. The Institute of Supply Management Index stayed above the 50-point threshold throughout the year, indicating that the economy had been expanding steadily. For 2011, the US economy should grow by 3.1%, following a 2.8% expansion in 2010.

America's greatest challenge is the fact that the recovery has created few jobs. The US lost 8.5 million private-sector jobs during the 2008-09 recession, compared to the loss of 3.4 million jobs during the 2001-03 recession. Only 1.35 million new jobs have been created in 2010, compared to a 1.65 million increase over the equivalent time frame during the 2004 economic recovery. Businesses have been unwilling to hire; outsourcing has increased. Hence, the outlook beyond 2011 is not very promising as the jobless recovery will cap the pace of expansion.

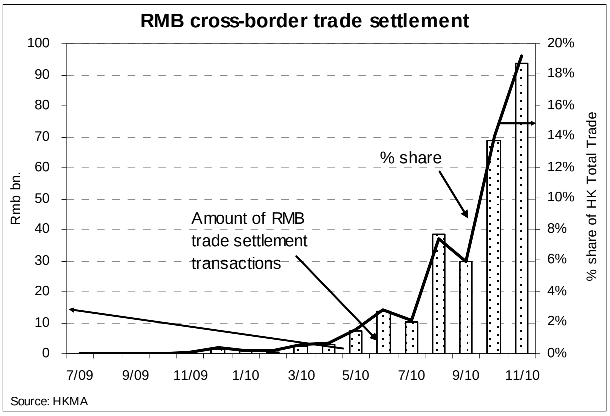
Mainland China will provide the momentum for recovery

For 2011, moderate demand from western markets will slow China's exports growth from 31.3% in 2010 to 15% in 2011. However, the domestic economy is expected to take up all of the slack created by slower export growth.

Sharply rising wages – both minimum wages and general wages in the manufacturing sector – suggest further strengthening of consumer spending power in 2011. Policy initiatives related to China's focus on boosting household income in the 12th 5-year plan should provide additional help. Together with an expected 3-5% appreciation in the Renminbi in 2011, demand for Hong Kong services, including shopping, education, medical and financial services, is likely to increase further.

For example, Mainland tourist arrivals grew by 27% in 2010, accounting for 72% of the increase during the year. In 2009, the latest year for which data is available, spending on shopping by Mainland tourists made up an estimated 17.8% of local retail sales. The number is expected to be even higher in 2010.

Meanwhile, the Hong Kong financial services industry should benefit from strong demand from the Mainland. In 2010, Hong Kong led the world in funds raised through IPOs, and has consolidated its role as the leading offshore centre for Renminbi business. With the support of Mainland authorities on capacity building for Hong Kong Renminbi financial services, Renminbi trade settlement in Hong Kong jumped to Rmb 93.7bn in November, accounting for 19.2% of Hong Kong's total trade. Fast expansion of Renminbi financial services should continue to bring in new banking business. As a result, demand from the Mainland for Hong Kong's consumer and financial services should compensate for any moderation in export growth in 2011.



Meanwhile, domestic demand should remain robust. Projects of infrastructural construction should progress in full swing. And as the unemployment rate trends down toward the 3.5% level, overall wage growth could accelerate to 4%. This will improve consumer sentiment and stimulate private consumption. The economy is projected to grow by 5% in 2011.

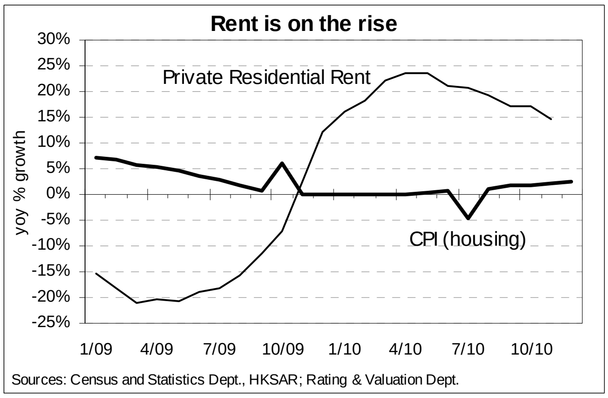
Government policy – the big question mark

While global economic recovery should be steady, authorities battling domestic issues will be a source of uncertainty this year. The lingering sovereign debt problems should encourage European governments to stick to belt tightening measures. Nevertheless, their penchant for pain is not unlimited, and it remains to be seen how long they could endure the depressing effects on their economies and political stability. US President Obama is in no hurry to address the growing fiscal problem, as the administration devotes its efforts to lowering the unemployment rate. Striking a balance between fiscal prudence and economic development will prove to be a headache for the US and European governments alike, and will continue to be a source of instability for the financial world.

Meanwhile, the Chinese government has been battling with rising prices. Capital inflow has fuelled a rise in commodity prices, and food inflation stayed high at 9.6% in December. In response, the People's Bank of China has raised the deposit reserve ratio and interest rates. Recent bad weather will likely keep food prices at high levels, while rising wages will fuel inflation for other consumer items in coming months. The Central Bank is likely to raise interest rates by 100 basis points this year to keep inflation from spiralling out of control.

The property market is also a continuing concern. Despite numerous government measures introduced last year, property prices continue to trend higher. Markets are now pondering if the introduction of the much anticipated property tax will be enough to stabilize prices.

Hong Kong faces similar challenges. Import food prices will go higher. Rents for private residential housing jumped 14% in the first 11 months of 2010, after a 12% increase in 2009. Hence, price pressure is in the pipeline and will be reflected in the housing component of the inflation figures this year. Together with the expected larger jump in wages this year, the overall inflation rate is projected to average at 4%. Also like the Mainland, the surge in property prices is a lingering headache. In late 2010, the government has imposed a punitive 5-15% stamp duty on the resale of property within 2 years and the measure has temporarily cooled the market activity. But factors including the low interest rate environment, shortage of new housing supply and interest of Mainland investors will continue to support the market.



In conclusion, global economies should continue to recover this year, though at a more moderate pace. Pre-occupied with the sovereign debt crisis and high unemployment rates, the US and European central banks will continue to pump liquidity into the market. This will fuel capital flows to Asian markets. In response, Asian governments will strive to contain the inflationary effects on their economies and asset markets. The challenge is the most acute for China. Nurturing private consumption is the core strategy of the new 12th 5-year plan. Hence, while the government must find ways to cool the economy, it must watch out for the risk of excess tightening that could depress consumer confidence. It will be a delicate balancing act.

Forecast of Major Indicators (yoy % change)		
	Real Growth Rate	
	2010	2011
1. Domestic Sector		
Private Consumption expenditure	5.3	5.0
Government Consumption Expenditure	3.5	4.0
Gross Domestic Fixed Capital Formation	8.5	7.0
2. External Sector		
Total Exports of Goods	15.0	7.0
Imports of Goods	16.2	9.0
Exports of Services	10.0	10.0
Imports of Services	7.0	8.0
3. Real Gross Domestic Product	6.5	5.0
4. Composite CPI	2.4 (A)	4.0

(A) : Actual figure

BEA Economic Research Forecasts