BEA
The Bank of East Asia, Limited

Economic Analysis

January, 2012

A Publication of the BEA Economic Research Department

Economic Outlook 2012

Europe at the brink of recession

Two years into the European debt crisis, and the rot is still spreading: First Greece, then Ireland and Portugal, and now that are "too big to fail" – Italy and Spain. Investors are demanding higher premiums on new bonds issued by European governments, for the fear of rising default risk. Ten-year government bonds for Italy and Spain have spiked, placing additional fiscal burden on both governments, especially for Italy, who has to refinance USD428 billion of securities this year. Each new bond sale is watched with apprehension for any shift in investor appetite for European sovereign debt.

Meanwhile, with the deterioration of financial environment, banks are being forced to reduce credits extend to companies. In turn, these companies have no choice but to lower inventory levels in order to maintain cash flow. Both investment and consumption have plunged, pushing the Purchasing Manager's Index (PMI) for both manufacturing and services sectors below the 50-point threshold that indicates whether demand is expanding or contracting.

On the other hand, governments have been either unable or unwilling to offer stimulus to offset the fall in business spending. European countries are instead implementing steep budget cuts in order to fix their dire fiscal positions. It is widely recognised that Europe is either already in recession, or on the brink.

Germany and France are widely seen as the only countries that can rescue the Euro zone. Yet Germany in particular has resisted taking on the role of saviour. It is Germany, above all others, that is demanding their more profligate neighbours to make tough choices and reign in spending. In fact, many European economies not only have to tighten their belts to lower their debt, but they also have to cope with the anticipated jump in government expenditure due to their aging populations. In absence of the political determination to reform their welfare systems, it is unlikely that they will produce a sustainable and achievable plan to restore their long-term financial health.

The agreement reached on 9th December last year by 26 European countries to set out a common approach on restoring the fiscal health of Europe is thus of great significance. Since some of the clauses of the pact will be written into the constitutions of the member countries, the agreement, once ratified by each member state, will mandate fiscal responsibility and put Europe on the right track for long-term fiscal sustainability. Nevertheless, this new fiscal compact does not bring any immediate measure to save the heavily indebted countries from default, the market is still threatened by the debt crisis in the short-run. In addition, the impact of the inevitable credit squeeze will only grow stronger in the coming months. European economies will be in recession for most of 2012.

Jobless Recovery in US

For the US, economic growth accelerated to 1.8% in the third quarter of 2011 from 1.3% in the second quarter. There are encouraging signs of an uptick in demand in key sectors of the economy, including the auto industry. The US business sector is borrowing again, with the total debt load resuming an upward trend since the third quarter of 2009. However, the sluggish housing market and weak employment growth still act as a brake on the economy.

Consumer demand remains low, constrained by a heavy household debt burden due to falling home values. A significant number of US homeowners is now under water on their mortgages. 10.9 million, or 22.5% of all residential properties with a mortgage, were in negative equity at the end of the second quarter of 2011. Facing this burden, American households are delaying purchases to lower their debt. As a result, total household debt fell by US$1.1 trillion, or 5%, from mid-2008 through the first half of 2011. The belt tightening will restrain consumption and, until the deleveraging process is over, it will continue to drag down economic growth.

Lacklustre consumer demand is a key contributing factor to the disappointing rate of job creation at the current stage of economic recovery. Two years after the recession in the US formally ended, the economy has gained just 2.395 million[1] of the nearly 8.394 million jobs lost during the downturn. Consumer-related industries have been hit the hardest. The sector lost close to 1.2 million jobs during the downturn, but has made up only 225,000 jobs during the recovery. Meanwhile, the US unemployment rate remained at historically high levels at 8.5% in December.

In view of the continued deleveraging of American household debt and the high unemployment rate, US firms are expanding abroad to tap the growing demand in emerging markets. One consequence is that the money pumped into the economy through quantitative easing has been diluted by firms preferring to invest overseas instead of domestically. Hence, the US can expect only moderate growth in 2012, with unemployment rate remaining at 8% level.

[1] Employment fell between December 2007 and October 2009, while recovery occurred between November 2009 and September 2011

Soft landing in China

The European debt crisis and the slow economic recovery in the US are weighing on the Chinese economy. Export growth slowed to 13.4% in December 2011. The situation is likely to get worse in months ahead. China's official manufacturing PMI was hovering at 50 in recent months, which suggests that manufacturing activity is weak.

Particular concern is focused on small and medium-sized enterprises (SMEs). Weak overseas demand, coupled with rising wages and yuan appreciation, has squeezed their profit margins. They also find access to credit difficult, as banks tighten lending. Since SMEs account for 80% of employment and 60% of industrial output in China, they play a crucial role in the economy. A widespread closure of SMEs could affect employment and threaten social stability. This is a key reason why the People's Bank of China announced a 50 basis point reduction in the bank deposit reserve requirement in December last year – the first decline since December 2008. This will free up more funds for lending to cash-strapped SMEs.

According to the China Real Estate Index System, property prices in 100 major Chinese cities dropped 0.25% month-on-month in December 2011, the fourth straight month of decline. Even though economic growth is slowing and housing prices are falling, the Central Government does not appear to be in any hurry to end its curbs on property market. In a recent speech, Vice Premier Li Keqiang vowed to keep the tightening measures in place throughout 2012. This indicates that policymakers are determined to tackle structural problems in the economy, in particular the property market, in order to pave the way for sustained economic development in the remainder of the 12th Five-Year Plan.

Hence, the policy focus in 2012 will be establishing a balance between sustaining the correction in the housing market and assisting SMEs. A moderate reduction of 150 basis points in the deposit reserve ratio is expected in 2012. Furthermore, the government will resort to administrative means to assist the SMEs. It has already issued orders that no less than 30% of government procurements must be from SMEs. Fiscal measures, such as lowering the tax burden of SMEs and individuals, are also expected.

In light of the economic adjustments, the Chinese government is likely to successfully engineer a soft landing in 2012. We forecast a GDP growth of 8.2% in 2012, down from an estimated of 9.1% in 2011. Inflation will ease to 3% in 2012 from 5.3% in 2011, reflecting falling in food costs.

Hong Kong Economy Taking a Pause

The Hong Kong economy has recovered fully from the financial tsunami. Unemployment has fallen from a high of 4.6% in June 2010 to 3.4% in November 2011. However, growth is not balanced across sectors in the economy. Hiring has been fuelled by an expansion in the financial, property and tourist-related industries, with an employment growth ranging 4.5-7.0% from the second quarter of 2008 to the second quarter of 2011. However, the Import/Export and Wholesale sectors suffered job losses of more than 6% during the same period. Layoffs in the trade sector are structural and will not easily be recovered, as rising production costs and weak overseas demand combine to squeeze the profit margins.

Hong Kong's exports are likely to remain weak in 2012, given the weakness of overseas economies outlined above. Europe accounts for 11.2% and 19.7% of the exports of Hong Kong and the Mainland, respectively. Recession in Europe will reduce Hong Kong's real export growth to 0% in 2012 from an estimated of 4% in 2011.

While the export engine loses power, the Mainland factor will continue to support Hong Kong's economy. With its foreign exchange reserves reaching US$3.2 trillion, China is finding ways to encourage more capital outflows. Hong Kong has played an important role in helping Mainland enterprises to expand globally under the "Going Out" policy of the Chinese government. Studies showed that 65% of Chinese companies intended investing overseas invests in Hong Kong or use Hong Kong as an investment platform. The influx of Mainland capital fuels demand for commercial services and pushes up office rentals in the city. At an average of HK$1,666.8 per square foot per year, Hong Kong's Grade A office space is ranked the most expensive worldwide.

The strong purchasing power of Mainland tourists also provides a forceful boost to the Hong Kong economy in supporting retails sales, which grew at a stunning 25% in the first eleven months of 2011. Mainland tourists spent HK$87 billion in Hong Kong in 2010, or 64% of the city's total tourism expenditure; 67% of their spending is on shopping. This strong spending supports employment growth in the consumer sector, and provided the labour demand that allowed for the smooth introduction of the minimum wage in May 2011. The labour market remained tight with total employment in the third quarter increased further by 31,800 over the previous quarter.

While export growth is expected to cool due to the global economic turbulence, domestic demand in Hong Kong should remain solid. Besides, the continue support from Mainland tourist spending, domestic wage growth – wages were 9.9% higher in the third quarter of 2011 compared to one year earlier – will help sustain private consumption. We therefore forecast a 3.5% GDP growth for Hong Kong in 2012, with the inflation at 3%.

Forecast of HK Major Indicators (yoy % change)

	Real Growth Rate	
	2011	2012
1. Domestic Sector		
Private Consumption expenditure	8.5	5.0
Government Consumption Expenditure	1.9	2.4
Gross Domestic Fixed Capital Formation	7.0	4.0
2. External Sector		
Total Exports of Goods	4.0	0
Imports of Goods	5.2	0.8
Exports of Services	7.6	3.0
Imports of Services	3.7	1.1
3. Real Gross Domestic Product	5.0	3.5
4. Composite CPI	5.2	3.0

BEA Economic Research Forecasts