

CHAPTER 2 : ECONOMIC OUTLOOK FOR 2009 AND THE MEDIUM TERM

Summary

- *Being small, open and highly integrated with the rest of the world, Hong Kong's economic performance is closely tied to the demand conditions of its major economic partners, many of which are being paralysed by the global financial tsunami. The Hong Kong economy is forecast to contract by 2% to 3% in 2009. This projection is subject to considerable uncertainty, especially if the negative feedback loop between global economic weakness and financial stress continues to intensify to prolong and deepen the crisis.*
- *Given the severity of the global economic downturn and the knock-on effects on Asia, Hong Kong's external trade this year is bound to be severely hit.*
- *Local consumer spending will be depressed by heightened uncertainties, falling household wealth and rising unemployment. Investment will similarly stall until clearer signs of an economic recovery are in sight.*
- *The measures implemented by the Government to stabilise the financial markets, support enterprises and create employment, together with the further growth of the Mainland economy and the Central Government's support measures to Hong Kong, will provide some relief to the Hong Kong economy in difficult moments like this.*
- *Inflationary pressures will come down notably further in 2009. Headline consumer price inflation is forecast at 1.6%, and the underlying inflation at 1.5%.*
- *After the current global crisis has fully run its course, the medium and longer-term economic prospects for Hong Kong should remain promising. The Government, together with the private sector, will continue to step up efforts to raise the competitiveness of the economy to complement the vibrant developments in the Mainland, by striving to restructure the economy towards knowledge-based, high value-added activities; by enhancing our roles as an international financial centre and a leading business hub; and by further strengthening our integration with the Mainland, especially positioning ourselves strategically in the PRD. The trend GDP growth rate in real terms is forecast at 3.5% per annum from*

2010 to 2013, and the trend rate of underlying consumer price inflation at 2%.

Major external factors

2.1 Being highly integrated with the rest of the world, the Hong Kong economy cannot avoid being significantly impacted by the global financial tsunami, the most severe economic crisis since the Great Depression. While the concern about a global financial meltdown has receded following the unprecedented government policy responses, the financial markets will likely remain turbulent in 2009. Advanced economies are mired in recession and emerging and developing economies have slowed sharply since the latter part of last year. The synchronised global downturn can be expected to get worse before getting better. The performance of the Hong Kong economy in 2009 will hinge much on how the financial crisis will play out and when the external environment will begin to improve.

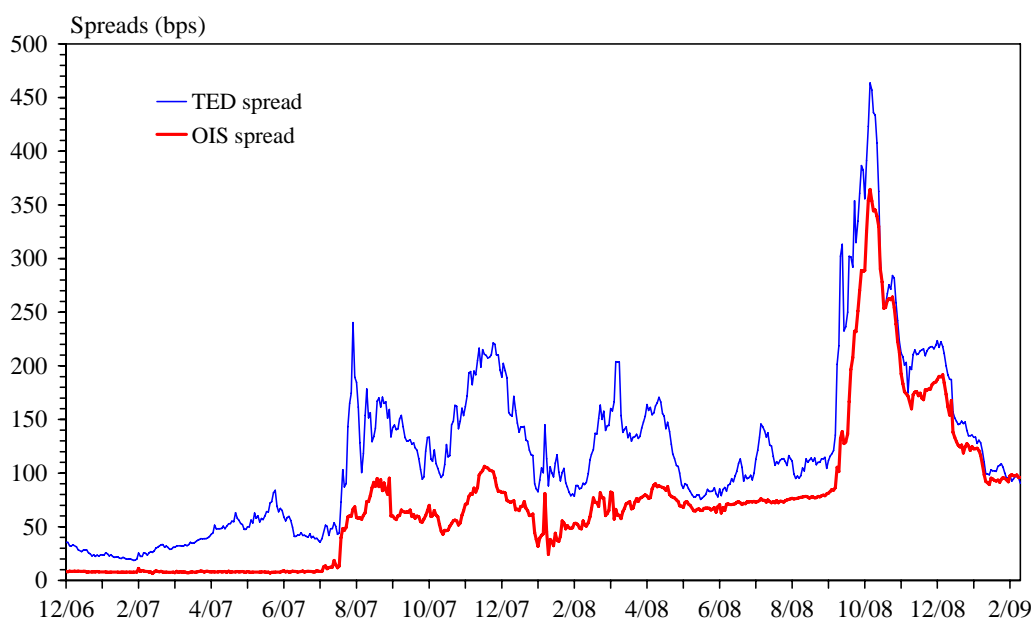
2.2 The global economic downswing and credit crunch have already dampened significantly the flows of trade, as evidenced by the double-digit declines in exports of many Asian economies in recent months. The external environment will remain extremely challenging going forward. There are significant uncertainties regarding the effectiveness of the aggressive fiscal and monetary measures being pursued by governments in the major economies, and hence the timing and vigour of the global economic recovery, particularly in the face of the negative feedback loop between financial market strains and global economic weakness. The uncertain direction of the US dollar movement, with its implications for the price competitiveness of Hong Kong's exports, will also complicate the picture. Yet inflationary pressures have and will continue to come down in 2009, along with the depressed commodity prices and weaker demand conditions.

Financial crisis and credit crunch

2.3 The global financial crisis triggered by the US subprime mortgage crisis deepened distinctly in 2008, particularly so after the collapse of the Lehman Brothers in September 2008, when confidence on the international financial system shrank to the lowest and the lending and borrowing activities among banks virtually came to a standstill as counterparty risks surged. The stability in the global financial system has since been restored following the unprecedented efforts by governments in advanced economies to tackle all aspects of the financial markets: liquidity, bad assets, shortage of capital, and especially confidence. Nevertheless, it will take time for the financial

institutions around the world, especially those in the advanced economies, to complete the process of de-leveraging, implying that global credit conditions will remain tight in 2009. Indeed, the prevailing yield spreads, particularly those for corporate credit risks in general and sovereign default risks for some developing economies, are high by historical standards. The tight credit conditions will directly restrain economic activities in every corner of the world. Emerging markets with high external debt, huge current account deficit or weak financial system would be particularly vulnerable to the credit crunch. This will also weigh on the already feeble world import demand, thereby further dampening international trade and hence Hong Kong's exports this year.

Diagram 2.1 : Ted spread remains high by historical standards

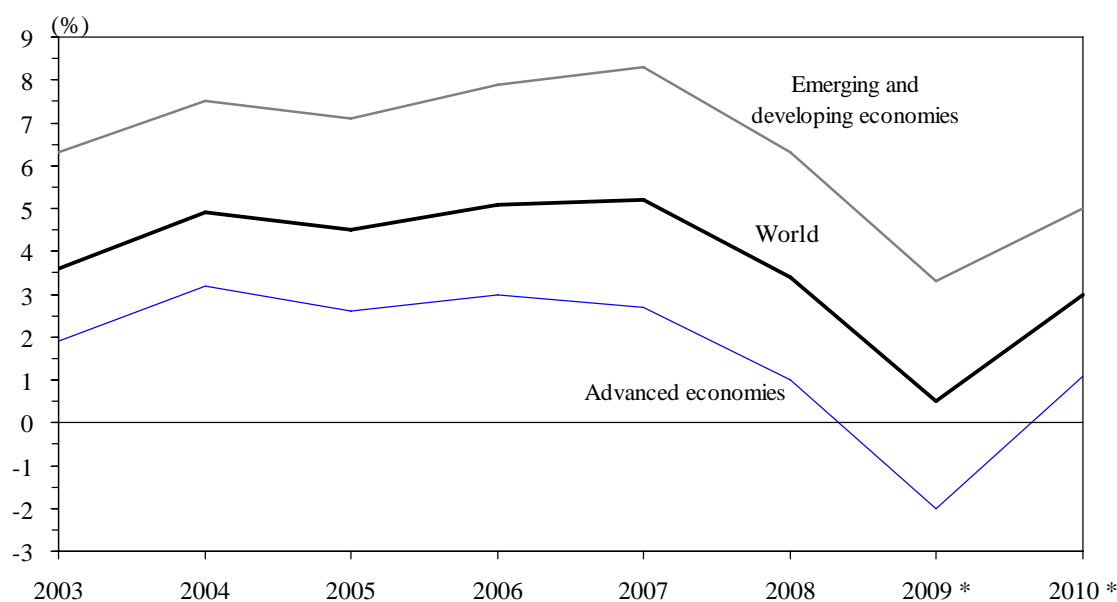


2.4 The substantial stock market corrections around the world over the past year or so, bringing with it significant negative wealth effects, will continue to weigh on consumption and import demand worldwide. In 2009, financial markets are likely to remain volatile in 2009, as investor sentiment remains fragile and sensitive to adverse news. Also, in recent months, major financial institutions in the US and Europe continued to report huge financial losses, and the risks of financial crisis intensifying again cannot be underestimated.

2.5 As an international financial centre, the financial markets and credit conditions in Hong Kong, and thus the real sectors of the Hong Kong economy, will inevitably be affected by the financial developments around the world. Nevertheless, the sound institutions and regulatory frameworks, on top of the pre-cautionary measures introduced by the Government in response to the global financial crisis have so far ensured financial stability in Hong Kong against the external shocks, a significant accomplishment especially when

viewed against the dire situations facing the banking sectors in the US and Western Europe.

Diagram 2.2 : The global economy has entered a severe synchronised downturn



Source: IMF World Economic Outlook Update January 2009.

(*) Forecast from the IMF.

Global economic outlook

2.6 The global economy is now in an uncharted territory, with credit flows being severely blocked and monetary policy rates approaching the zero bound in many advanced economies. As a result, governments and central banks in the advanced economies have to resort to unconventional stimulus measures, the effectiveness of which is uncertain. The ramifications of the financial tsunami have translated into a synchronised global economic downturn since the latter part of last year. In the United States, job loss during 2008 was the largest since 1945, and the economy is still deep in recession. Also, the US housing market downturn, the trigger of the current financial crisis, has yet to bottom out. The fall in housing prices, if continued, could add to the strains in the financial markets and deepen the recession.

2.7 The economies in Europe worsened distinctly in the latter part of 2008. European financial institutions, being significant holders of impaired financial assets, have been hard hit. Economic situations in some European economies have also been impacted by the fallout from their property markets. Business sentiment in the euro area is at a record low. In Japan, the economic situation is likewise in doldrums, with exports, the driving force of its recent economic expansion, falling substantially in recent months and consumer and investor sentiments remaining subdued. In sum, the advanced economies are mired in

recession. According to the International Monetary Fund (IMF), GDP of the advanced economies as a whole is projected to contract by 2.0% in 2009, the most severe downturn during the post-war period. The timing and vigour of the recovery are highly uncertain. The prospects for a turnaround in the latter part of this year will depend very much on how the financial crisis will play out and whether the policy actions taken by these economies, including huge fiscal stimulus measures and aggressive monetary easing, can effectively attain their goals in kickstarting the economy.

2.8 Emerging economies in Asia, which are generally export-dependent, should likewise experience further sharp deceleration in 2009, as the global trade flows will continue to be halted by the faltered demand from the advanced economies. The difficult credit conditions amidst the stress on international financial markets will also restrain investment demand. This impact should particularly be pronounced for economies with sizeable current account deficits and those reliant on external financing. As to the commodity-exporting economies that were used to gain from the run-up in commodity prices until mid-2008, they will now face a sudden and sharp deterioration in their terms of trade, posing significant pressure on their domestic demand.

2.9 Specifically, the growth momentum of the Mainland economy, the hinterland featuring significantly in all aspects of the economic activities in Hong Kong, is likely to diminish somewhat in 2009. While the Mainland economy will face a challenging situation in the light of slackening exports and weakening industrial production on top of the cooling off in its asset markets, the series of government stimulus measures, including the RMB 4 trillion fiscal package announced last November, hikes in exports tax rebates, measures to assist small and medium sized enterprises, as well as the accommodative monetary policies, should render some firm support to its domestic demand and, to a lesser extent, its external sector. The developments in the Mainland should still be a positive factor to the Hong Kong economy, particularly when viewed against the dire situation elsewhere in the world.

Table 2.1 : Growth forecasts for major economies in 2009

	2009		
	2008* (%)	IMF* (%)	Private sector forecast ^ (%)
World	3.4	0.5	-
Advanced economies	1.0	-2.0	-
US	1.1	-1.6	-2.1
Euro area	1.0	-2.0	-2.0
Japan	-0.3	-2.6	-3.8
Emerging market and developing economies	6.3	3.3	-
Developing Asia	7.8	5.5	-
Mainland China	9.0	6.7	7.0
India	7.3	5.1	5.4
Middle East	6.1	3.9	-

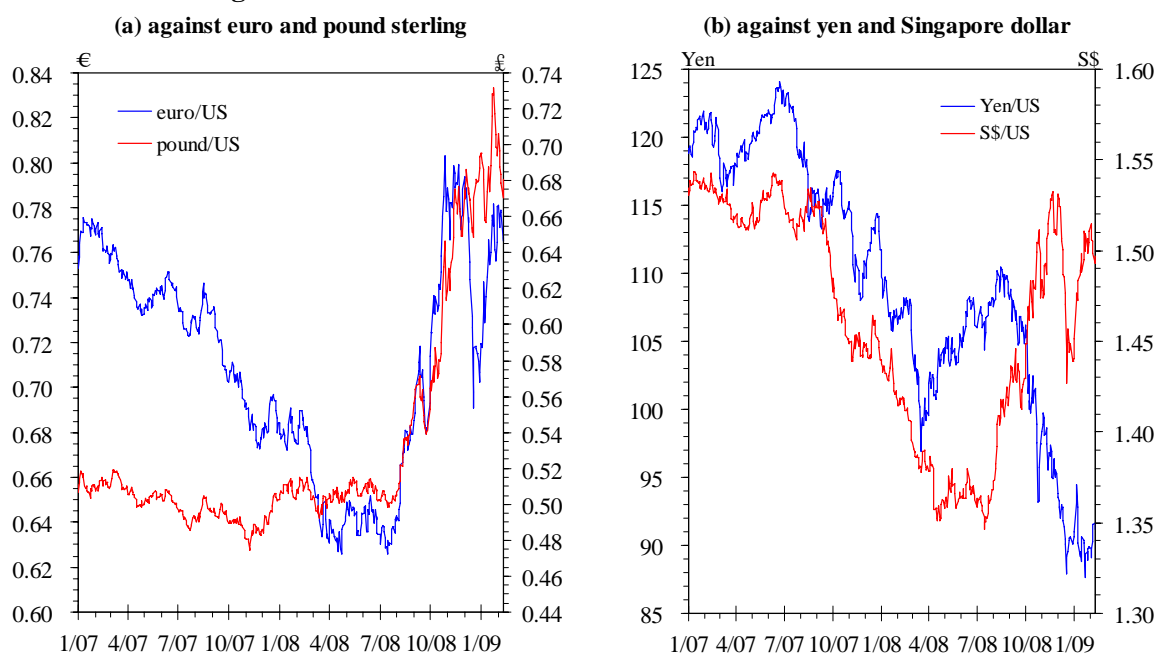
Notes : (*) World Economic Outlook Update, IMF, January 2009.
 (^) Average forecast as in February 2009.
 (-) Not available.

Exchange rates and price competitiveness

2.10 The movement of exchange rates can affect Hong Kong's external competitiveness and thereby influence Hong Kong's external demand. Unlike previous years, given the dire situation in the advanced economies, the exchange rate factor is likely to feature less prominently in determining the demand for Hong Kong's exports in 2009, which will be more affected by the deteriorating income levels in the overseas markets. Since mid-2008, there has been a rebound of the US dollar against other major currencies, with the exception of Yen and Renminbi. This probably reflected the capital flights to safety assets, including the US Treasury bonds, amid the financial tsunami and the narrowing of the interest rate spreads across currencies following the aggressive interest rate cuts by major central banks around the world. Tracking closely to the US dollar, the Hong Kong dollar also strengthened against a basket of currencies of Hong Kong's trading partners, appreciating by 0.2% in December 2008 from a year earlier. As such, the recent exchange rate development should be less conducive to the external competitiveness of Hong Kong in the near term.

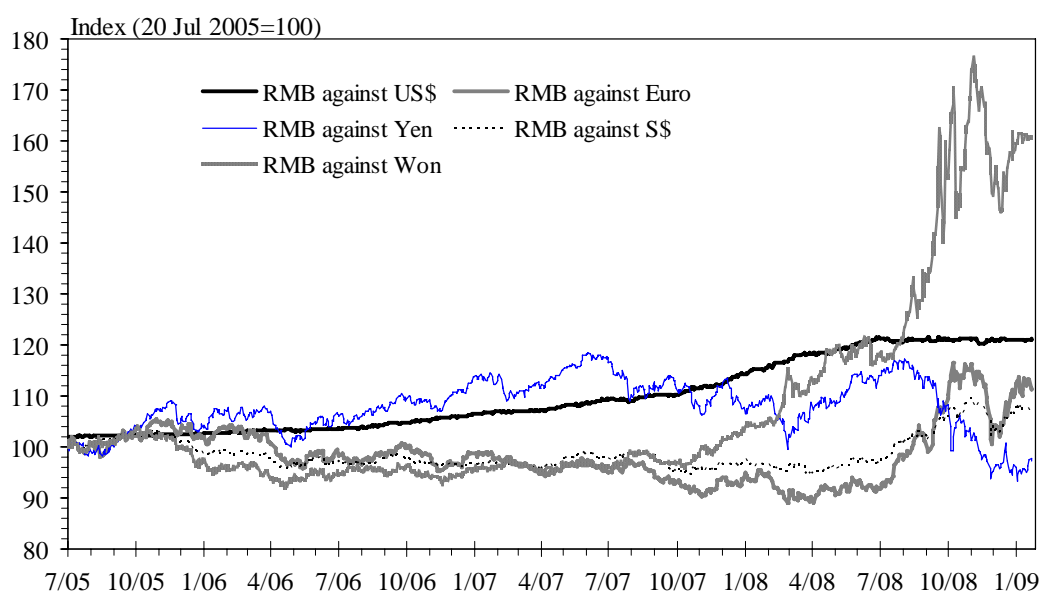
2.11 The outlook for US dollar, to which the Hong Kong dollar is linked, is subject to a large degree of uncertainty. The aggressive monetary and fiscal actions taken by the US Federal Reserve and US government in the recent past can be expected to increase government debt and budget deficit in the years to come. These expected repercussions could have implications on the future movements of the US dollar. Market sentiment can also easily reverse as the financial crisis continues to unfold. The unwinding of the global trade imbalances, which is now underway, will also complicate the picture. Thus the risk of experiencing more volatile exchange rate movements in 2009 has heightened, with its potential adverse effects on financial market stability and international trade flows.

Diagram 2.3 : Future direction of the US dollar is a source of risks



2.12 As the Hong Kong economy is increasingly integrated with the Mainland, the value of the Renminbi against other major currencies can also affect Hong Kong's external price competitiveness. The continuous appreciation of the Renminbi against the US dollar since July 2005 accelerated in the latter part of the 2007 and in early 2008, against the backdrop of the strong economic growth and rising trade surplus in the Mainland. In the latter part of 2008, the value of the Renminbi measured against the US dollar largely hovered within a narrow range, partly because of the strength of the US dollar against other major currencies. For 2008 as a whole, the Renminbi appreciated by an average of 9% against the US dollar. A more stable Renminbi, coupled with the measures by the Mainland authorities to help export-oriented enterprises, should be a supportive factor as far as the export competitiveness of Hong Kong-owned factories in the Mainland are concerned.

Diagram 2.4 : Movements of renminbi against other currencies are also important to Hong Kong's trade performance



Note : An increase in the index represents an appreciation of renminbi against the currency concerned.

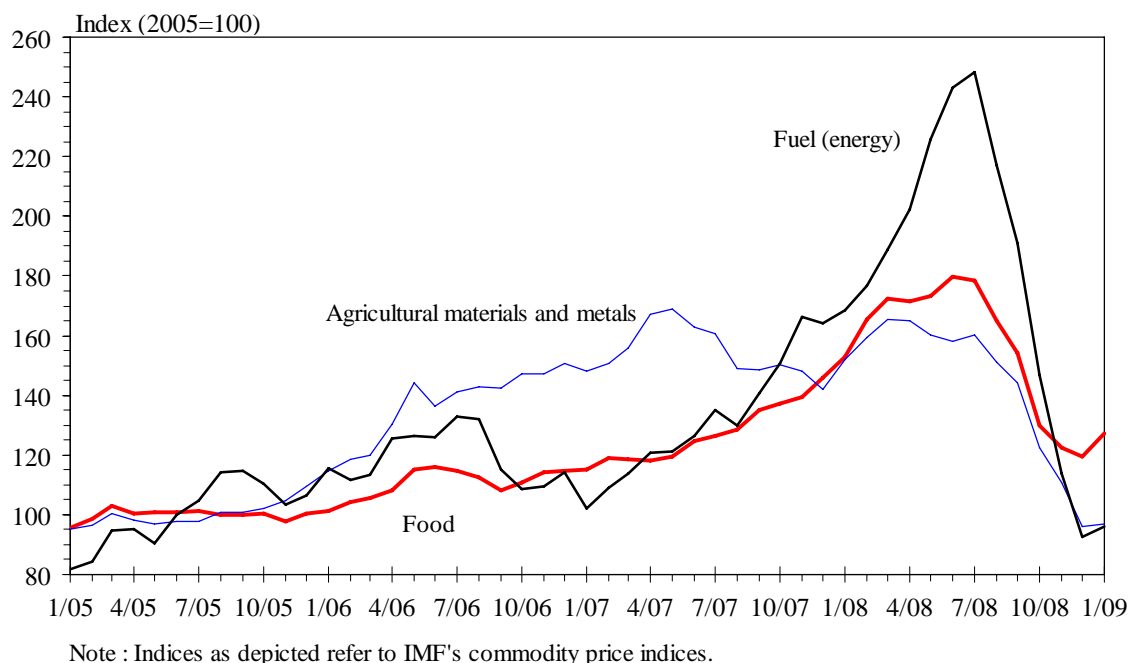
World inflation and global commodity prices

2.13 Inflation was a global concern during most of 2008. Consumer price inflation in many economies in the world continued to rise during the first half of 2008, on account of the surges in food and energy prices. Yet global inflationary pressures receded notably in the latter half of the year, along with the retreat of commodity prices and the deepening global economic downturn. Price pressures are likely to come down further during the course of 2009 on a global scale, considering the expected subdued demand conditions amid a synchronised global downturn. Efforts by central banks around the world have also shifted from containing inflation to avoiding a deep and lingering economic downturn.

2.14 Specifically on world commodity prices, the worsening economic conditions had precipitated significant corrections of these prices in the latter half of 2008. Crude oil prices fell to an average of around US\$40 per barrel in December, around 70% off its peak in July 2008 and down 56% from a year earlier. The prices remained low in January 2009. Food prices also came down notably by 33% in December 2008 as compared to the peak in June 2008, according to the statistics compiled by the IMF. A better supply-demand balance following the increase in food supply guided by the elevated prices earlier and the reduced demand for bio-fuels amid falling energy prices were all contributory to the fall in food prices. Prices of commodities for industrial uses also declined sharply in the latter part of 2008. In view of the sluggish demand outlook, commodity prices should remain depressed in 2009, though they can be

rather volatile from time to time. The weaker global inflationary pressures and the subdued commodity prices should help to lower inflation in Hong Kong during the course of 2009.

Diagram 2.5 : Commodity prices likely to remain rather depressed in 2009 but can be volatile from time to time



Major sources of risks

2.15 While governments in the major economies have and will continue to implement various unprecedented rescue and stimulus measures, the timing and strength of the global economic recovery are subject to a great deal of uncertainty. The effectiveness of these measures, given their unconventional nature, to shore up consumer and investor confidence and to avoid a deep and lingering global recession needs to be watched closely. On top of this, there are several other sources of risks to the external economic environment. First, the negative feedback loop between the downturn of the real economy, including the housing market corrections in the US and Europe, and financial market stress, if not well contained, can lead to a new wave of financial instability. Secondly, the US dollar movement can be rather volatile, given the concerns about the aftermaths of various aggressive policy measures. This can increase the volatility of the financial and foreign exchange markets. Thirdly, the unwinding of the global trade balances, already underway, can turn out to be disorderly, especially in this turbulent period. Fourthly, the economic downturn around the world could result in a rise in protectionist sentiments, restricting international trade and even international finance, and Hong Kong would suffer in the event. These downside risks can linger on beyond 2009.

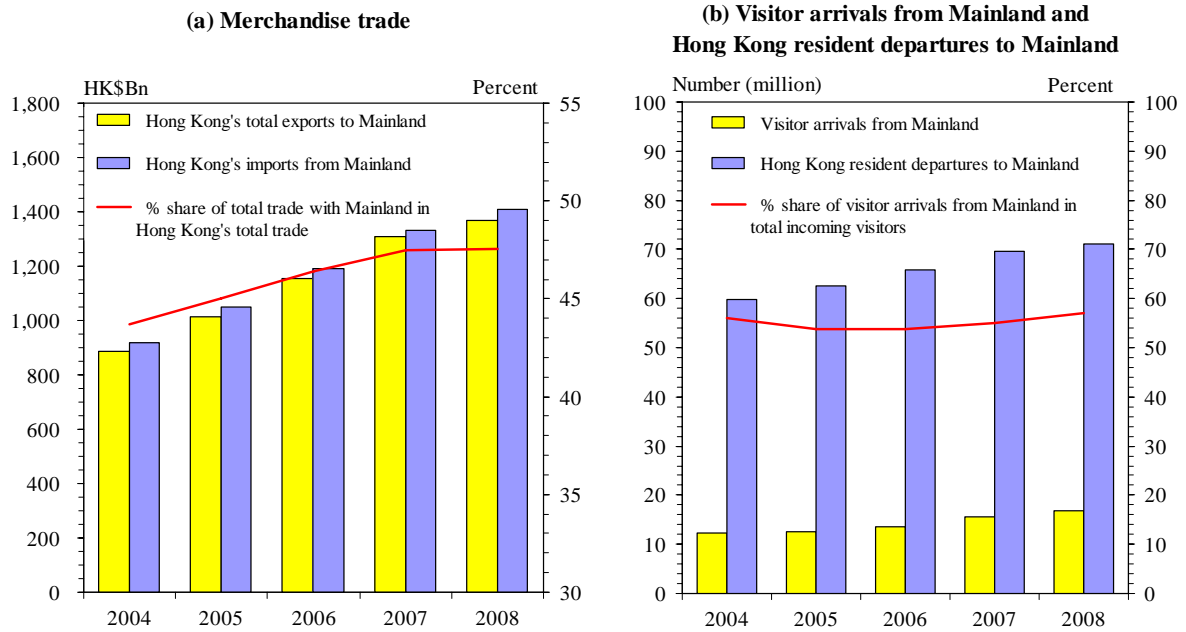
Outlook for the Hong Kong economy in 2009

2.16 Hong Kong is a small open economy. The vicissitudes of the economy are closely tied to the demand conditions of its major economic partners. Given the sheer scale of the global financial crisis, advanced economies are now in their worst recession in decades, and Asian economies have also deteriorated rapidly since the latter part of last year. Hong Kong's economic performance in 2009 is bound to be severely affected. Nevertheless, the Government has already implemented a series of measures to stabilise the financial markets, ease credit conditions, support enterprises, accelerate public works, and create employment. Also, the sustained economic growth in the Mainland and particularly the 14 supportive measures to Hong Kong announced by the Central Government in December 2008 will render support to Hong Kong economy.

2.17 External environment will be extremely challenging going forward, with Hong Kong's major overseas markets deep in recession into 2009. Many export-dependent Asian economies should lose most of their growth momentum, putting a further drag on intra-regional trade. The strength of the US dollar in the past few months, with its lagged effects on Hong Kong's external price competitiveness, will also add to the strains on Hong Kong's exports in the near term. Overall, *total exports of goods* are likely to show a rather notable decline in most of 2009.

2.18 The outlook for *exports of services* is likewise not encouraging. Inbound tourism will be subject to the pressure from shrinkage in travel demand as the incomes of overseas tourists drop alongside the global economic downturn. In this regard, visitors from the Mainland, being relatively less affected by the crisis, will continue to play an important role in supporting the performance of inbound tourism. Hong Kong's offshore trade will also fall victim to the fallout from global trade flows. Exports of finance, business and other services, having expanded rapidly prior to the financial tsunami, should now turn very sluggish, as financial market and other commercial activities will continue to be dampened by the headwinds from the financial tsunami.

Diagram 2.6 : Sustained growth in the Mainland economy will be a positive factor



2.19 As to *domestic demand*, local consumer spending will be depressed by heightened uncertainties, falling household wealth and rising unemployment. Private sector investment will similarly stall until clearer signs of an economic recovery are in sight. The results of the latest Business Tendency Survey conducted by the Census and Statistics Department confirm that large companies surveyed were pessimistic about the near-term business outlook. Nevertheless, the fast-tracking of public sector works by the Government should provide some timely support. Measures to ease the credit tightness facing the small and medium-sized enterprises will also help to reduce their difficulties to some extent.

Diagram 2.7 : Local consumer spending will remain depressed amid rising unemployment

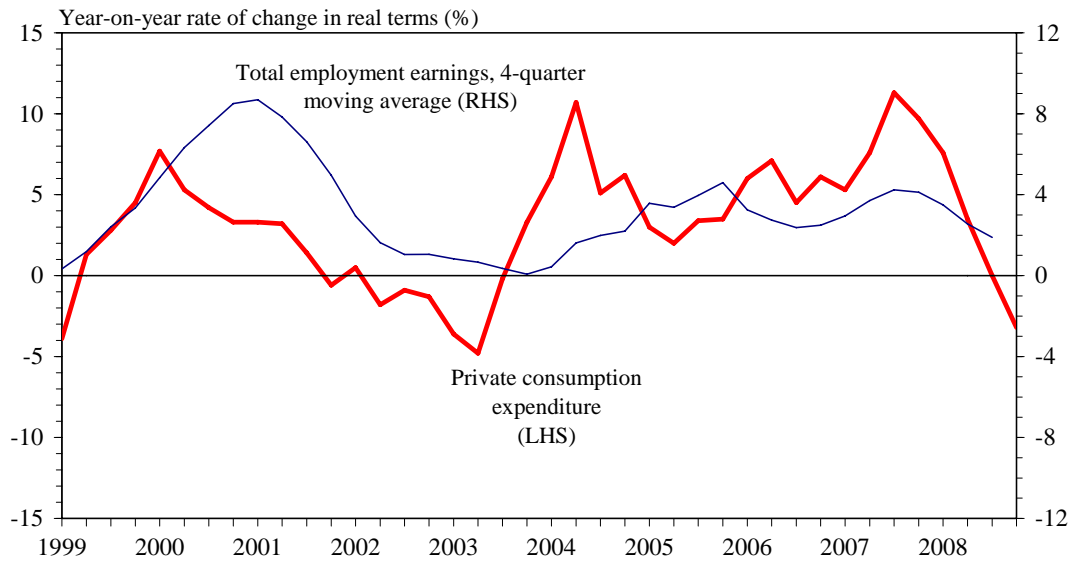
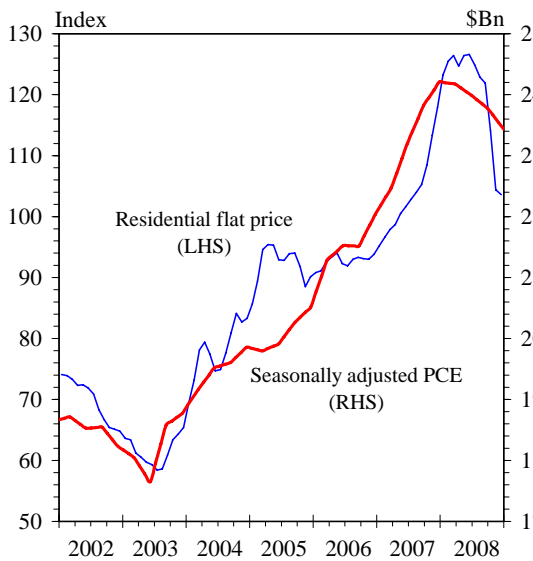


Diagram 2.8 : Asset market correction has hurt consumer sentiment

(a) Residential flat price



(b) Hang Seng Index (month-end figures)

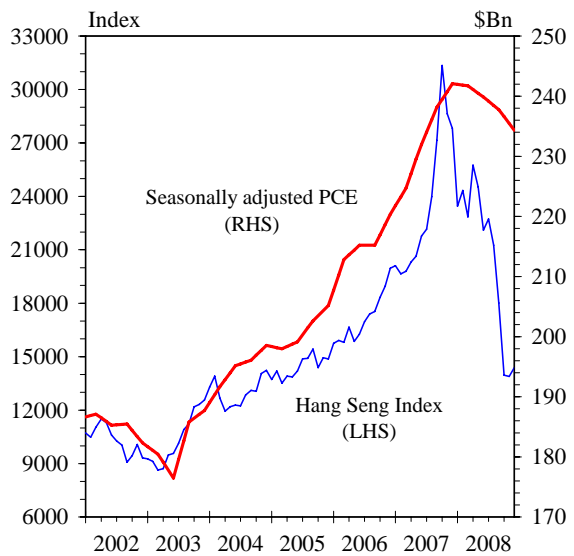
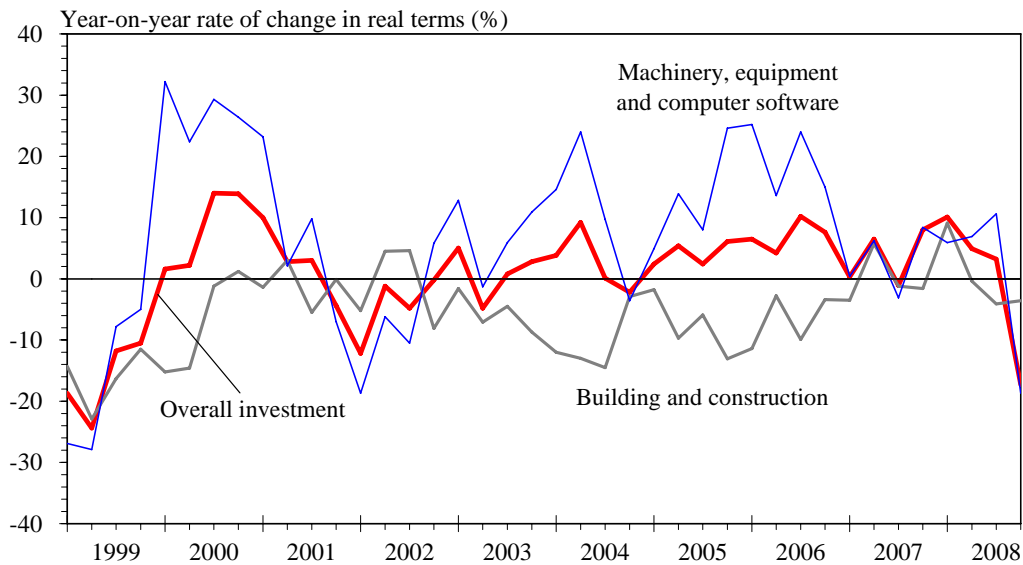
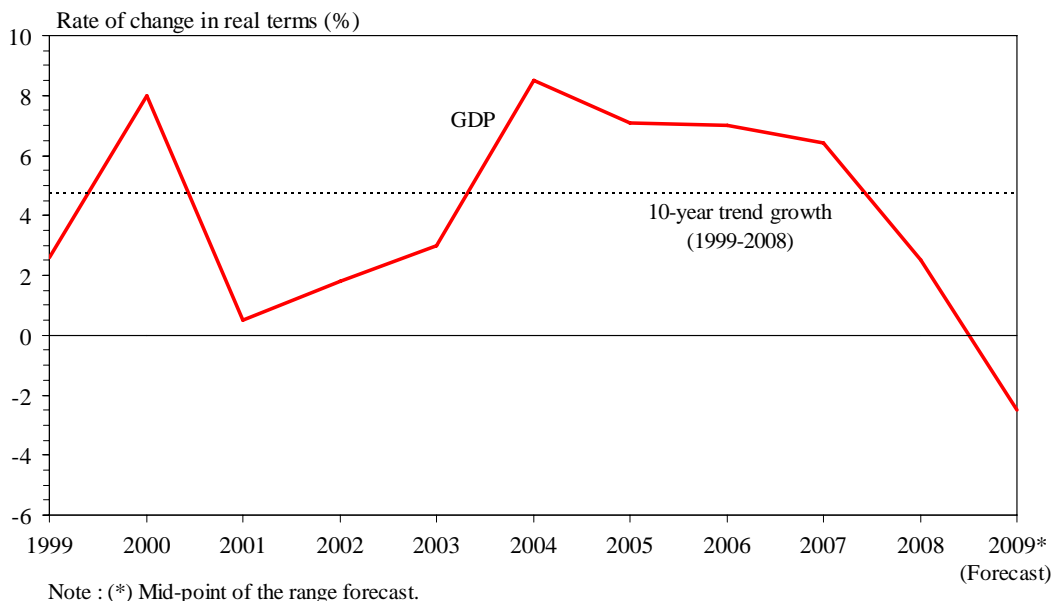


Diagram 2.9 : Investment sentiment will turn more cautious



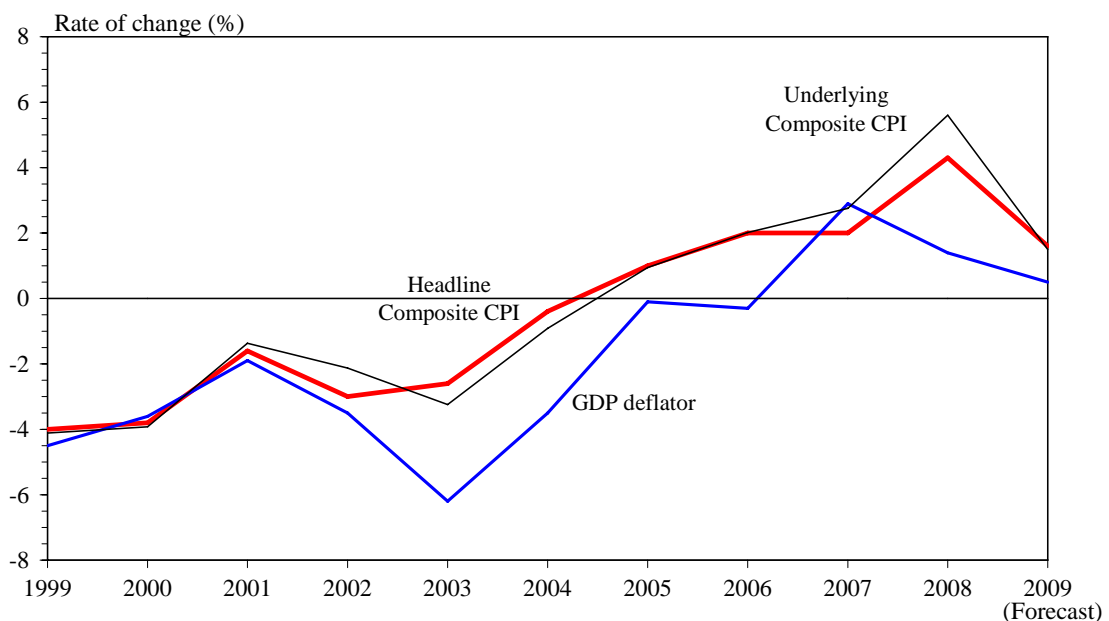
2.20 Taking all these developments together, the Hong Kong economy is likely to contract in 2009, by 2% to 3%, the first annual decline since 1998. The prospects for a turnaround will depend much on how the financial tsunami will play out and when the global economic environment will begin to improve. The forecast is broadly in line with the prevailing views by the private sector analysts, with their forecast rates of contraction averaging at around 2%. This projection is subject to considerable uncertainty, especially if the negative feedback loop between global economic weakness and financial stress continues to intensify to prolong and deepen the crisis.

Diagram 2.10 : Economy set to face a contraction in 2009 amid the global recession



2.21 Inflationary pressures have been receding notably since the latter part of 2008, as the deepening global downturn has precipitated subdued demand conditions worldwide. The earlier sharp declines in food and energy prices in the international markets have also contributed. The adjustment of the property market is also keeping the housing and commercial rents in check. Taking a broader perspective, global inflationary pressures are expected to come down further in 2009. Along with this global trend, underlying inflation in Hong Kong would also fall visibly during the course of 2009. Against this background, the *underlying Composite CPI* is forecast to increase by 1.5% in 2009 as a whole, down from the 5.6% increase in 2008. The one-off relief measures announced in the 2009-10 Budget will help to lower the Composite CPI, but the impact will be largely offset by the lower base effect created by those one-off relief measures introduced during 2008. Thus, for 2009 as a whole, the *headline Composite CPI* is forecast to increase by 1.6%. The *GDP deflator* is forecast to rise by 0.5%, largely reflecting the deceleration in the increase of domestic prices and also the more stagnant movement in export prices.

Diagram 2.11 : Inflation will recede visibly over the coming 2009



Forecast rate of change in 2009 (%)

Gross Domestic Product (GDP)

<i>Real GDP</i>	-2 to -3
<i>Nominal GDP</i>	-1.5 to -2.5
<i>Per capita GDP, in real terms</i>	-2.8 to -3.8
<i>Per capita GDP at current market prices</i>	HK\$232,500-234,900 (US\$29,800-30,100)

Composite Consumer Price Index

<i>Headline</i>	1.6
<i>Underlying</i>	1.5

GDP Deflator	0.5
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Forecast on Hong Kong's GDP growth in 2009 recently made by other selected parties

	(%)
International Monetary Fund	-2.0
The University of Hong Kong	-3.0
The Hong Kong University of Science and Technology	-2.2
Average forecast by private sector analysts [#]	-2.1

Note: (#) Forecast GDP growth by private sector analysts mostly falls between -1% and -3%.

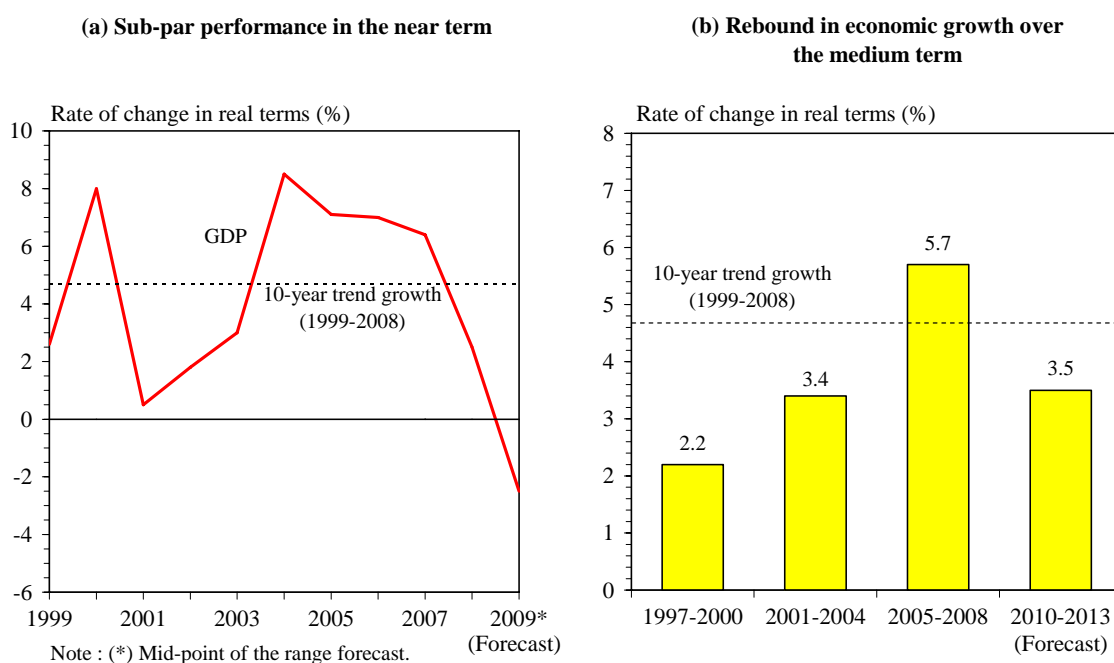
Medium-term outlook for the Hong Kong economy

2.22 At this juncture, whether the massive and unprecedented government policy responses taken by the major economies are effective in reviving the global economy in a sustainable manner is still highly uncertain. Even if the global economy can recover in the course of 2010 as expected, the growth pace is likely to be slow and sub-par in the initial stage of rebound, this will mean also sub-par growth in the Hong Kong economy. However, the Hong Kong economy looks set to stage a strong recovery once the global economy is back on the normal growth path. The intensification of construction of the major infrastructure projects will also help this recovery process. Taking cognizance of the sub-par growth in the early part of the medium term period, the average GDP growth rate in real terms is forecast at 3.5% per annum from 2010 to 2013.

2.23 Local inflationary pressures will recede rapidly and this trend may continue for a while. External price pressures will also ease off amid the current global economic slowdown, although food and energy prices may still show some volatility from time to time upon sudden supply shocks. Reflecting these expected developments, the trend rate of increase in the underlying Composite CPI over the medium term is likely to be moderate, at 2% per annum.

2.24 After the current global crisis has fully run its course, the medium and longer-term economic prospects for Hong Kong remain promising. The Government, together with the private sector, will continue to step up efforts to raise the competitiveness of the economy to complement the vibrant developments in the Mainland, by striving to restructure the economy towards knowledge-based, high value-added activities; by enhancing our roles as an international financial centre and a leading business hub; and by further strengthening our integration with the Mainland, especially positioning ourselves strategically in the PRD. Specifically on integration with the Mainland, the efforts to further expand CEPA, the supportive measures from the Central Government, and the initiatives to enhance greater cooperation with Guangdong and Shenzhen should continue to generate immense growth opportunities for Hong Kong to ride on.

Diagram 2.12 : Economy will recover strongly once the crisis is over



2.25 Apart from the issues regarding the timing and strength of a global economic recovery, there are several other challenges prevailing in the external

environment over the medium term. The financial tsunami will lead to reforms in the global financial framework, to which Hong Kong will have to adjust and adapt quickly. The unwinding of global trade imbalances is now underway, and this could complicate the global economic recovery process. The aftermaths of the unprecedented policy responses by the US government can bring about a great deal of uncertainty over the movements of the US dollar in future, which can heighten volatility in financial and foreign exchange markets. Also, the political implications of higher unemployment in the advanced economies due to the current downturn cannot be ignored, as stronger protectionist sentiment from the US and EU against Mainland products may emerge, increasing the risk to Hong Kong's trade. Domestically, the structural shift of the Hong Kong economy to high value-added and knowledge-based activities would lead to greater variability in income and wealth distribution. Also, the ageing population will have profound implications on our health care and social welfare systems, as well as on public finance, over the medium and longer run. In view of these possible challenges, it is important to stick to a prudent fiscal policy.