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Hong Kong

RESEARCH

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Hong Kong Economic Outlook: Hopeful for Recovery in 2Q09

Hong Kong economy showing signs of stabilization, may start to recover in 2Q09

Recent economic indicators have shown a slowing pace of decline in merchandise exports since March; a stabilizing unemployment rate; a rebound in housing prices; a turn-around in household/corporate wealth effect; and receding inflation pressure. However, retail sales remain slack, reflecting in part the ongoing negative impact of H1N1 influenza on tourism and business activities.

We expect a deceleration in Hong Kong's YoY economic contraction with modest sequential growth in 2Q09, benefiting from the "green shoots of recovery" in advanced economies and China's growth momentum. Recent capital inflows have contributed to a market upswing; the recovery in wealth, together with the HK government's stimulus measures, is expected to support consumption. Unemployment rate stabilization suggests that economic activity may have started to improve in 2Q09. We maintain our forecast that the HK economy will post a 5% GDP contraction and 1.2% underlying inflation in 2009.

HK the first non-Mainland area to allow RMB settlement

Effective on July 1, 2009, Hong Kong has become the first region outside mainland China where local banks are allowed to conduct cross-border RMB trade settlement. This is a policy breakthrough, a step in the right direction to build a foundation for RMB internationalization, and promotes financial cooperation between Mainland Chinese and Hong Kong financial systems.

Major state-owned banks and commercial banks from Mainland China have successfully made several cross-border RMB settlements with major HK banks (e.g. HSBC and BoCHK) so far in July. With increasing demand for cross-border RMB settlement services, we expect more Mainland and HK banks will participate in the pilot scheme, hence enhancing the channels for RMB flows between the two places.

This bodes well for banking and capital markets. In 2008, Hong Kong's exports to and imports from mainland China totaled US\$200bn, accounting for 8% of China's total trade (4.7% of GDP) and surpassing the trade volume between China and any other emerging Asian economy. That said, there will be huge room for cross-border RMB trade settlement to develop between Hong Kong and mainland China, pushing RMB further into the international arena.

I. Hong Kong economic outlook

The Hong Kong economy is showing signs of stabilization and may recover starting from 2Q09.

Latest developments

Recent economic indicators have shown a slowing pace of decline in merchandise exports since March; a stabilizing unemployment rate; a rebound in housing prices; a turn-around in household/corporate wealth effect; and receding inflation pressure. However, retail sales remain slack, reflecting in part the ongoing negative impact of H1N1 influenza on tourism and business activities.

- ▶ **The pace of goods export shrinkage narrowed to the slowest in five months.** Hong Kong's merchandise exports fell by 14.5% YoY to HK\$204.4bn in May, the seventh consecutive month of decline but with a milder pace from April's -18.2%. Meanwhile, merchandise imports declined by 19.2% to HK\$215.4bn, worse than the 17% fall in the previous month. In all, trade deficit shrank to HK\$11bn from HK\$16.4bn. Hong Kong Trade Development Council predicts that exports for 2009 will fall by 10~12% YoY (Figure 2).
- ▶ **Unemployment rate remained unchanged for the first time in nine months, end of rampant joblessness.** Hong Kong's unemployment rate stayed at the 3-year high of 5.3% in May, flat with April and slightly better than the market forecast of 5.4%. According to the HK Census and Statistics Department, decreases in the unemployment rate were mainly observed in construction, transportation, accommodation and recreational services, while increases were more apparent in the food services, social work and wholesale sectors. Meanwhile, the underemployment rate climbed 0.1ppt to 2.3%. Despite the unchanged unemployment rate, the job market remained slack in May with unemployed persons totaling almost 200,000 (Figure 3).
- ▶ **Housing prices rallied strongly recently.** Despite the jittery job market and the uncertainty of economic recovery, housing prices in Hong Kong rose more than 10% in the first five months with trading volume climbing from 5,000+ in December 2008 to 13,000+ in May, close to the 10-year high recorded in 1Q08 (Figure 4).
- ▶ **Household/corporate wealth effect on the rise.** Hong Kong equity funds experienced a significant liquidity inflow since March, leading to an ongoing rally of the Hang Seng Index (56% since March). Meanwhile, liquidity also continues to flow into Hong Kong banks, driving up HK dollars and hence forcing the HKMA to inject more. Starting from late March, the HKMA has totally infused US\$24.1bn equivalent in HKD in an effort to rein in the strong Hong Kong dollar. The improving household/corporate wealth effect stemming from the stock market upswing will support future household consumption and business investment.
- ▶ **Inflationary pressure eased.** Underlying inflation slowed from 1.9% in April to a more than 3-year low of 1.3% in May, mainly traceable to the sharp fall in private housing rent and tourism fees. The unchanged overall inflation in May is mainly attributable to the Hong Kong government's stimulus measures, particularly an electricity tariff subsidy. The inflationary pressure on food prices kept easing but fuel charges rose on a MoM basis, revealing the pressure from the previous surge in international oil prices. However, we do not think the overall inflationary pressure will mount much in the near term as the Hong Kong economy is still weak (Figures 5 & 6).
- ▶ **Retail sales remained slack and recorded a 6.2% YoY decline in May, worse than the 5.4% drop in April.** Auto sales recorded the biggest decline of 32.2% in May while sales of jewelry, watches, clocks and valuable gifts dropped by 10.9%, much worse than the decline of 0.2% in the previous month, revealing the negative impact of H1N1 influenza on tourism and business activities in Hong Kong (the number of inbound tourists shed 3.2% YoY in May, visitors from mainland China dropped by 9.6%, the biggest decline since the 2003 SARS) (Figure 7).

Hong Kong economic outlook

We expect Hong Kong GDP will moderate its pace of YoY contraction and post modest sequential growth in 2Q09, benefiting from the “green shoots of economic recovery” in advanced economies and China’s growth momentum. The HK government’s stimulus measures, together with the recent recovery in wealth, are expected to support consumption. A more stable unemployment rate suggests that economic activity may have improved in 2Q09, evident from a consecutive rise in PMI and improved consumer confidence. We maintain our forecast that the HK economy will post a 5% GDP contraction and 1.2% underlying inflation in 2009.

- ▶ **PMI and consumer confidence keeps improving.** PMI rose from 44.8 in May to 47.1 in June, the seventh consecutive month of increase. But the PMI is still below the 50 threshold, pointing to continued slackness in manufacturing industries, though market confidence has been restored to some extent. In addition, the consumer confidence index has recovered to the level before the collapse of Lehman Brothers, rising from 68 in 4Q08 to 81 in 1Q09, greater than the 60 recorded in October 2008.
- ▶ **Economy to recover upon rising domestic demand.** Domestic consumption was supported to some extent as the rising unemployment rate started to slow down and the Hong Kong government rolled out HK\$16.8bn in stimulus measures in late May (about 1% of GDP). Moreover, as recent capital inflows triggered a clear rally in stock and real estate markets since March, the subsequent positive wealth effect will also give a hand to domestic demand.
- ▶ **We maintain our forecast for a 5% GDP contraction and 1.2% underlying inflation in 2009** (Figure 1). Our GDP projection has modeled in the HK\$16.8bn stimulus measures launched in end-May. Given the about 50% import leakage, the stimulus measures, if being fully exercised, are expected to boost GDP growth by an extra 0.5ppt. Therefore, our GDP forecast is close to the upper range of the government guidance of -5.5~-6.5% (see our Macroeconomy Weekly *Quantifying Future Low Growth and High Inflation* dated May 19). The Jan-May underlying inflation was 2.5%; the full-year figure is estimated at 1.2%, far below the level of 5.6% in 2008.
- ▶ **We expect Hong Kong GDP will moderate its pace of YoY contraction and post sequential growth in 2Q09.** In view of the signs of stabilization in neighboring economies, the strong liquidity-driven rally in stock and real estate markets, the subsequent wealth effect and the government’s stimulus measures, we maintain our forecast for a 5% GDP contraction and 1.2% underlying inflation in 2009. The slowdown in rising unemployment rate also shows that economic activity may have started to improve in 2Q09. However, the path to an economic recovery is still bumpy, and uncertainties in the global economic recovery cast shadows on the Hong Kong economic outlook.

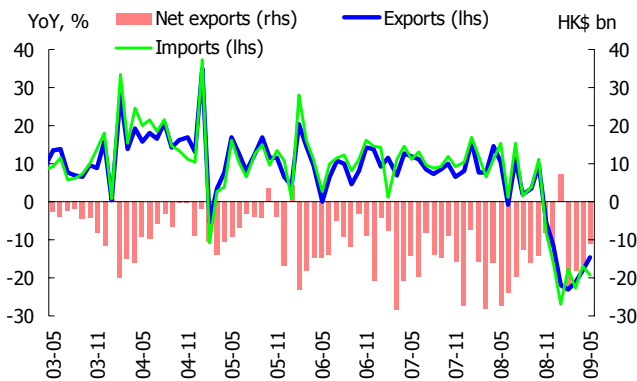
Figure 1: Hong Kong economic projection for 2009

	Asia financial crisis		Bursting of IT bubble		SARS outbreak						Forecast
	1998	1999	2001	2002	2003	2006	2007	2008	4Q08	1Q09	2009F
Real GDP	-6.0	2.6	0.5	1.8	3.0	7.0	6.4	2.4	-2.6	-7.8	-5.0
Private consumption	-5.5	1.2	1.8	-0.9	-1.3	5.9	8.5	1.5	-4.1	-5.5	-4.0
Government consumption	0.5	3.1	6.0	2.4	1.8	0.3	3.0	1.7	1.8	1.5	4.0
Investment spending	-7.6	-16.8	2.6	-4.7	0.9	7.1	3.4	-0.5	-17.8	-12.6	-7.0
Change in inventories*	-2.7	0.6	-1.7	1.0	0.3	0.2	0.9	-0.2	-0.8	-0.9	-0.7
Net total exports*	2.4	7.3	-0.3	2.4	2.6	1.7	-0.6	1.6	4.0	-1.2	-0.8
Total exports	-4.5	4.5	-1.7	9.0	12.8	9.4	8.3	2.7	-3.8	-19.6	-12.3
Total imports	-5.7	-0.5	-1.5	7.4	11.3	9.1	9.2	2.0	-6.1	-20.2	-12.6
Underlying inflation	3.2	-4.1	-1.4	-2.1	-3.2	2.0	2.8	5.6	5.4	3.1	1.2
Core inflation	3.4	-4.5	-1.5	-2.1	-3.8	2.0	2.4	4.1	2.2	1.0	1.0
Unemployment rate	4.7	6.2	5.1	7.3	7.9	4.8	4.0	3.6	4.1	5.2	6.3

* Contribution to GDP growth (ppt)

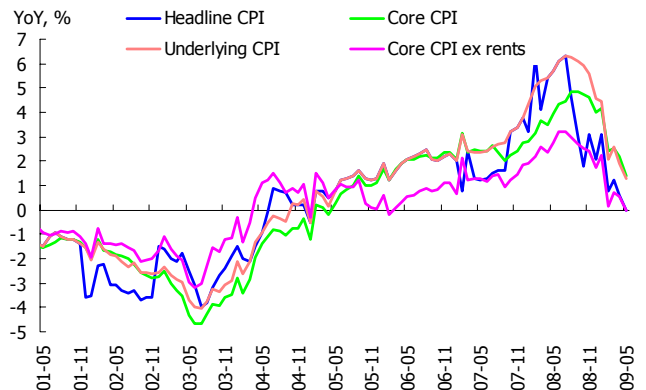
Source: CEIC, CICC Research

Figure 2: Slower decline of goods exports



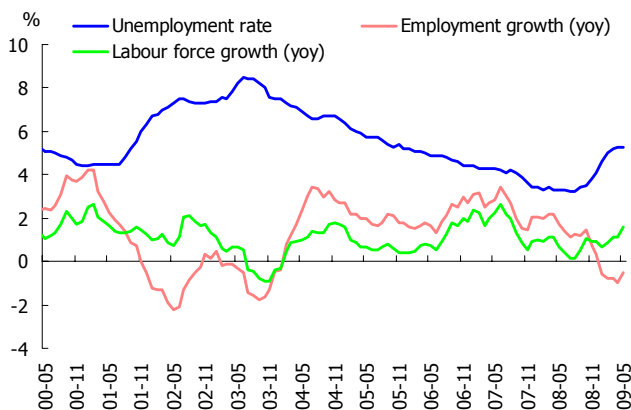
Source: Bloomberg, CEIC, CICC Research

Figure 5: Easing inflationary pressure



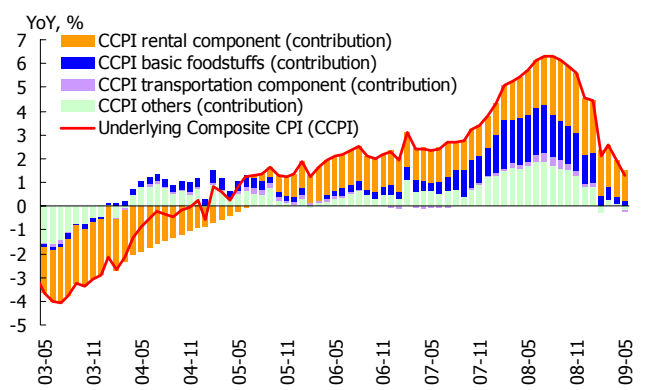
Source: Bloomberg, CEIC, CICC Research

Figure 3: First notice of unchanged unemployment in nine months



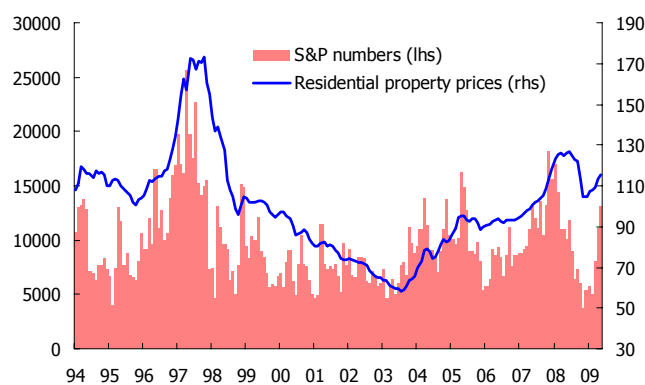
Source: Bloomberg, CEIC, CICC Research

Figure 6: Component contributions to inflation



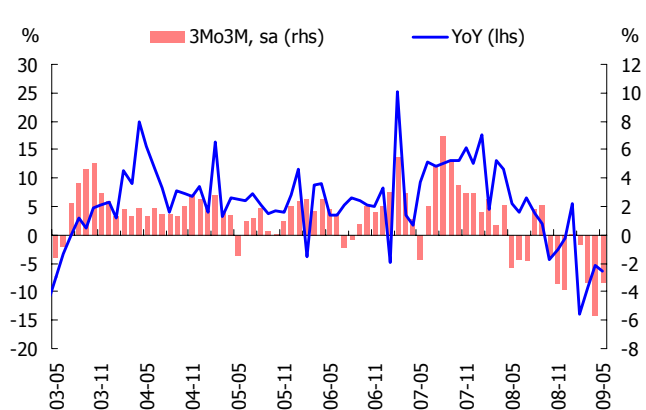
Source: Bloomberg, CEIC, CICC Research

Figure 4: HK housing prices and sales



Source: Bloomberg, CEIC, CICC Research

Figure 7: Retail sales still slack



Source: Bloomberg, CEIC, CICC Research

II. Cross-border RMB trade settlement pilot in Hong Kong

Cross-border RMB trade settlement is a policy breakthrough standing to promote the development of both Chinese and Hong Kong financial systems

Hong Kong has become the first region outside mainland China where local banks have started to conduct cross-border RMB trade settlement. On July 1, the PBoC, MoF, MoC, China Customs, China Taxation and CBRC jointly released a rule on cross-border RMB settlement. Eligible pilot enterprises can settle cross-border trade deals in RMB with Hong Kong trade partners while commercial banks are encouraged to back such settlements (see our Macroeconomy Weekly *First Step in RMB Internationalization* dated July 6). This is a result of long-term cooperation. To facilitate implementation, the PBoC and HKMA signed a MOU on June 29, agreeing to make concerted efforts to regulate RMB trade settlement services, promote RMB businesses in Hong Kong and improve interactions between the two financial systems so as to solidify Hong Kong's position as an international financial center.

Cross-border RMB trade settlement is a policy breakthrough and a step towards RMB internationalization standing to promote the development of both financial systems in mainland China and HK:

- ▶ Hong Kong enterprises can find a settlement bank in HK to open RMB accounts in pilot mainland banks;
- ▶ Pilot mainland banks can provide RMB financing services to participant Hong Kong banks, giving them a new source of RMB funds;
- ▶ Pilot mainland banks are allowed to directly provide Hong Kong companies RMB trade financing services for trade deals.

In July, ICBC, BOC, BoCom and CMB made several cross-border RMB trade settlement transactions. With increasing demand for cross-border RMB trade settlement, we expect more mainland and HK banks to participate, enhancing the channels for RMB flows between the two places.

- ▶ July 6~7, ICBC dealt with over Rmb17mn (US\$2.49 million) cross-border RMB settlements in two days.
- ▶ July 6, BoCHK and BOC Shanghai branch made their first cross-border RMB trade settlement for Shanghai Electric Hong Kong and Shanghai Electric International Economic & Trading before arranging another six transactions. After the breakthrough in Shanghai (100 pilot companies, versus 400 across the country), a bigger deal emerged in Guangdong. On July 7, BOC Guangdong branch made Rmb6.93mn cross-border RMB trade settlement for Guangdong Silk-Tex Group.
- ▶ July 6, BoCom provided its first cross-border RMB trade settlement service for Shanghai Silk Group who sold goods to Hong Kong's China Products Holdings Ltd. BoCom also remitted its first RMB payments on behalf of Shanghai Huanyu Im&Ex to HSBC.
- ▶ July 6, CMB Shenzhen arranged its first cross-border RMB trade settlement deal with Hong Kong Wing Lung Bank for BYD.

Going ahead, the official launch of cross-border RMB trade settlement **bodes well for banking and capital markets.**

- ▶ **It maps out an ordered utilization of RMB outside mainland China and will strengthen cooperation between PBoC and HKMA.** The renminbi will have a broader domain as a trade currency going forward, which is an important step towards RMB internationalization. In 2008, Hong Kong's exports to and imports from mainland China totaled US\$200bn, accounting for 8% of China's total trade (4.7% of GDP) and surpassing the trade volume between China and any other emerging Asian economy. We believe cross-border RMB trade settlement will have huge room to develop in Hong Kong, pushing the RMB further into the international arena.
- ▶ Hong Kong opened cross-border RMB trade settlement ahead of neighboring economies, which will bring more RMB businesses to the Hong Kong financial system and make HK more instrumental as an overseas RMB settlement center, solidifying Hong Kong's position as an international financial center (Figure 8).
- ▶ **As the pilot scheme proceeds, Hong Kong banks will significantly increase demand for RMB,** enhancing the channels for RMB flows between the two places. They may borrow RMB from the local interbank market and borrow/exchange for RMB from/with mainland counterparts, pushing forward the development of HK interbank RMB lending market and strengthening cooperation among banks in the two places.
- ▶ **The pilot scheme will improve Hong Kong banks' RMB offshore services.** As overseas enterprises hold more RMB, there will be increasing needs for convenient RMB exchange, FX risk avoidance and hedging, conducive to the development of HK banking and capital markets. This will in turn call for RMB to become exchangeable under capital accounts, hence pushing the mainland financial market to open further as well as encouraging the HK capital market to launch more RMB-denominated investment vehicles.

Figure 8: China's major trade partners in Asia



Source: CEIC, CICC Research

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