Hong Kong, China

Growth in this open economy was dealt a heavy blow toward the end of 2008 by the global financial crisis and trade slump. The important financial and real estate services industries contracted in the second half of 2008. For the year, consumption barely grew and fixed investment flattened. In 2009, exports are forecast to fall and both private consumption and investment will likely shrink. GDP is expected to contract, before growth resumes in 2010. Inflation has decelerated and is expected to remain low over the forecast period.

Economic performance

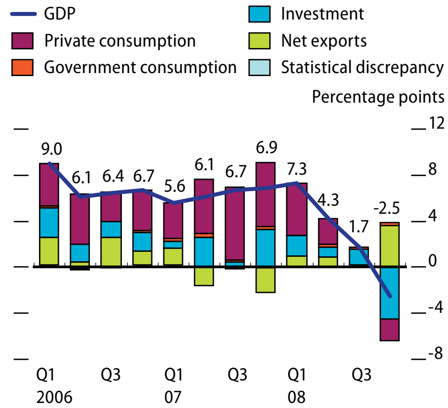
The economy opened 2008 with robust growth of 7.3% in the first quarter, year on year, slowed sharply in the second and third quarters, then contracted by 2.5% in the fourth (Figure 3.10.1). For the full year, growth decelerated to 2.5%, from 7.2% on average over 2004–2007. It was undermined by the global financial crisis, given the importance of financial services to this economy, and further eroded late in the year by the slump in world trade. Hong Kong, China is one of the most open economies in the world—the ratio of exports and imports to GDP was about 410% (including reexports) in 2008. The deteriorating external conditions severely dented consumer and business confidence.

Private consumption grew by a meager 1.8% in 2008, compared with buoyant growth of 8.5% in 2007. Spending was curtailed by the increasingly gloomy international outlook and its deleterious effect on employment and personal wealth. Unemployment rose from 3.4% in the first quarter to 4.1% in the fourth. As for asset markets, the share price index plunged by 48% in 2008 (Figure 3.10.2) and property prices turned down in the second half (Figure 3.10.3). Moreover, growth in visitor arrivals slowed to 4.7% from 11.6% in 2007, and that in the volume of retail sales slowed by about half, to 5.0%. Spending on services edged up by less than 1%. Consumption contributed about half of total GDP growth, much less than in 2007.

The deterioration in external and domestic demand caused businesses to cut back on investment in machinery and equipment in the fourth quarter. Fixed investment overall was flat in 2008 (it grew by 3.4% in 2007). When adjusted for changes in inventories, total investment contracted by 1.1% and subtracted 0.3 percentage points from GDP growth.

Growth in real exports of goods and services slowed, especially in the second half of the year when the global downturn intensified. For the year, real exports decelerated to 2.7% from 8.3% growth in 2007. Growth in real imports pulled back even faster than that for exports, with the

3.10.1 Contributions to growth (demand)



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 2 March 2009.

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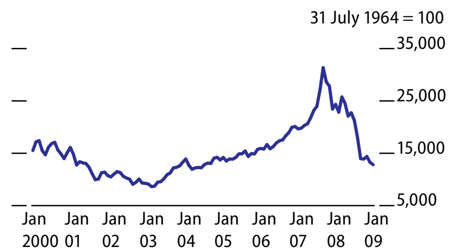
3.10.2 Hang Seng index



Source: CEIC Data Company, Ltd., downloaded 15 March 2009.

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This chapter was written by Juthathip Jongwanich of the Economics and Research Department, ADB, Manila.

result that net exports of goods and services contributed 1.5 percentage points to total GDP growth.

Reexports, mainly originating from the People's Republic of China (PRC) and accounting for 97% of total merchandise exports, rose by about 6% in nominal US dollar terms, the weakest result since 2001. Domestic merchandise exports fell. Financial services exports slowed as international capital market activity shriveled. Total services exports grew by 9.2% in nominal terms, another area whose growth slowed by around half. Still, a large surplus in services trade and a surplus in the income account more than compensated for a widening of the merchandise trade deficit (Figure 3.10.4). The current account surplus rose to the equivalent of 14.2% of GDP. After accounting for investment inflows, the overall balance of payments registered a surplus of 15.7% of GDP (Figure 3.10.5).

Services account for virtually all of GDP, and sector growth slowed to 2.5%, also the weakest since 2001. Wholesale and retail trading and transport and storage subsectors contracted in the fourth quarter, year on year. The important finance, insurance, and real estate subsectors were hit harder: they contracted in both the third and fourth quarters. Nevertheless, the services sector was the only one to contribute to GDP growth. Production of the small manufacturing and agricultural sectors fell in 2008.

Slower economic growth and increases in government spending in FY2008 (ended 31 March 2009) resulted in a fiscal deficit estimated at 0.3% of GDP, compared with a surplus of more than 7% in FY2007. Fiscal concessions, largely aimed at cushioning the impact of rising prices in the first half, included temporary increases in welfare benefits, a one-time grant to subsidize household electricity costs, income tax rebates, and a waiver on property tax.

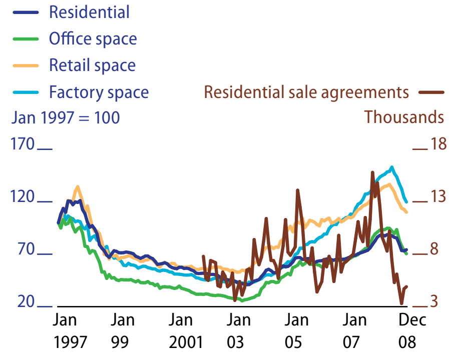
Inflation accelerated to 6.3% through July, driven by higher prices for imported food and by fuel and rent increases (Figure 3.10.6). As global food and fuel prices declined and domestic demand weakened during the second half, inflation moderated to 2.1% by December. Year-average inflation was 4.3%. After adjusting for the fiscal concessions, which subdued some prices, underlying inflation was 5.6%.

Given that the United States (US) and Hong Kong dollars are linked, interest rates in this economy broadly follow those in the US. The Hong Kong Monetary Authority lowered the base rate under its discount window throughout 2008, to 0.5% at year-end. Bank lending rates in real terms declined in the first half, but rose in the second half as inflation moderated, leaving them unchanged by year-end.

Economic prospects

Contracting economies in the eurozone, Japan, and US, coupled with the continuing global financial crisis, are particularly bad news for this trade- and services-dependent economy. The slowdown in the PRC—with which Hong Kong, China has extensive trade, logistics, and services links—adds further gloom to the outlook. The forecasts assume that the yuan will appreciate slightly against the US dollar and that the Hong Kong dollar's link with the US dollar will be maintained.

3.10.3 Property price indexes and number of transactions



Source: Rating and Valuation Department, available: http://www.rvd.gov.hk, downloaded 15 March 2009.
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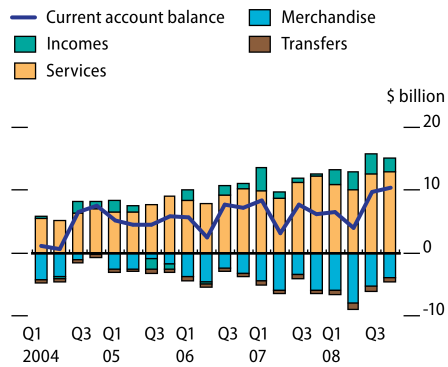
3.10.4 Current account components



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 23 March 2009; Hong Kong Monetary Authority.
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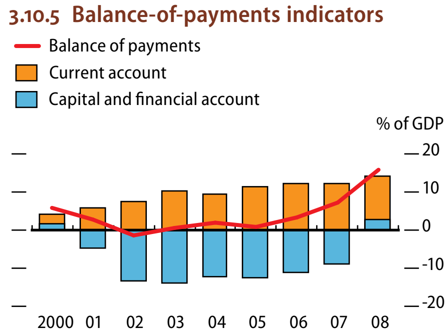
3.10.5 Balance-of-payments indicators



Sources: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 23 March 2009; Hong Kong Monetary Authority.
Click here for figure data

Slack external demand will further weaken the labor market in 2009, pushing up unemployment and suppressing consumer confidence. Slower growth in tourist arrivals and the softening property market will also damp consumer spending. Investment will decline as a result of the somber outlook for both exports and demand for new buildings. Furthermore, banks have generally adopted a more guarded approach to lending. Both consumption and investment are forecast to contract this year. An expansionary fiscal stance (Box 3.10.1) will provide some support for domestic demand. So should low interest rates. But these positive influences cannot neutralize the powerful negative forces.

Real exports of goods and services are forecast to weaken in 2009 compared with 2008. As a services-based economy, the prolonged global financial crisis and slump in both trade and tourism will further erode services exports, while merchandise reexports will remain sluggish. Imports in real terms will contract, given the decline in domestic demand.

On balance, GDP is forecast to fall by 2.0% in 2009, the first contraction since the economy shrank by 6.0% in 1998 during the Asian financial crisis. In 2010, growth is expected to resume at about 3% (Figure 3.10.7) as world trade picks up and financial markets rally. Growth in the PRC is projected to pick up by about 1 percentage point in 2010, which would support a recovery in Hong Kong, China. These influences are likely to feed through to and boost consumer and business confidence next year.

Merchandise exports and imports in the first 2 months of 2009 slumped by 22% from prior-year levels on a customs basis. This rate of decline is not expected to continue through the year: exports for the whole year are projected to drop by about 5%, subject to substantial downside risks because of the uncertain global prospects. Imports will fall faster than exports owing to the sluggish domestic demand and lower prices of imported oil and other commodities compared with 2008. The merchandise trade deficit will likely narrow, but the services trade surplus will fall, reflecting weaknesses in financial services and tourism. The income account is expected to be in deficit as dividends from overseas investments decline in the context of lower global corporate profits. Consequently, the current account surplus will likely decline, but remain substantial at 9–10% of GDP in the forecast period.

Inflation pulled back to average 2.0% in the first 2 months of 2009. It is expected to be about 1.5% for the whole year, a result of subsiding domestic demand and lower prices for imported fuel and food than in 2008. Against this, some fiscal concessions, such as waivers on public housing rents and grants to subsidize household electricity bills will expire this year so that the consumer price index will not fully reflect the weakness in domestic demand. In 2010, inflation is expected to edge higher as the recovery gets underway.

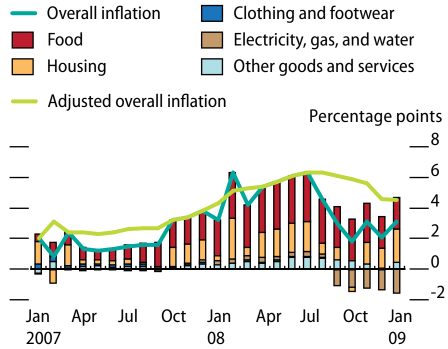
Risks to these forecasts stem mainly from external influences and are predominantly on the downside. Further jolts to the international financial system would quickly spill into domestic financial markets, causing further contraction in financial services, steeper declines in equity and property prices, and greater caution in lending. A deeper than expected slump in global trade would curtail growth in the PRC, with spillover effects to Hong Kong, China.

3.10.1 Selected economic indicators (%)

	2009	2010
GDP growth	-2.0	3.0
Inflation	1.5	2.0
Current account balance (share of GDP)	9.0	10.0

Source: Staff estimates.

3.10.6 Monthly inflation and components



Note: Adjusted overall inflation refers to the rate after the effects of the Government's one-time relief measures are removed.

Sources: CEIC Data Company Ltd., downloaded 15 March 2009; Census and Statistics Department, *Monthly Report on the Consumer Price Index, January 2009*, Table B, available: http://www.censtatd.gov.hk.

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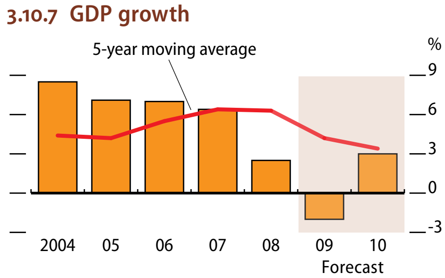
3.10.7 GDP growth



Sources: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 2 March 2009; staff estimates.

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3.10.1 Global financial crisis and the economy

The Government and the Hong Kong Monetary Authority (HKMA) have taken a range of policy measures to support the economy and its financial institutions since mid-September 2008, when the global financial crisis intensified.

Monetary and financial policies

HKMA injected HK$179 billion (US$23 billion) into the banking system during September–December through market operations involving the purchase of US dollars for Hong Kong dollars, to address a squeeze in the interbank market and rising demand for Hong Kong dollars.

The monetary authority expanded acceptable collateral for borrowing under the discount window to include US Treasury securities, while maturities of liquidity assistance provided through its discount window were extended to up to 3 months. It reduced the base rate to 50 basis points above the prevailing US Federal Funds target rate and delinked the base rate from interbank rates. It took these temporary measures to enhance liquidity in the banking system.

The Government announced a blanket guarantee of all customer deposits held with all authorized institutions in Hong Kong, China, to end-2010. It also unveiled a facility to provide capital to locally incorporated banks, if they needed it.

HKMA offered banks foreign exchange swaps and a term lending facility to provide Hong Kong dollar liquidity against approved collateral for maturities of up to 3 months, until March 2009.

The People's Bank of China and HKMA signed an agreement for a CNY200 billion (US$29 billion) currency swap facility to provide short-term liquidity support to operations of Hong Kong banks in the PRC and vice versa.

Fiscal policies

The Government announced a HK$100 billion (US$12.8 billion) package of loan guarantees for small and medium-sized firms in December 2008.

A package of measures was outlined by the governments of the PRC and Hong Kong, China aimed at increasing cooperation on trade, financial, and infrastructure matters.

The budget unveiled in February targets a deficit equivalent to 2.4% of GDP for FY2009 and a deficit of 1.5% of GDP in FY2010. The budget includes spending of HK$1.6 billion aimed at generating 62,000 jobs and internships over 3 years, HK$39.3 billion in outlays on infrastructure, and several social support measures.

Economic and financial indicators

Key indicators of economic and financial health have generally strengthened in recent years. The current account surplus exceeded 10% of GDP and gross international reserves increased to US$182.5 billion at end-2008. Fiscal reserves also are substantial. The real exchange rate has closely tracked the long-run equilibrium real exchange rate, which implies that the Hong Kong dollar is valued broadly in line with economic fundamentals.

In the financial sector, the loan-to-deposit ratio in 2008 at about 54% indicates that bank funding is mainly through deposits rather than external sources. The capital-adequacy ratio of locally incorporated banks increased and the nonperforming loan ratio decreased in 2008. Some banks incurred losses on US "toxic" assets, but total exposure in relation to banking system assets is low.

There are concerns that banks will face pressure on profits from declining margins between funding costs and loan interest rates, as well as from reduced fee income, as a consequence of the slump in share offerings and in wealth management activity. As in other economies, nonperforming loans are likely to rise during the economic slowdown.

Economic and financial indicators

	2008
Fiscal reserves (% of GDP)	31.2
Loan–deposit ratio	54.0
Nonperforming loans (% of total)	1.2
Capital-adequacy ratio	14.8
Current account (% of GDP)	14.2
Gross international reserves (months of retained imports)	22.5

Sources: CEIC Data Company Ltd., downloaded 27 February 2009; staff estimates.

Development challenges

Hong Kong, China has extensive investment and trade with the Pearl River delta area of the PRC's Guangdong province. The delta is a major low-cost manufacturing and export base for products such as electronics, toys, clothing, and textiles. Investors from Hong Kong, China account for over 70% of the cumulative foreign direct investment there. Furthermore, Hong Kong, China has leveraged its comparative advantages to provide services such as logistics, shipping, and finance to firms in the delta.

Since global trade slumped in the second half of 2008, orders for products from factories in the delta fell sharply, and layoffs have been widespread. Even after world trade picks up, many low-end manufacturers are expected to relocate to other provinces or to other countries where labor and land costs are lower. The PRC Government, acting to bolster confidence, announced ambitious plans in December to deepen cooperation between Guangdong; Hong Kong, China; and Macau, China in an effort to achieve closer integration and to transform the delta into a center for high-technology industries and services. Early priorities are to extend road and rail links and accelerate construction of a long-planned US$5.5 billion bridge between the three places.

For Hong Kong, China to gain the full benefits of closer integration, it needs to further improve its infrastructure links with Guangdong and reduce bottlenecks in customs clearance. Also, it will be important to boost investment in tertiary education to build a larger base of professionals who can operate in both economies. Joint efforts to reduce air pollution caused by rapid development in both economies should be intensified. At the same time, Hong Kong, China needs to safeguard the reputation of its high-quality institutions that make it a predictable and stable services center.