Hong Kong, China

This trade-oriented economy was dealt a heavy blow by the global recession and financial crisis. A gradual recovery from the second quarter accelerated late in 2009, spurred by a pickup in exports, strong growth in the People's Republic of China, and a massive expansion in the monetary base. The economy is forecast to grow in 2010, driven by the better global outlook for trade and financial services. Inflation will rise to moderate levels. A near-term challenge is to prevent speculation in housing from inflating an unsustainable property boom.

Economic performance

Owing to its heavy reliance on trade-related and financial services, this economy was shaken by the financial crisis and the plunge in global trade that unfolded from 2008 through early 2009. Exports, consumption, and fixed investment contracted sharply.

The first signs of recovery emerged in the second quarter of 2009 (Figure 3.10.1), as the global outlook improved and recovery gathered pace in the People's Republic of China (PRC), driven by its aggressive stimulus programs. Further impetus was provided by targeted fiscal stimulus enacted by the Hong Kong, China authorities, combined with a massive expansion of the monetary base, reflecting the Hong Kong dollar's link with the United States (US) dollar. For the full year, GDP shrank by 2.7% (Figure 3.10.2), compared with average growth of 6.2% over the previous 5 years.

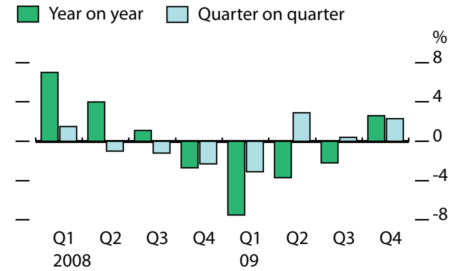
Private consumption fell by 0.3%, depressed in the first half of the year by the slump in trade in goods and services and the related softening of the labor market. Retail sales gradually improved, after a plunge early in the year (Figure 3.10.3).

As companies cut back on investment in equipment and construction, private fixed investment fell by 3.7% in 2009. The rate of contraction slowed in the second half. By contrast, public fixed investment rose by 13.5% in 2009. Public sector construction grew by 10% in the second quarter and 31% in the third, because of increased public spending on infrastructure projects. The government also stepped up its consumption spending to support aggregate demand.

The external sector was a major drag on the economy throughout the year. Goods exports—about 98% of which are reexports—plunged in the first quarter as external demand evaporated, but then improved progressively, thanks to solid growth in the PRC and the better global trade environment toward the end of the year. Nevertheless, goods exports fell by nearly 13% in real terms in 2009.

Faring better than goods trade, services exports fell by 0.7% in real terms. Trade and transportation services contracted over the year, but

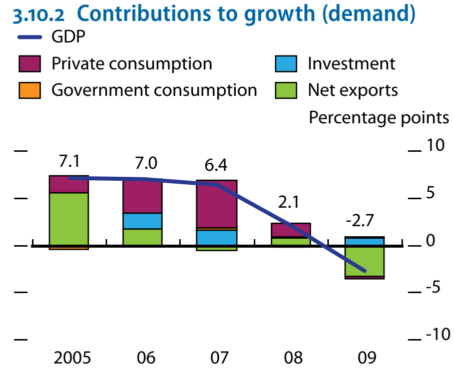
3.10.1 Quarterly GDP growth



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 11 March 2010).

Click here for figure data

3.10.2 Contributions to growth (demand)



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 11 March 2010).

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This chapter was written by Benno Ferrarini of the Economics and Research Department, ADB, Manila.

travel and financial and business services staged a strong rebound during the second half, benefiting from a rise in visitor arrivals, coupled with a brightening economic outlook and abundant liquidity in the banking system. Capital raising activity rebounded in the second half, mostly for PRC companies. Initial public offerings of shares raised the equivalent of US$31.4 billion last year, more than any other financial center. Since services accounts for more than 90% of GDP, this sector's rebound was crucial to the overall pickup. In the fourth quarter, services contributed all the economy's growth.

The current account remained in surplus throughout 2009, though narrowing, and averaged 8.7% over the year. The overall balance of payments registered a huge surplus equal to 33.6% of GDP, reflecting sustained financial capital inflows that more than outweighed the narrowing of the current account surplus.

Employment shrank for the first time since 2003. The jobless rate rose to 5.4% in April–June 2009, in part a result of layoffs in private construction. As recovery took hold in the second half, the unemployment rate declined to 4.9% by year-end. Loan guarantees provided by the government to small and medium-sized firms facing a credit squeeze, together with increased public construction, helped protect jobs. The slack labor market put downward pressure on wages (Figure 3.10.4), which fell by 1.3% in real terms in 2009.

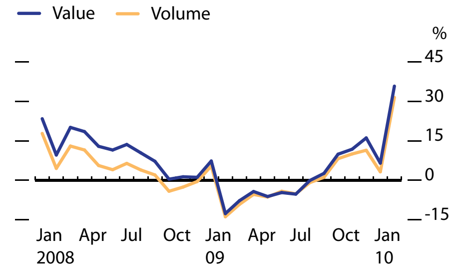
Asset markets slumped, then rebounded. By year-end, the Hang Seng index of share prices had climbed by 87% from its March 2009 low. Similarly, price indexes for residential, office, retail, and factory property turned up (Figure 3.10.5), against the background of substantial inflows of funds and easy monetary conditions that drove interest rates to very low levels.

Sales of residential properties surged, and prices of apartments rose by an average 28% last year. Mortgage loans increased markedly, driven by the ample banking liquidity and low interest rates. Acting to maintain stability in the banking system and limit increases in apartment prices, the Hong Kong Monetary Authority (HKMA) in October 2009 raised the minimum deposit requirement to 40% (from 30%) for residential mortgages valued at HK$20 million or more, and capped maximum loans at HK$12 million for properties valued at less than HK$20 million.

The surge of capital inflows (Figure 3.10.6), driven by expansionary monetary policies in the US, boosted the monetary base (Figure 3.10.7), reflecting the Hong Kong dollar's link to the US dollar through a currency board framework. Inflows early in 2009 reflected firms' repatriation of funds to meet liquidity needs and investors' search for a safe haven.

Later, inflows were driven by investment in the buoyant asset markets and in share offerings. The HKMA undertakes to buy US dollars at HK$7.75 and sell them at HK$7.85 (the convertibility band). The inflows pushed the Hong Kong dollar to the strong side of its convertibility band, and the HKMA acted as counterparty to banks selling foreign currency. The monetary authority purchased US$62 billion in 2009, in doing so it injected HK$480.8 billion into the banking system. Although this drove interest rates to very low levels, bank credit contracted in 2009 (banks

3.10.3 Growth in retail sales



Source: CEIC Data Company (accessed 31 March 2010).
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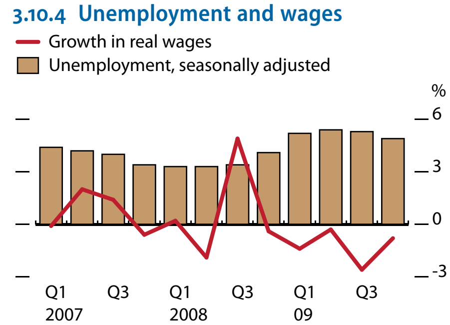
3.10.4 Unemployment and wages



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 11 March 2010).
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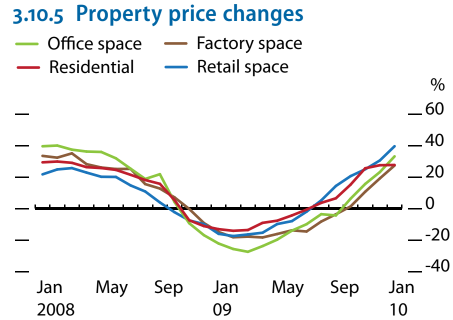
3.10.5 Property price changes



Source: CEIC Data Company (accessed 11 March 2010).
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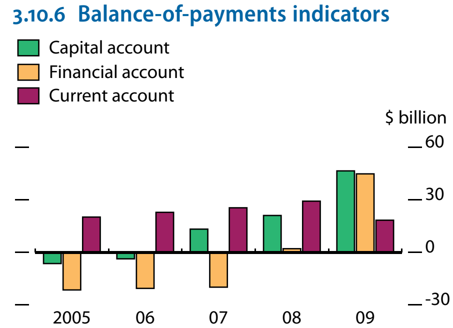
3.10.6 Balance-of-payments indicators



Sources: Hong Kong Monetary Authority; CEIC Data Company (accessed 11 March 2010).
Click here for figure data

were cautious to lend and demand for credit was suppressed by the recession), except for mortgage lending, which rose in the second half.

Moderate deflation pressures prevailed during the first 3 quarters of 2009 (Figure 3.10.8), given the slack economy and lower global oil and commodity prices. Inflation picked up in the last quarter, and averaged 0.5% for the year.

High transaction volumes in property markets generated considerable tax revenue, and produced a budget surplus estimated at 0.8% of GDP in FY2009 (ended 31 March 2010).

Economic prospects

The growth momentum that built in late 2009 is forecast to continue through 2010, lifting GDP by 5.2% this year (Figure 3.10.9). This open economy will benefit from its close links with the PRC (where growth is forecast to accelerate to nearly 10%), from solid growth in much of Asia, and from the expected modest recovery in industrial economies. The low base set in 2009 will contribute to the growth spurt forecast for this year. In 2011, GDP growth is forecast to ease to 4.3%, taking into account that base effect in 2010 and the phasing out of exceptional government stimulus policies in the PRC.

Private consumption is forecast to pick up throughout the year, underpinned by the strengthening labor market. Retail sales rose by just over 17% in volume terms in the first 2 months of 2010 (from a low prior-year base). Private demand will receive a further boost on the investment side, as business confidence continues to improve in light of the improved global economic and financial environment.

Outlays on public works are expected to be at least US$6.5 billion a year for some time, according to the FY2010 budget. Several large public infrastructure projects that began in late 2009 will continue through 2010 and beyond. The government expects to have a budget deficit equivalent to 1.5% of GDP this fiscal year, compared with the actual surplus last year.

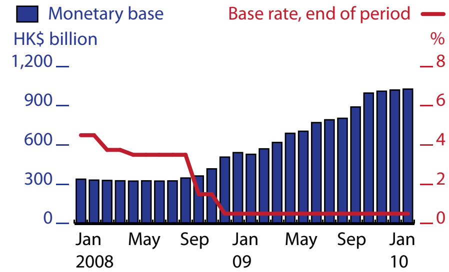
On the supply side, financial services are set to benefit from the capital inflows and corporate fund-raising activity. Fund management and retail sales of mutual funds have picked up considerably since the second quarter of 2009, and insurance has recorded strong gains in premium incomes. Tourism, too, is rising.

Inflation is forecast to pick up moderately, to average 2.2% in 2010 and 2.8% in 2011, a result of the stronger domestic demand, higher prices for imported food and fuel, the end of a subsidy on household electricity bills, and expected increases in residential and commercial rents. In the first 2 months of 2010 inflation averaged 1.9%.

Merchandise exports are expected to rebound by about 13% in US dollars this year. Services exports will rise, too, a result of robust demand for financial services, as well as a rebound in tourism and business travel. Merchandise imports are seen rising by about 11% in 2010. (In the first 2 months of 2010 exports rose by nearly 23% and imports by 31%). (Figure 3.10.10).

The merchandise trade deficit will be more than offset by a healthy surplus on trade in services. Supported also by sustained earnings from foreign exchange reserves and overseas investments, the current account

3.10.7 Monetary indicators



Source: Hong Kong Monetary Authority. http://www.info.gov.hk/hkma (accessed 31 March 2010).

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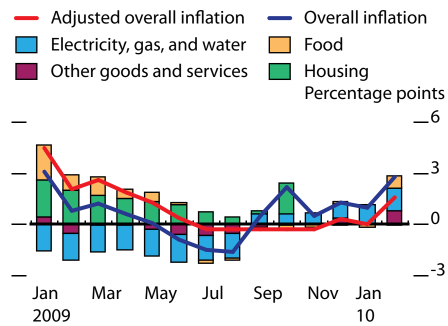
3.10.8 Monthly inflation and components



Note: Adjusted overall inflation refers to the rate once the effects of temporary subsidies by the government are removed.

Sources: CEIC Data Company (accessed 31 March 2010); Census and Statistics Department. 2010. *Monthly Report on the Consumer Price Index*. February. http://www.censtatd.gov.hk

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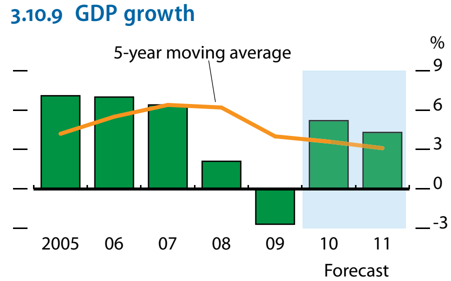
3.10.9 GDP growth



Sources: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 11 March 2010); ADB estimates.

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3.101 Selected economic indicators (%)

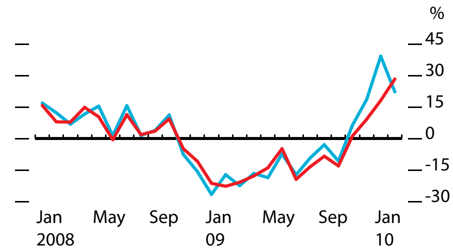
	2010	2011
GDP growth	5.2	4.3
Inflation	2.2	2.8
Current account balance (share of GDP)	7.6	7.2

Source: ADB estimates.

is forecast to record comfortable surpluses exceeding 7% of GDP this year and next.

There are a number of risks to the forecasts. Depending on the pace of withdrawal of monetary stimulus in the US and PRC, it is likely that excess liquidity and very low interest rates will prevail in Hong Kong, China, with the associated risk of fueling a credit boom and further upward pressure on asset prices. Conversely, capital flows might reverse and interest rates rebound when the US phases out its monetary stimulus. The Hong Kong dollar exchange rate will likely move to the lower side of its convertibility band and the HKMA will absorb Hong Kong dollar liquidity. These adjustments could cause disruptions in financial markets.

3.10.10 Merchandise trade growth



Source: CEIC Data Company (accessed 2 April 2010).

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Development challenges

While the flood of liquidity and low interest rates have fueled speculation in high-end apartments, speculative activity does not appear to have significantly spilled over into the broader residential market at this stage. A housing affordability index rose to 38% of median incomes in the fourth quarter year on year (Figure 3.10.11), still below the historical average and far below the peak in 1997. Similarly, the number of transactions involving a buyer reselling a property before the completion of the original sale, usually for a quick capital gain, is around 2%, also well below the previous peak.

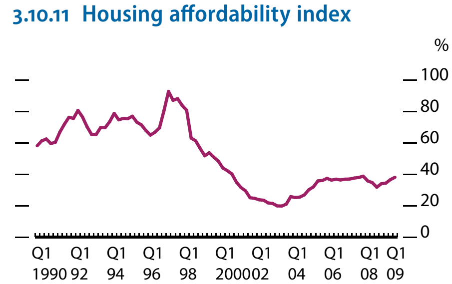
Nevertheless, at a time of low interest rates and rising investor confidence, apartment prices may continue to increase for some time, raising the risk of an overextended market that would eventually peak and then dive, denting consumer and investor sentiment with knock-on effects for economic growth and for the health of the banking sector.

In an effort to prevent such an outcome, the government in February 2010 followed up its tightening of bank prudential regulations for housing loans with moves to check speculation in housing. The FY2010 budget raised the stamp duty tax on high-end housing and indicated that the increase will be extended if speculation takes hold in the broader residential market. To increase supply of apartments, the government plans to speed up the pace of auctioning urban residential sites.

Still, it will take several years for these moves to substantially increase the number of apartments on the market. In the meantime, affordability of private housing is likely to worsen and rents are likely to rise, after a lag of 1 or 2 years.

Hong Kong, China is constrained by its linked exchange rate system from raising interest rates to damp a housing boom. Rather, it is tied to US monetary policy, which is unlikely to tighten much this year. Monetary policy also remains expansionary in the PRC, with some spillover impact on the housing market. Further, if the yuan starts to appreciate against the US dollar, the attractiveness of Hong Kong, China's assets to investors from the PRC would increase.

3.10.11 Housing affordability index



Note: Data refer to the ratio of mortgage payments (for a 45-square meter apartment) to median income of households (excluding those living in public housing).

Source: Economic Analysis and Business Facilitation Unit, Financial Secretary's Office.

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