



## Examine Hong Kong's Economic Recession and Transformation

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In the first quarter of this year, Hong Kong's gross domestic product declined by 7.8% from a year ago, the second worst outcome on record since 3Q98's -8.1% plunge. Seasonally adjusted GDP contracted by 4.3% or annualized -18.0% from the previous quarter, which was worse than any quarters during the Asian Financial Crisis. The Government revised downward substantially the full year growth estimate from the original -2.0% to -3.0% to -5.5% to -6.5%.

### Excessive decline and downward revision

The rapid deterioration in GDP from -2.6% to -7.8% seems excessive in terms of its speed and the magnitude. However, due to the unusually high comparison base of the same period last year (Hong Kong's real GDP growth was 7.3%, 4.1%, 1.5% and -2.6% for the four quarters of 2008, 2.4% for the whole year), there are technical explanations behind such an outsized decline.

From the expenditures point of view, the Hong Kong economy lost almost all growth momentums in the first quarter. Decline in private consumption expenditure accelerated from -4.1% in the previous quarter to -5.5%. Because it accounts for some sixty percent of the local economy, it set the tone for a gloomy quarter. Although decline in gross domestic capital formation narrowed from -17.8% to -12.6%, it was still in double digits. Combined with the decline in inventory, the private sector seemed pessimistic about the near term prospects. Goods and services trade fared even worse, with goods imports and exports recorded significant declines of -21.4% and -22.7% from -6.4% and -4.9% previously due to collapse of external demands. As a result, services exports were down -8.8%. The only sector recording positive growth was government expenditure, which was up 1.5%. But it could not support growth alone due to its limited proportion of about ten percent in the whole economy.

The more worrisome decline was recorded in the seasonally adjusted contraction of 4.3% from the previous quarter (annualized at about -18.0%). None of the expenditure components recorded growth if measured in this way. It is believed that the HKSAR Government substantially revised downward the full year growth estimate on this figure.

Due to the low base established in the first quarter, we also revise downward the full year GDP estimate from -2.0% to -4.0%. The four quarter breakdown is that decline in the second and third quarter in GDP could amount to -5.0% and -4.0% respectively. It is only in the last quarter of this year when external demands stabilize, growth could resume at 1.0% from last year's -2.6%. As for the unemployment rate, the pace of deterioration has eased in April at 5.3%. Therefore, the forecast of an unemployment rate at 6.0% by yearend is maintained. Moreover, Hong Kong does not seem to face the imminent threat of lingering deflation due to the global resurging excess liquidity boosting the local asset prices. Even though consumer price may turn negative in certain months, it is most likely the government's waivers and concessions at work. For the year, CCPI is expected to rise by a modest 1.0%.

### The context of decline and the implications

The 1Q09's -7.8% decline in GDP is not only the second worst on record since the Asian Financial Crisis, it is also the second worst since the 1970s, demonstrating the severity of the current global economic and financial crisis. Since no crisis is exactly the same, the context of the decline and the implications are different even though the magnitude of decline is similar.

First of all, the causes of the crisis are different, in which the external shocks are to blame this time while the interaction of external and internal shocks were at work to trigger the crisis ten years ago. After conquering the neighboring nations, speculators concentrated their attacks on Hong Kong dollar's Peg during Asian Financial Crisis. The local stock and property markets went into freefall. The shocks came from the region and within. Yet for the developed world, the US economy was at the peak of its growth cycle at the time, with GDP growing by 4.2% in 1998. Europe's situation was similar, with the Eurozone's GDP at 2.8% during the same period. Thus, although the bursting of Hong Kong's stock and property bubbles destroyed domestic consumption and investment, the external demands were held up during the precious crisis.

This time, the complete opposite took place. The local stock and property market do not have severe bubbles to begin with. But the external demands evaporate due to the US subprime crisis engulfing the developed world. Hong Kong's goods and services trade deteriorate at an alarming speed. The ensuing financial tsunami also deals our leading financial industry with heavy blows. Eventually, the external shocks spill over to the domestic sectors. But the latter avoid the comprehensive collapse as in the Asian Financial Crisis. Statistically, Hong Kong's goods exports were down -22.0% in 1Q09, twice the decline of -10.2% in 3Q98. Meanwhile, the -5.5% decline in retail sales was much smaller than the -19.6% then.

As for the unemployment rate, even though it was 5.2% in 1Q09, the same as in 3Q98, the uptrend started from 3.3% twelve months ago, compared to from 2.1% in the previous crisis. In other words, the deterioration of the labor market was severer in the previous crisis due to the collapse of internal demands. As for consumer price, even though CCPI was up 2.5% in 3Q98, higher than the 1.2% in 1Q09, the bursting of the property bubble dictated that Hong Kong entered a deflationary period that lasted sixty months starting from November 1998. Nowadays, Hong Kong does not seem to face a long spell of deflation due to ample liquidity and the modest correction in the property market. Low inflation should prevail in the foreseeable future.

The main explanation of the divergence between the real economies with similar decline in output is liquidity. The Asian Financial Crisis already resulted in substantial capital outflows from Hong Kong. The speculative attacks on the Hong Kong dollar forced Hong Kong interest rates to go up in an effort to defend the Peg. As a result, the economy was badly hurt. Nowadays, the global synchronized easing drives liquidity into Hong Kong, which boasts free flows and China factor. The aggregate balance of the local banking system made records such as HKD20.7bn daily increase and HKD250bn in total balance. The benchmark savings deposit rate is reduced to zero, as well as the overnight interbank rate. Three month Hibor averaged 0.87% in 1Q09, and Prime Rate 5.00%, much lower than 3Q98's 10.10% and 10.00% respectively.

The extremely accommodative monetary environment coupled with no major imbalance within the local economy lends support to asset prices. Average residential property price rebounded by 3.2% from the previous quarter while still down 14.6% from a year ago, outshining 3Q98's quarterly decline of -12.4% and yearly decline of -43.0%. Providing the US economy can stabilize by yearend and help restore Hong Kong's exports and local confidence, the economic contraction could be a milder -4.0% for the full year, as compared to 1998's -6.0%.

## **The dilemma of economic transformation**

In the past, every economic crisis triggered the debate of Hong Kong's economic transformation. It is no exception this time. Nevertheless, the two major recessions post Handover fail to yield a consistent and clear answer to the subject because different causes, different impacts, and different reactions lead to different conclusions as to how to transform the Hong Kong economy, even though the severity of recessions are much alike.

Post Asian Financial Crisis, the exploration of the issue lies mainly in industrial structure. Some believe that Hong Kong should revitalize its manufacturing sector, especially high tech manufacturing to increase the proportion of industry and reduce volatility to growth. The major consideration is that Singapore, which is similar to Hong Kong in terms of economic structure, demonstrated several advantages in handling the crisis. Decline in its GDP was -2.4% in 1998, much smaller than Hong Kong's -6.0%. During that year, Hong Kong's unemployment rate surged from 2.4% to 5.9% while Singapore's from 1.7% to 3.3%. Starting in November 1998, Hong Kong was plunged into sixty months of deflation, while Singapore stepped out of the deflationary spiral in eleven months. All these suggest greater resilience of Singapore's economy because approximately one third of its economy was goods

production, eighty percent of which was manufacturing including high tech manufacturing of biomedicine, transportation engineering, chemical and electronics, etc.

However, the real difference lies in the robust growth in the US and Europe at that time that supported Singapore's products. Other than that, the exchange rate factor is also important because Singapore resorted to multiple devaluations to shoulder part of the adjustment, while Hong Kong dollar's exchange rate was fixed due to the Peg. Thus, the difference in industrial structure could be just one of the explanations. In Hong Kong's case, its manufacturing failed to revive even after 2003's CEPA agreement, suggesting Hong Kong's high cost environment is a disincentive to manufacturing's revival. And without the government's full support, high tech manufacturing cannot find a foothold. Hong Kong's manufacturing has mostly relocated to the Mainland over the past decades.

Without the manufacturing base, Hong Kong still seized the development opportunities offered by China's opening and globalization and achieved impressive growth in the years of 2004 to 2007. When this crisis hit, the US, Europe and Japan enter synchronized recession that cripples the global trade. Hong Kong's total exports, consisted of mostly re-exports due to the relocation of manufacturing, have been declining for six consecutive months with average decline of -16.8%. For Singapore, who possesses high tech manufacturing, its exports have been down for seven consecutive months, with average decline of -20.7%. Other Asian economies renowned for their high tech manufacturing such as Japan, Korea and Taiwan have all recorded severer decline in exports. In terms of GDP contractions, both Singapore and Hong Kong recorded consecutive quarterly decline starting from 2Q08, with Hong Kong's averaging -8.4% per quarter while Singapore's -10.2%. This argues against Singapore economy's resilience. But it must be recognized that Hong Kong boasts much greater supports from the China factor than ten years ago, which may be the decisive difference.

Therefore, in terms of industrial structure of manufacturing versus service, the two crises yield diverging conclusions. Assuming the external demands are well maintained, economies with manufacturing base, especially high tech manufacturing, will be more resilient with less volatility to their outputs. However, when external demands collapse, with or without manufacturing base, with or without high tech manufacturing, externally oriented economies will be severely impacted. Economies with manufacturing base fare even worse. Thus, there is no ideal economic structure that can handle all types of crisis. Small, open, city economies with limited industrial structure have to face such natural constraints.

Thus, when this crisis passes, the debate of Hong Kong's economic transformation will need to refocus, expanding the scope and shifting the focal point. The main transformation pressure facing the Hong Kong manufacturing that has relocated to the Mainland do not necessarily come from external shocks that are cyclical and uncontrollable and do not discriminate against the types of manufacturing. Instead, the main pressure comes from China's economic development and rising costs. Without upgrading, lower value added manufacturing find it hard to survive in the original way. Moreover, the crisis show that China's domestic market is more stable than the US and Europe's, which argues strongly for shifting the target markets.

As for the service sector, challenges are substantial. The global trade collapse caused by the synchronized recession of the developed world deals heavy blows to Hong Kong's largest trade and logistics industry. The last quarter of 2008 saw Hong Kong's import and export industry recorded -1.9% decline, while transportation and storage industry down 5.4%. Their situation is bound to worsen earlier this year. The trade and logistics industry is facing both cyclical and structural pressure, just like the manufacturing relocated to the Mainland. The right thing to do post crisis is to extend its services to serve all manufacturing in the Mainland, maintain and strengthen the original industrial linkage.

Regarding the financial industry that has been the fastest growing and biggest contributor to GDP, its transformation pressure is just as acute due to the wholesale change of the financial world. During 4Q08, decline in the financial industry already reached -6.1%. Even though the markets may recover lost ground, the industry may no longer return to its glory days because stricter regulation, change of business model and change of investor behavior make it impossible. Thus, its transformation lies in returning to sound operation, leveraging the Mainland's financial opening and the RMB's internationalization to expand its service area and scope, and strengthening its financial intermediation role when the cross strait economic and financial relationships reach breakthroughs. Doing so will usher in many prosperous years for the Hong Kong financial industry.

# 主要經濟指標 (Key Economic Indicators)

<b>一. 本地生產總值 GDP</b>	<b>2007</b>	<b>2008</b>	<b>2008/Q4</b>	<b>2009/Q1</b>
總量(億元) GDP (\$100 Million)	16,154	16,536	4,245	3,766
升幅(%) Change (%)	6.4	2.4	-2.6	-7.8
<b>二. 對外貿易 External Trade</b>	<b>2007</b>	<b>2008</b>	<b>2009/4</b>	<b>2009/1-4</b>
外貿總值(億元) Total trade (\$100 Million)				
港產品出口 Domestic exports	1,091	908	46	170
轉口 Re-exports	25,784	27,334	1,944	6,867
總出口 Total exports	26,875	28,242	1,990	7,038
進口 Total Imports	28,680	30,253	2,154	7,543
貿易差額 Trade balance	-1,805	-2,011	-164	-506
年增長率(%) YOY Growth (%)				
港產品出口 Domestic exports	-18.9	-16.8	-40.2	-43.3
轉口 Re-exports	10.8	6	-17.5	-20.1
總出口 Total exports	9.2	5.1	-18.5	-20.9
進口 Imports	10.3	5.5	-17	-21.2
<b>三. 消費物價 Consumer Price</b>				
綜合消費物價升幅(%) Change in Composite CPI (%)	2	4.3	0.6	1.4
<b>四. 樓宇買賣 Sale &amp; Purchase of Building Units</b>				
合約宗數(宗) No. of agreements	145,691	113,298	11,148	30,012
年升幅(%) Change (%)	47	-22.2	1.9	-43.7
<b>五. 勞動就業 Employment</b>	<b>2007</b>	<b>2008</b>	<b>2009/2-4</b>	<b>2009/3-5</b>
失業人數(萬人) Unemployed (ten thousands)	14.6	12.8	19.7	20
失業率(%) Unemployment rate (%)	4	3.5	5.3	5.3
就業不足率(%) Underemployment rate (%)	2.2	1.8	2.2	2.3
<b>六. 零售市場 Retail Market</b>	<b>2007</b>	<b>2008</b>	<b>2009/4</b>	<b>2009/1-4</b>
零售額升幅(%) Change in value of total sales (%)	7.3	10.5	-4.4	-4.0
零售量升幅(%) Change in volume of total sales (%)	5.8	5	-5.5	-5.4
<b>七. 訪港遊客 Visitors</b>				
總人數(萬人次) arrivals (ten thousands)	2,817	2,951	244	984
年升幅(%) Change (%)	11.6	4.7	0.8	1.5
<b>八. 金融市場 Financial Market</b>	<b>2007</b>	<b>2008</b>	<b>2009/3</b>	<b>2009/4</b>
港幣匯價 (US\$100 = HK\$)	780.15	775.05	775.05	775.05
H.K. Dollar Exchange Rate (US\$100 = HK\$)				
貨幣供應量升幅(%) change in Money Supply (%)				
M1	25.4	4.7	11.2	12.8
M2	20.6	2.7	4.2	4.4
M3	20.4	2.7	4.2	4.3
存款升幅(%) Change in deposits (%)				
總存款 Total deposits	23.1	3.3	4.5	4.6
港元存款 In HK\$	19.7	-1.3	3.5	4
外幣存款 In foreign currency	27.1	8.3	5.6	5.3
放款升幅(%) Change in loans & advances (%)				
總放款 Total loans & advances	20.0	10.9	-0.1	-2.2
當地放款 use in HK	15.7	10.2	-0.2	-2.5
海外放款 use outside HK	46.9	14.2	0.4	-0.9
貿易有關放款 Trade financing	20.4	1.8	-20.4	-26.6
最優惠貸款利率(%) Best lending rate (%)	6.7500	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	27,813	14,387	13,576	15,521