HONG KONG

VINCENT KWAN
Hang Seng Bank

2003: FROM PESSIMISM TO OPTIMISM

Starting in the second half of 2003, the economy of the Hong Kong Special Administrative Region (HKSAR) went through an abrupt change, from one filled with pessimism to one full of optimism. Factors that clouded the outlook for the economy in the first half of the year—the Middle East hostilities, the outbreak of Severe Acute Respiratory Syndrome (SARS), the record fiscal deficit and tax hikes—have either been resolved or swept behind the scenes with the rebounding economic activity and improving sentiment.

The economy staged a strong rebound as SARS receded. Real GDP growth jumped back to 4% and 5% year-on-year for the third and fourth quarters respectively, lifting full-year growth to 3.3%. A strong pick-up in private consumption, reviving tourism, and favourable external trade all contributed to the strong showings in the second half of the year.

External trade remained resilient throughout the year on the back of mainland China's strong exports performance. Total exports, including re-exports, recorded 14.2% real growth in 2003, up from 8.7% in 2002.

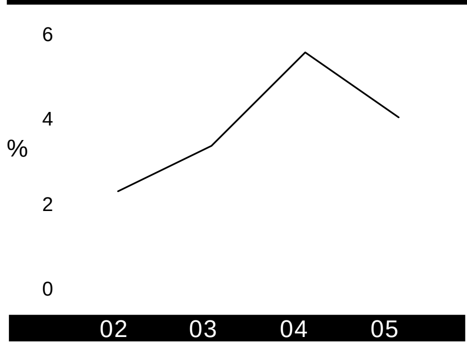
The signing of the Mainland/Hong Kong Closer Economic Partnership Arrangement (CEPA) in June 2003 and the relaxation of travelling restrictions under CEPA have undoubtedly been the major driving forces behind the economic pick-up. By tearing down barriers impeding the two-way flow of goods, people and funds, CEPA will speed up the economic convergence of the HKSAR and mainland China.

CEPA facilitates trade and investment in a wide range of goods and services. Starting 1 January 2004, a total of 276 products manufactured in Hong Kong can enjoy zero import tariffs when entering mainland China. It is estimated that the HKSAR will save about HK$750 million in tariffs based on HK$42 billion worth of domestic exports to the Mainland in 2002. While such an arrangement is welcome, it is not expected to bring many manufacturing industries to the HKSAR. Even with the benefit of zero tariffs, the HKSAR is simply not cost competitive enough for the revival of these industries.

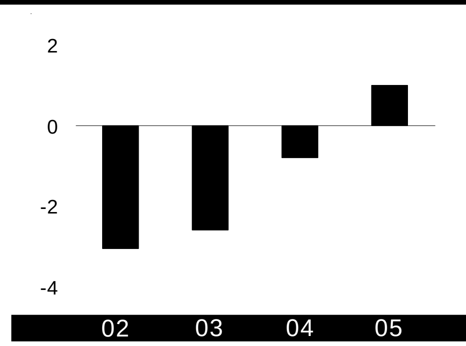
A more important benefit of CEPA is the preferential treatment that has been given to companies fulfilling the 'Hong Kong company' definition in selective service industries in mainland China. A 'Hong Kong' company will be required to have at least 50% of its total staff in Hong Kong.

The most meaningful aspect of CEPA lies in the opportunity it provides for Hong Kong to reinforce its role as the metropolis of southern China. As such, CEPA lays a solid foundation for a closer partnership between the HKSAR and the Pearl River Delta under the 'one country, two systems' framework. Although the immediate benefits from CEPA have mainly been the rise in visitor

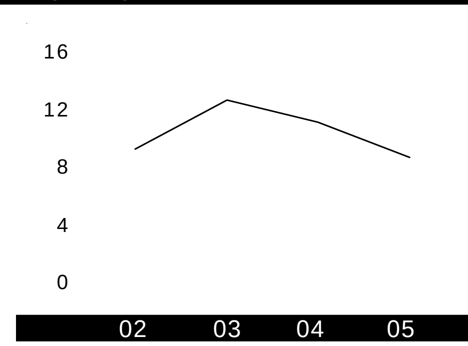
GDP growth



CPI inflation



Export growth



spending from the surging number of Mainland visitors, the long-term benefit should come from the normalisation of the bilateral economic relationship between the Mainland and the HKSAR through the lifting of barriers that are no longer necessary.

OUTLOOK: 2004 AND BEYOND

The momentum seen in the second half of 2003 has lasted through the early part of 2004. A combination of many factors, including the inflow of funds, record low interest rates, rising asset prices and improving sentiment, are expected to push economic growth higher through the remainder of 2004.

The inflow of funds into Hong Kong has been substantial since the second half of 2003. This was due to the macro-environment of funds seeking to diversify away from a sustained weakness in the US dollar, improving Asian economic fundamentals, a fast-growing Chinese economy, and a rebounding HKSAR economy. The fund flows at one time pushed the Hong Kong dollar exchange rate versus the US dollar to 7.70, its highest level in six years.

Given the currency board arrangement under which the Hong Kong dollar is pegged to the US dollar at 7.80, a strengthening in the Hong Kong dollar would push down interest rates and expand Hong Kong's monetary base and hence money supply. In February 2004, total M1 was 42.9% higher than one year before, while total M3 showed a year-on-year growth of 11.8%. So far this year, the three-month interbank rate has been around 0.1%–0.3%.

These very relaxed monetary conditions have added strength to the rebound in asset prices. Since June 2003, property prices have started to improve and the stockmarket has staged a strong rebound. The recovery in asset prices was stimulated in part by the cyclical improvement in the local economy, and in part by the huge amount of liquidity in the market. Rising property prices, moreover, have spurred private consumption and investment in building and construction, both of which have been severely hampered for years by the sagging property market and negative equity suffered by many homeowners.

With all these favourable developments, real GDP growth in 2004 is projected to reach 5.5%, underpinned by a projected 4% rise in private consumption and an 11.1% growth in exports of goods and services. Investment is also expected to return to a growth of 3.6% in 2004 after contracting for two consecutive years. Consumer price deflation could be coming to an end towards the latter half of the year, although the composite CPI is still projected to show an average fall of 0.8% in 2004.

For 2005, it is estimated that real GDP growth will resume at a slower pace of 4%, mainly as a result of projections of higher interest rates and a stabilising property market following a strong rebound in 2004.

RISK FACTORS

The highly externally oriented nature of the Hong Kong economy means that GDP growth is vulnerable to external shocks. This is particularly true today. The strength of the economy since the second half of 2003 is due in large part to the significant inflow of funds chasing H-shares (shares of mainland Chinese enterprises listed in Hong Kong) in anticipation of a renminbi revaluation and/or fast-growing Chinese economy. It is always difficult, however, to predict the direction of fund flows and the timing of its reversal. Any reversal of the fund inflows could reduce the pace of recovery, and in the event that the reversal of fund flows is coupled with a possible interest rate hike in the United States later in the year, the very low interbank rates would be pushed up sharply.

Hong Kong's re-export trade is also vulnerable to a slowdown in mainland Chinese exports. Furthermore, Hong Kong's container ports face keen competition from the fast-expanding and improving port facilities in nearby Shenzhen and Guangdong province. Over the past year, the gap between Hong Kong's re-export growth and mainland China's export growth has been widening, indicating that an increasing volume of Chinese exports has been shifting to the mainland's own port facilities.

Last, Hong Kong's fiscal deficit will remain substantial—at around 5%–6% of GDP over the next two fiscal years before capital financing through bond issues and/or government asset privatisation or securitisation. As the government steps up its expenditure control measures to tackle the structural deficit problem, fiscal policies may become less stimulatory.

Funds inflow driving domestic credit

The strong inflow of funds to Hong Kong since the third quarter of 2003 has depressed interest rates, spurred domestic credit expansion and helped boost the level of economic activity.