Hong Kong's Economy in the Financial Crisis

ZHANG Yang*

Hong Kong's economic growth moderated significantly to 2.5% in 2008. In the last quarter of 2008, it registered a negative growth of -2.5%. The Hong Kong government has responded swiftly to the financial turmoil by putting forward measures to stabilise the financial market, support enterprises and create employment, including a proposed budget deficit of about HKD 40 billion. Cushioned by the growing mainland, Hong Kong's economy in 2009 is projected to shrink modestly by two to three percent.

BATTERED BY THE worst global economic slowdown in decades, Hong Kong's economic growth moderated significantly to 2.5% in 2008, down from 6.4% in 2007. This deceleration of growth indicated a below-trend performance and a derail from the upturn since 2002 (see Figure 1). The 2.5% annual GDP growth rate however was not representative of the annualised quarter-to-quarter rate of 1.7% in the third quarter and a contraction of 2.5% in the fourth, due mainly to the outbreak and ramification of the global financial crisis. These numbers show a marked slowdown from the strong 7.3% growth in the first quarter and 4.3% in the second.

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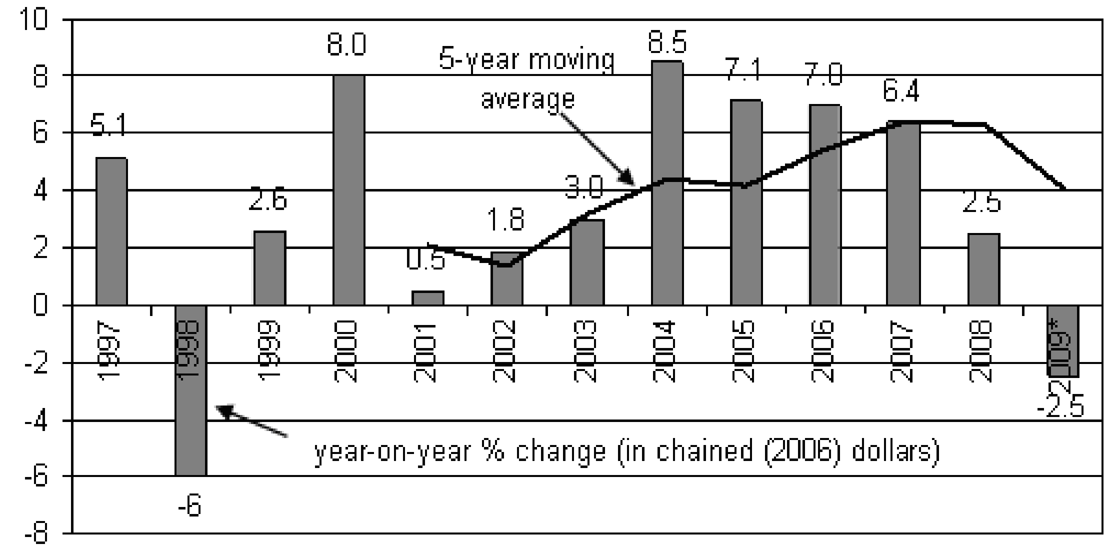
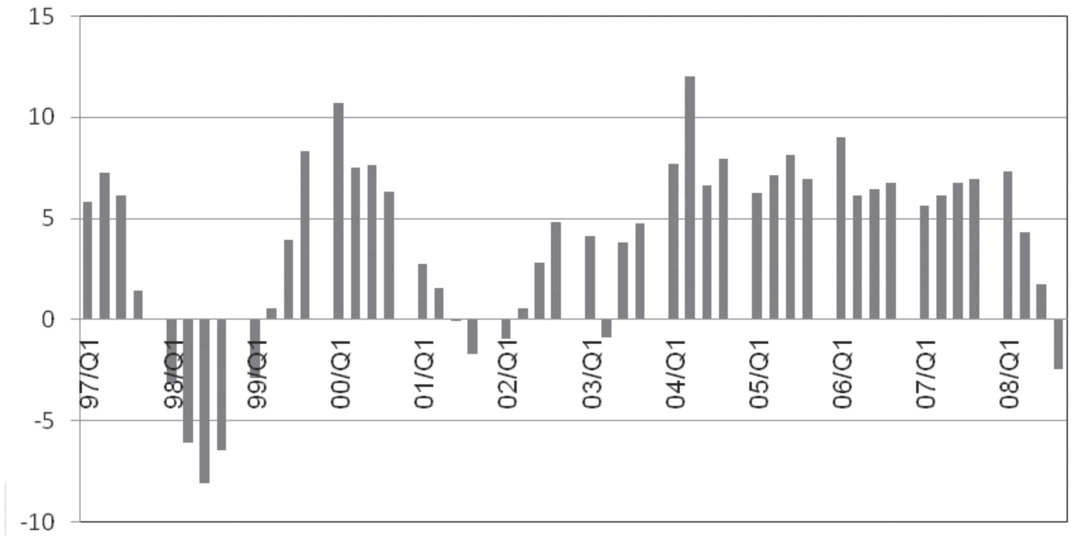
FIGURE 1 HONG KONG'S ECONOMIC GROWTH



*Source: Hong Kong Census & Statistics Department; *: Projected by the government*

In retrospect, Hong Kong's economy was first hit hard by the catastrophic ripples of the Asian financial crisis in 1998 and then further plagued by the global economic downturn in 2001 before being crippled by the outbreak of the Severe Acute Respiratory Syndrome (SARS) in 2003. As depicted in Figure 2, the last quarter of 2008 dipping deep into the negative growth of 2.5% has been Hong Kong's worst performance

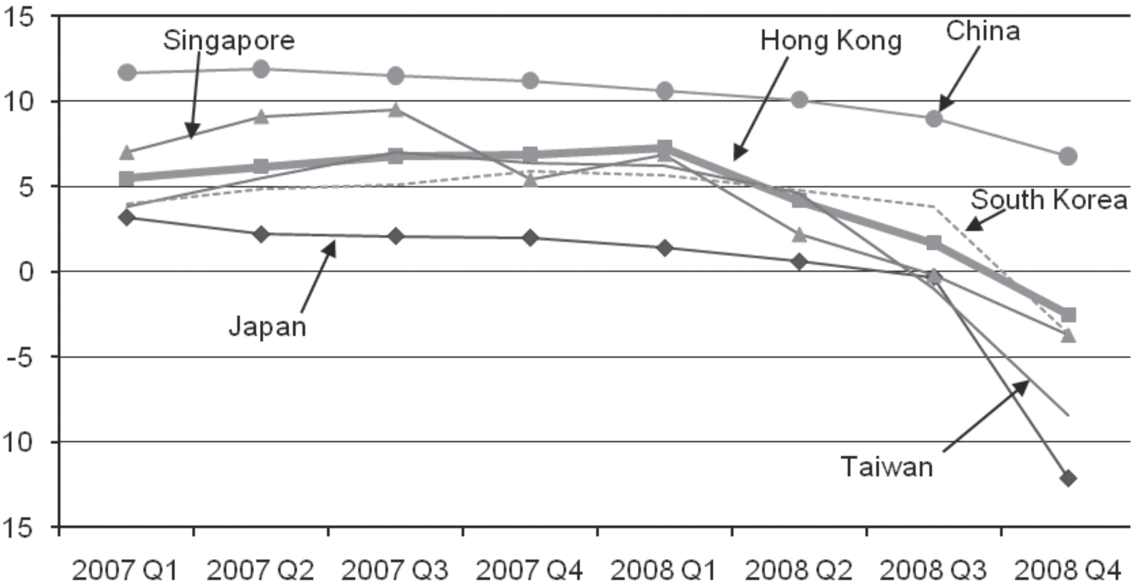
FIGURE 2 QUARTERLY GDP GROWTH (YEAR-ON-YEAR % CHANGE, IN CHAINED (2006) DOLLARS)



Note: 08/Q4 Figures subject to revision.

Source: Hong Kong Census & Statistics Department

FIGURE 3 ECONOMIC PERFORMANCE OF SELECTED ASIAN ECONOMIES



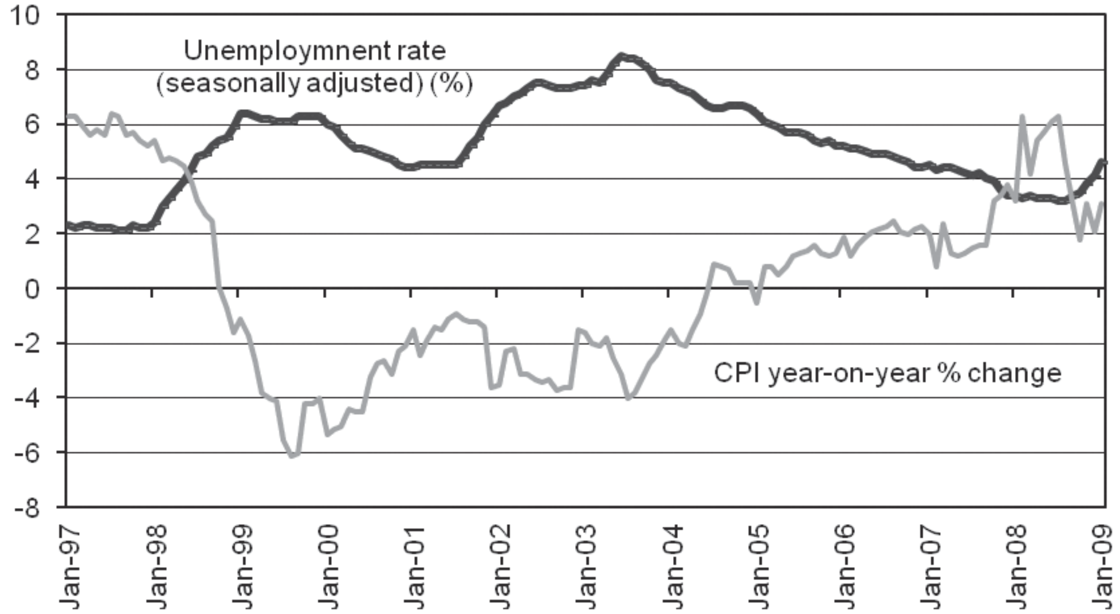
Source: EIU country data

since 1999, echoing sharp declines reported recently by China, Taiwan, Japan and Singapore (See Figure 3), and indicating a downward spiral and even tougher times ahead.

Indeed Hong Kong's economy still held firm in the first half of 2008, but took an abrupt turn after September when the global financial crisis intensified with the collapse of the Lehman Brothers. Labour market has since seen rapid deterioration with unemployment rate on the rise. On close examination, unemployment rate climbed up distinctly towards the end of 2008, reversing the declining trend prevalent for more than five years which led to a 10-year low of 3.2% in mid-2008. For the three-month period ending February 2009, unemployment rate registered five percent, compared to 3.3% a year earlier. Meanwhile, inflation pressure receded considerably with Consumer Price Index falling notably from its peak in July 2008. See Figures 4 and 5.

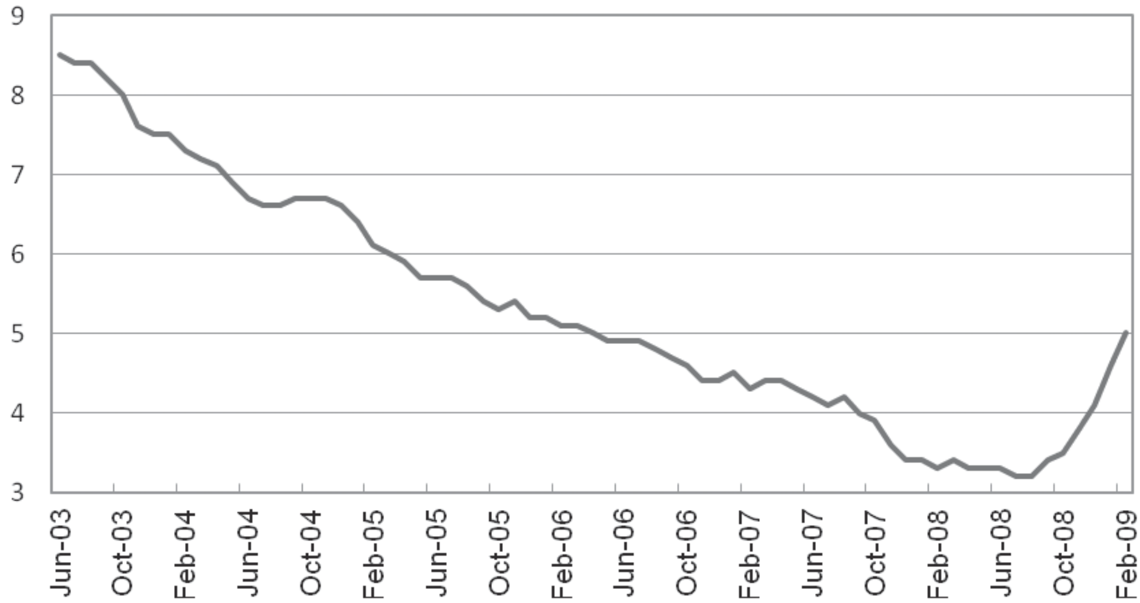
The residential property market had also lost its growth momentum in the previous year and began faltering in the second half of 2008 (see Figure 6). By December 2008, flat prices, rentals and number of transactions in residential properties fell notably by 18%, 19% and 22% respectively from their peaks earlier last year. Hong Kong's stock market, another indicator of local asset market, continued its downward adjustment that started in late 2007 but has seen a sharper decline after September 2008. The Hang Seng index closed the year at 14,387, plunging 48% from a year before, unseen since 1974, and wiping out more than HKD 6 trillion of wealth (see Figure 7). Due to doom market sentiments, market capitalisation shrank and fund raising activities also receded.

FIGURE 4 HONG KONG'S UNEMPLOYMENT AND INFLATION



Source: Hong Kong Census & Statistics Department

FIGURE 5 UNEMPLOYMENT RATE SINCE 2003 (SEASONALLY ADJUSTED, %)



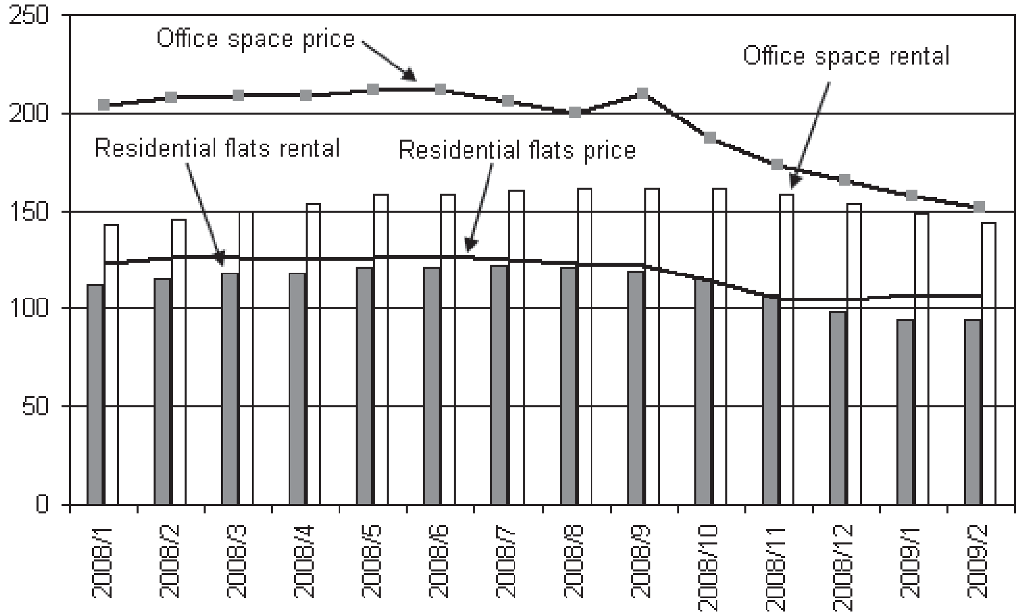
Note: # Provisional figures for Feb 2009

Source: Hong Kong Census & Statistics Department

Main Attributes of the Economic Slowdown

Amid a deepening global economic downturn, the external demand for Hong Kong exports worsened over the course of 2008. More importantly, domestic demand lost much of its momentum with weaker consumer and investor sentiments amid tighter

FIGURE 6 PROPERTY PRICES AND RENTALS (INDEX 1999=100)



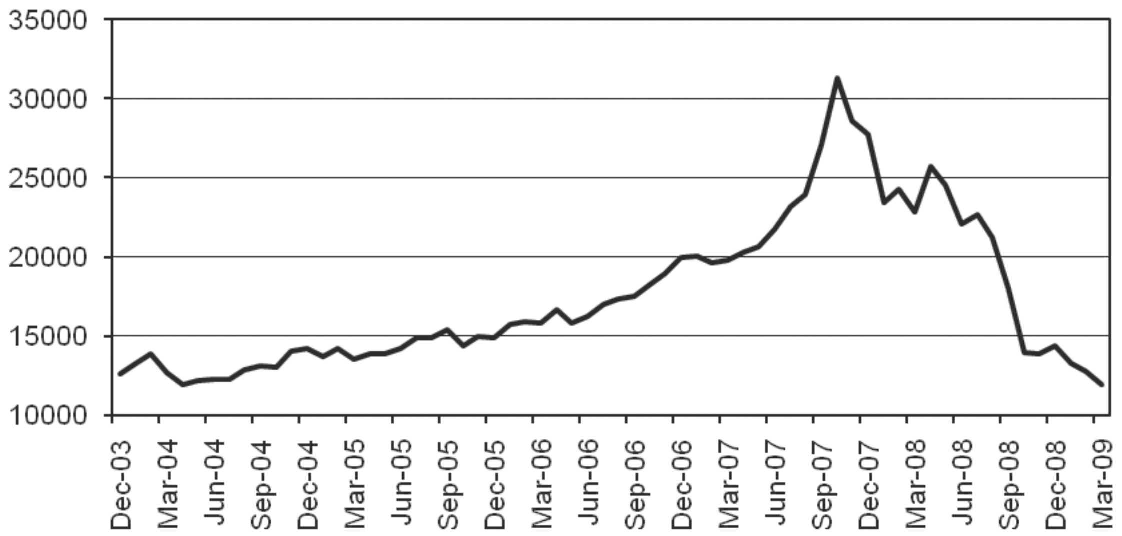
Source: Rating and Valuation Department, http://www.rvd.gov.hk

credit market. As shown in Figure 8, of the -2.5% GDP contraction in the last quarter of 2008, net export contributed 3.7%, government spending 0.2% while investment -4.5% and private consumption -1.9%.

Specifically, Hong Kong's exports slackened during 2008 with the advanced economies sliding into recession and the resultant weaker demand for products from

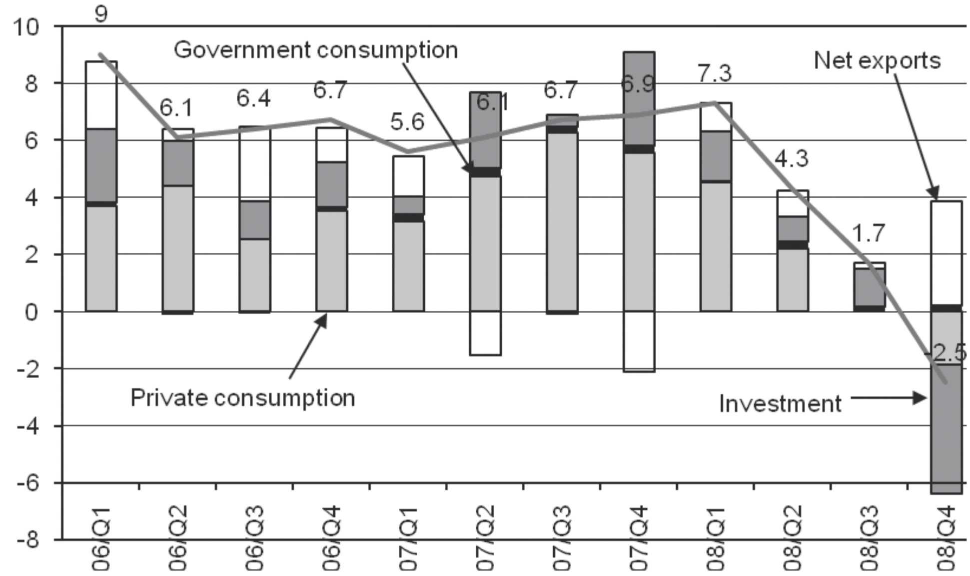
FIGURE 7 HANG SENG INDEX

(CLOSE PRICE ADJUSTED FOR DIVIDENDS AND SPLITS)



Source: Yahoo Finance

FIGURE 8 CONTRIBUTIONS TO QUARTERLY GDP GROWTH (PERCENTAGE POINT)

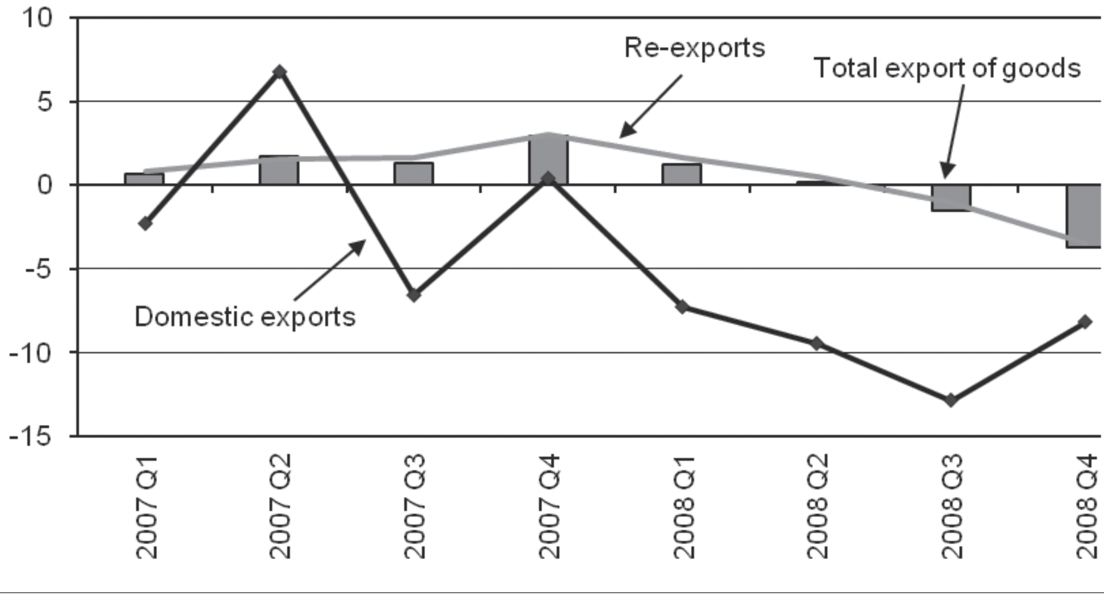


Source: Hong Kong Census & Statistics Department

emerging economies. Total export of goods in 2008 grew by two percent in real terms, a notable drop from the seven percent increase in 2007, registering a year-on-year decrease of 4.9% in the fourth quarter, as evidenced in Figure 9. Hong Kong's main export markets are the Mainland and the US, accounting for 49% and 13% respectively in 2008. Exports to the former increased by 4.7% while sales to the latter fell by 2.4%. What is more, total exports dropped by 21.8% year-on-year in January 2009.

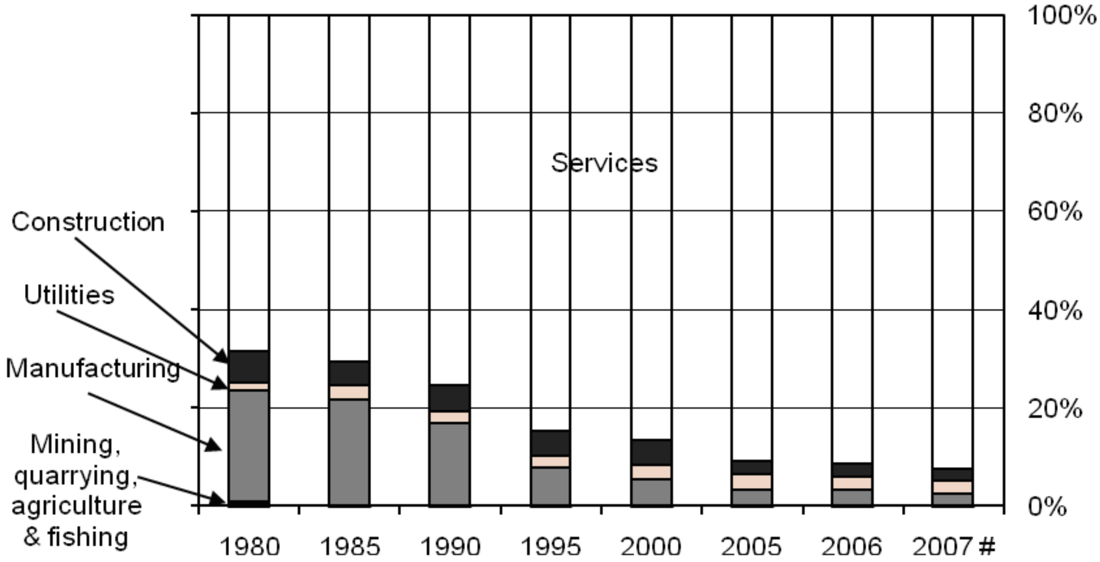
FIGURE 9 EXPORTS OF GOODS

(SEASONALLY ADJUSTED QUARTER-TO-QUARTER RATE OF CHANGE)



Source: Hong Kong Census & Statistics Department

FIGURE 10 COMPOSITION OF HONG KONG'S GDP BY SECTORS



Note: 2007 figure is subject to revision.

Source: Hong Kong Census & Statistics Department

Resembling the decelerating trend in trade of tangible goods, exports of services rose by 5.6% over the year 2008, much slower than the 14.1% in 2007. In the last quarter of 2008, exports of services declined by 0.2%. This was particularly significant given the predominance of the service sector in Hong Kong's economy with its contribution to GDP rising from 70% in 1980 to 92.3% in 2007, as shown in Figure 10. Indeed, the service sector accounted for 87% of total employment in the first three quarters of 2008.

Weakness stemming from evaporating demand overseas was compounded by poor domestic demand, the key pillar of growth for the previous few quarters. Domestic demand held up relatively well in the first quarter of 2008 after which the deceleration in private consumption became evident due to gloomy job prospects and negative wealth effect from a downward correction in local asset markets. Private consumption grew by 1.8% in real terms for 2008 as a whole, down from a robust 8.5% rise in 2007. Worse, it posted a contraction of 3.2% in the last quarter of 2008. Due partly to the cooling down of the local property market from the second half of 2008, investment in building and construction activities shrank by 3.6% in the last quarter. Fixed capital formation in machinery, equipment and computer software posted an even bigger decline of 18.7%. Overall investment remained sluggish and registered a marginal decline of 0.3% for the year.

Government's Counter-Cyclical Measures

The Hong Kong SAR Government has responded swiftly by putting forward a series of measures since late 2008 to stabilise the financial market, support enterprises and create employment. Indeed a Task Force on Economic Challenges was established in October 2008 to assess the impact of the ongoing crisis on the economy and propose means and ways to meet the challenges.

Soon after the outbreak of the financial crisis, two pre-emptive measures were announced in October 2008 by the Financial Secretary. One is to use the Exchange Fund to guarantee repayment of all deposits held with authorised institutions in Hong Kong. Two is the establishment of a Contingent Bank Capital Facility to provide additional capital to locally incorporated banks when necessary. These measures helped stabilise Hong Kong's financial system and will remain in force until the end of 2010.

Amidst the global credit crunch, the small and medium-sized enterprises (SMEs) inevitably face very tight credit conditions and are crippled by cash flow problems. In response to this, a Special Loan Guarantee Scheme was first introduced in November and then substantially expanded in the Chief Executive's announcement on 8 December 2008. The government's commitment was increased to HKD 100 billion with the provision of up to 70% guarantee to participating lending institutions granting loans to Hong Kong companies.

In the same announcement, the government pledged to provide more than 60,000 employment opportunities in 2009 through expediting projects, recruiting civil servants and creating temporary and other posts. Along with these efforts, the Hong Kong Monetary Authority also rendered liquidity assistance to licensed banks, lowered the base interest rate on money borrowed through discount window and injected Hong Kong dollar into the banking system.

More recently, in the 2009/2010 Budget released by the Financial Secretary John Tsang on 25 February 2009, the government proposed an expenditure of over HKD 300 billion for the year and set a budget deficit of about HKD 40 billion. Counter-cyclical measures were announced particularly to reduce business costs, secure and preserve jobs and boost consumption. Details are documented in Table 1. In the same

TABLE 1 KEY MEASURES ANNOUNCED BY THE BUDGET

To reduce business costs	20% rental reduction for government properties and short term tenancies for three months
To create jobs	To earmark HKD1.6 billion to create 62,000 jobs over three years • HKD36,000/HKD24,000 annual internship subsidy to employers who hire university graduates for jobs in the mainland/Hong Kong • Creating some 14, 000 jobs in the next two years with subsidies for building maintenance and cultural events.
To boost consumption	• An one-off rebate of 50% of salary tax paid up to a maximum of HKD 6, 000 • Exemption of property rates for two quarters for 2009/10, capped at HKD 1, 500 • Freezing government fees and charges until March 2010

Source: THE 2009-10 BUDGET, by Hong Kong Financial Secretary.

Budget, the government pushed forward an array of initiatives to further expand cross-boundary transportation capacity including the 29 km Hong Kong-Zhuhai-Macau Bridge to commence construction by 2010 and complete in 2016, and the Guangzhou-Shenzhen-Hong Kong Express Rail Link to start in end 2009. These infrastructure projects will boost investment in the short run and foster closer economic integration with the Mainland in the long run.

A conservative fiscal package as perceived by many, the proposed deficit accounts for only about 2.4% of Hong Kong's GDP. The concession on property rates and tax rebates has been greatly reduced from that of last year when the economy was growing robustly. Specifically, the bonus of social security allowances for the elderly and disabled and subsidies on electricity bills are no longer offered this year. Moreover, tax rebates will only be credited to next year's bill and therefore have limited immediate impact on consumer sentiment.

On a regional scale, the Budget is considered rather modest by many (See Table 2), especially so given Hong Kong's ample fiscal resources with fiscal reserves projected to reach HKD 488 billion, equivalent to 27.2% of GDP or 18 months of government expenditure, by 31 March 2009. To maintain fiscal prudence, the government reactively fine-tuned revenue and expenditure rather than proactively roll out aggressive stimulus measures and commit to a larger deficit; the budget would probably offer little quick and immediate relief measures to offset the external environment and lift the sagging economy.

Outlook for 2009

The SAR government projects its economy to shrink by two to three percent in 2009, the first annual decline since 1998. This is against the backdrop of turbulent financial markets which have resulted in a synchronised global downturn with advanced economies mostly mired in recession and the emerging economies in a sharp slowdown. Hong Kong's economy is expected to face more pain as job losses mount, exports slump and property prices tumble; economic performance is likely to further deteriorate before getting better. Prospects of a turnaround however depend on how the financial

TABLE 2 PROJECTED GOVERNMENT BUDGET DEFICIT FOR 2009 IN SELECTED ASIAN ECONOMIES

Economies	Local Currency	USD	Share of GDP %
Hong Kong	HKD40 billion	5.2 million	2.4
Singapore	SGD8.7 billion	6 billion	3.5
China	RMB950 billion	130 billion	3
Taiwan	T$134.6 billion	4 billion	1.3
South Korea	KRW51,600 billion	34.4 billion	5.4
Malaysia	N/A	N/A	7.6
Japan	YEN13.1 trillion	145.6 billion	2.6

Source: Compiled by authors from different sources.

crisis plays out globally and when the financial market resumes its function. This in turn hinges on the effectiveness of the huge fiscal stimulus measures and aggressive monetary easing policies implemented across the world.

The projection of two to three percent contraction is based on the following factors. First, credit crunch and the global economic downturn have already dampened significantly Hong Kong's external trade. The recent appreciation of the US dollar, to which the Hong Kong dollar is closely pegged, has weaken to some extent the price competitiveness of Hong Kong's exports. Exports in goods will be reined in further by waning global demand.

Second, the prospects for exports of services are likewise not promising. Inbound tourism will be negatively affected by dropping incomes. Exports of financial, business and other services will remain sluggish as financial market sees no solid sign of rebound and commercial activities are dampened greatly by the financial tsunami. Market sentiments are likely to stay fragile in the face of an intensifying financial crisis where huge losses are reported recently by major financial institutions in the US and Europe.

Third, domestic demand may be the sole engine of growth, which too looks set to gear down. Local consumer spending is likely to wither further with falling household wealth, rising unemployment and heightened uncertainties. Investment likewise will stall with no clear signs so far of a global economic recovery.

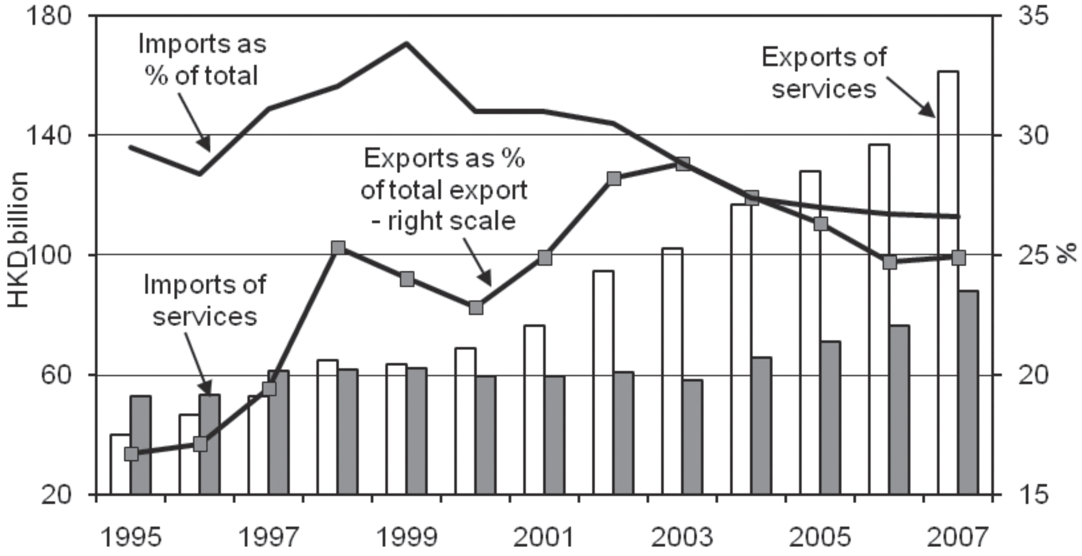
On other aspects of the economy, inflationary pressure will continue to ease, given the retreat of international commodity prices and continuous adjustments in the local property market. The headline Composite CPI will remain depressed amid slackening business conditions. Labour market conditions are about to worsen further, as reflected by the recent cut-backs in private sector vacancies. Jobless rate will rise given weaker

FIGURE 11 HONG KONG'S MERCHANDISE TRADE WITH MAINLAND (HKD BILLION AND %)

Source: Hong Kong Census & Statistics Department.

FIGURE 12 HONG KONG'S TRADE IN SERVICE WITH MAINLAND

(HKD BILLION AND %)



Source: Hong Kong Census & Statistics Department

hiring demand in the financial sector, the main driver of Hong Kong's employment growth. Hence it is the government's top priority to maintain employment and prevent job loss, which has been deliberately addressed in the Budget.

Unlike its fellow regional financial centre Singapore, which expects its economy to shrink by as much as nine percent this year, Hong Kong's economy will be somewhat cushioned by the Mainland, whose economy will probably register a growth of 6.5% as forecast by the World Bank, if not eight percent as targeted by its government. This provides a huge and growing hinterland for the SAR's economy. Indeed, Hong Kong has over time developed closer integration with the mainland economy.

Hong Kong's merchandise trade relationship with the mainland has seen steady increase since 1996, mainly on re-exports though. Overall, the Mainland is getting increasingly important as a partner of Hong Kong's trade in goods, both as an export destination and import supplier, as shown in Figure 11. Likewise trade in service has seen similar trend where Hong Kong's export of service to the mainland has increased considerably over time. See Figure 12.

To boost Hong Kong's economy, Beijing on 19 December 2008 announced 14 measures, from speeding up cross-boundary infrastructure projects to encouraging and supporting Mainland enterprises to use Hong Kong as a financial services platform. See Table 3. It also included the endorsement of the "Outline of the Plan for the Development of Pearl River Delta (PRD) Region" and another supplement to Closer Economic partnership Arrangement (CEPA). Both plans will foster closer links and co-operation between Hong Kong and the mainland economy.

For CEPA, on top of the provisions granted in previous phases, Supplement V, signed in July 2008 and effective from January 2009, includes a string of further

TABLE 3 CENTRAL GOVERNMENT'S MEASURES TO BOOST HK'S ECONOMY	
1	Allow qualified enterprises to settle trade in *renminbi* in Hong Kong;
2	Set up a currency swap arrangement between the People's Bank of China and the Hong Kong Monetary Authority;
3	Encourage Mainland enterprises to use Hong Kong as a financial services platform to start local and international businesses. Mainland organisations are also encouraged to set up or expand their branches in Hong Kong;
4	Support Mainland enterprises to list in Hong Kong;
5	Assist in speeding up the construction of the Hong Kong-Zhuhai-Macao Bridge;
6	Support the speeding up of other selected cross-boundary infrastructure projects;
7	Endorse the "Outline of the Plan for the Development of Pearl River Delta Region" to enhance cooperation among Guangdong, Hong Kong and Macao with a view to developing the region into a world-class metropolis circle;
8	Support Hong Kong enterprises to participate in the construction of Shenzhen Metro Line 4 with the Build-Operate-Transfer (BOT) mode;
9	Support the development of Shenzhen-Hong Kong border areas;
10	Consolidate Hong Kong's position as an international shipping centre;
11	Introduce policy measures to help SMEs, including Hong Kong-funded SMEs in the Mainland;
12	Expand further the Individual Travel Scheme;
13	Study further liberalisation measures with a view to signing the CEPA VI as soon as possible;
14	Ensure the stable supply of food, water, electricity and natural gas to Hong Kong.

TABLE 4 COOPERATION MEASURES WITH GUANGDONG UNDER SUPPLEMENT V TO CEPA	
Education	(i) delegate to Guangdong the authority to approve applications submitted by Hong Kong institutions for setting up schools for the children of Hong Kong residents; and (ii) set up a joint approval mechanism by the Ministry of Education and the Guangdong authorities to jointly assess and approve education institutions and projects operated jointly by Guangdong and Hong Kong;
Environment	i) permit Guangdong to approve the qualification of HKSS to set up enterprises to operate environmental pollution control facilities in Guangdong; and (ii) support the abatement of atmospheric pollution in the Pearl River Delta region, as well as the prevention and control of water pollution of the Pearl River;
Tourism	(i) extend the coverage of "simplified entry arrangement for a period of 144 hours" to the whole of Guangdong; (ii) allow Mainland-authorised Hong Kong travel enterprises to organise group tours to Hong Kong Disneyland for non-Guangdong residents who have resided and worked in private enterprises, joint venture enterprises or foreign enterprises in Shenzhen for over one year; and (iii) support Guangdong's pilot programme for a wholesale tourism reform, including the strengthening of Guangdong-Hong Kong tourism cooperation.

liberalisation measures such as expanding the business scope allowable in China for Hong Kong companies and lowering thresholds required to set up business and provide services in the mainland. The supplement allows early and pilot implementation in Guangdong province where greater power of approval of projects is delegated. See Table 4 for details.

An important area with immediate relevance is tourism. Mainland visitors to Hong Kong rose by 8.9% in 2008 while non-mainland arrivals dropped by 0.3%. Accounting for 57% of total, visitors from Mainland are getting more important to the SAR's tourism income given their rising spending power. With new facilitation measures under the Individual Visit Scheme, mainland residents especially those from Guangdong can now enjoy enhanced convenience when visiting Hong Kong, which will boost inbound tourism and in turn benefit retailing, hotels and other related industries in Hong Kong.

In the race for financial supremacy, Hong Kong still has advantages that Shanghai cannot match in terms of financial infrastructure and sophistication. However, challenges faced by SAR's financial sector cannot be underestimated as big investment decisions and big profits are increasingly being made northward in the Mainland.

Closer cooperation and deeper integration with the bordering PRD and the vast hinterland beyond have many implications. Among others, Hong Kong can raise its competitiveness as a financial centre and business hub, restructuring itself towards higher value-added and knowledge-based activities. However, one of the consequences of this rising integration is the inevitable increasing dependence of Hong Kong's economy on that of the Mainland. Yet turning to Beijing for last resort during this turbulent and difficult period is in line with the pragmatism of the SAR government.

Ranked as the world's freest economy by the Heritage Foundation for 15 straight years, Hong Kong has long followed a "Market Leads, Government Facilitates" principle in forming public policies. During economic hard times like now, the SAR government has deliberately implemented counter-cyclical measures to cope with the financial crisis which also prompted the relevant authorities to step up supervisory efforts and strengthen oversights of the financial institutions to ensure resilience. The outcome of these initiatives will have influence over whether Hong Kong's extraordinary commitment to "lassie faire" economic freedom will endure.

At industry level, Hong Kong's financial market, an integral part of the international nexus, was seriously hit by the current global financial crisis. Its financial service sector, accounting for six percent of its total workforce but 16% of GDP, is bound to be adversely affected. Activities dwindled in the financial services sector including fund raising, share trading and asset management. Indeed, financing and insurance activities had posted y-o-y decline of -0.8% and -6% in the last two quarters of 2008. What is more, due to staff retrenchment in recent months by some financial institutions, there was a decrease in sector employment by 11,400 or 5.4% from August 2008 to February 2009.

Over the longer term, the financial crisis, after fully running its course, will bring about reforms in the global financial framework, to which Hong Kong needs to use its freewheeling ability to adjust swiftly and adapt wisely. The question of its long-term pre-eminence as a financial hub resurfaces as the State Council in Beijing outlined new plans to develop Shanghai into an international financial centre by 2020. In the race for financial supremacy, Hong Kong still has advantages that Shanghai cannot match in terms of financial infrastructure and sophistication. However, challenges faced by SAR's financial sector cannot be underestimated as big investment decisions and big profits are increasingly being made northward in the Mainland.