

ECONOMIC FOCUS

Treasury Division



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Hong Kong One Year after the Financial Tsunami: Double Dip Recession Cannot be Ruled Out

The global economy is emerging from the deepest recession since the Great Depression and Hong Kong also staged a strong rebound in the second quarter, buffered by government efforts.

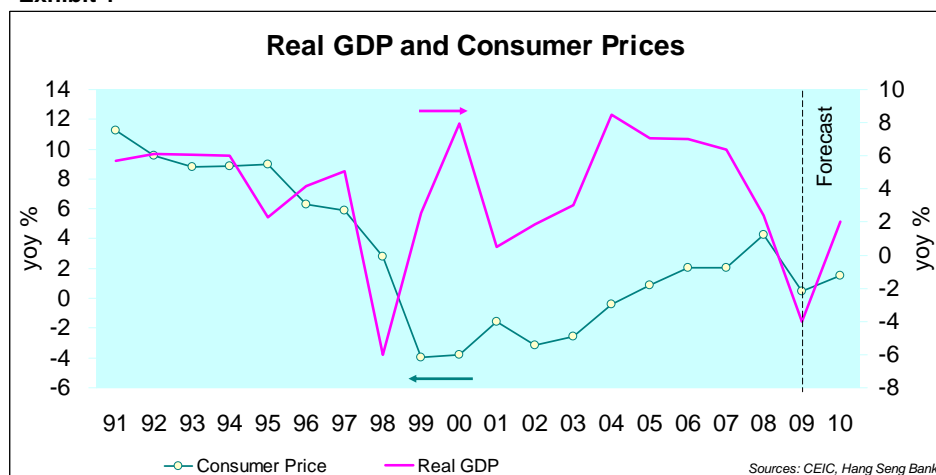
Policy makers' aggressive response to the financial crisis and economic downturn suggest that history may not repeat itself this time. However, a sustained recovery cannot rely solely on government efforts, but on consumer and business spending.

While the worst may be over, we may also have seen the strongest rebound. The local economy is still expected to contract on a year-on-year basis in the second half of the year to give a full year contraction of 4%. The outlook for 2010 is better, with a projected growth of 2.0%.

The massive fiscal stimulus and unprecedented monetary easing by governments and central banks in the major economies is not without side effects. Fuelled by excess liquidity, asset markets have rallied so fast that they can hardly be justified from the weak economic fundamentals.

Policy makers are unlikely to tighten any time soon, as growth is not solid. There is increasing risk of an asset market bubble, as the excess liquidity is likely to stay longer. The possibilities of double dip recession cannot be ruled out, if the bubble bursts.

Exhibit 1



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The Worst Is Over

The first quarter marked the end of the deepest recession in a decade for the Hong Kong economy following the collapse of Lehman Brothers in September 2008. The year-on-year contraction in GDP narrowed to 3.8% in the second quarter from 7.8% in the first. Seasonally adjusted sequential data showed that the Hong Kong economy rebounded 3.3% from the first quarter, indicating clear signs of bottoming out.

The latest economic reports from around the world also show that the pace of global contraction is easing. A major leading indicator for Hong Kong's economic growth, the US ISM manufacturing index, also signals better times ahead.

Exhibit 2

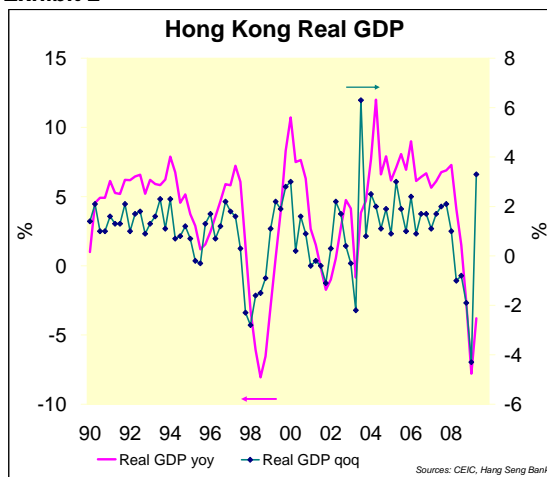
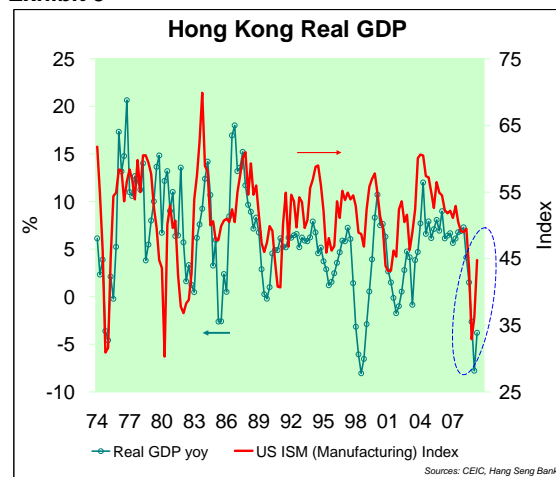


Exhibit 3



History May Not Repeat Itself

Despite the depth and breath of the crisis, the rebound appears to come earlier-than-expected. Is a strong recovery underway? Or is the present economic cycle going to track the Asian Financial Crisis -- the beginning of a six-year long economic slowdown?

The collapse in exports has been far worse than during the first year of the Asian Financial Crisis when the crisis was of much smaller scale, where countries outside of Asia maintained growth momentum.

But this time, the domestic demand displayed greater resilience. Consumption spending was less negative, underpinned by tax rebates and other fiscal stimulus. The unemployment rate rose at a slower pace, as government infrastructure projects and employment programmes helped ease some pressure in the construction sector.

Policy makers' responses suggest that history may not repeat itself this time. The question is whether the major economies' massive fiscal stimulus and central banks unprecedented monetary policy will be able to offset the effects of huge destruction of private sector wealth.



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Exhibit 4

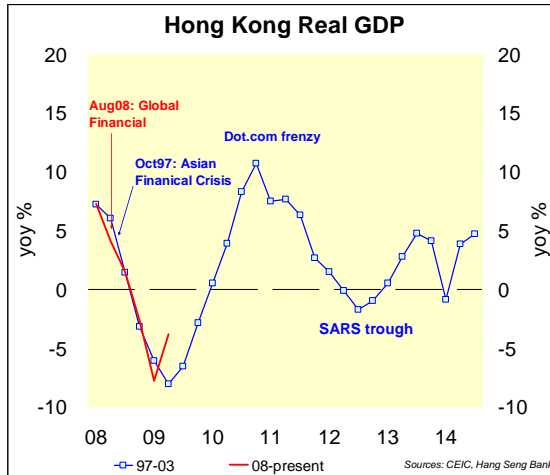


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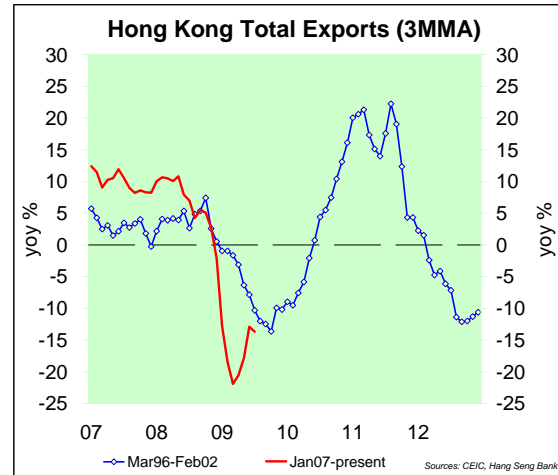


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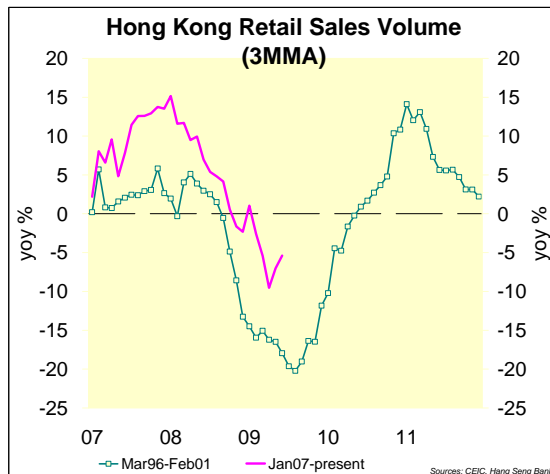


Exhibit 7



The Power of Liquidity

The massive fiscal and monetary stimulus is not without side effects. The global economy is awash with liquidity, as the depth and breath of the recession has called for central banks' ultra-loose monetary policy. The Fed cut interest rates to near zero, injected funds into financial systems and adopted unprecedented quantitative easing measures to ease stress in credit markets.

The excess liquidity depressed local interbank interest rates to near zero under the currency peg. The strong capital inflows led to a strengthening of the Hong Kong dollar, which has been trading on the strong side of the convertibility band. The aggregate balance in the banking system and monetary base has also been surging.



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Exhibit 8

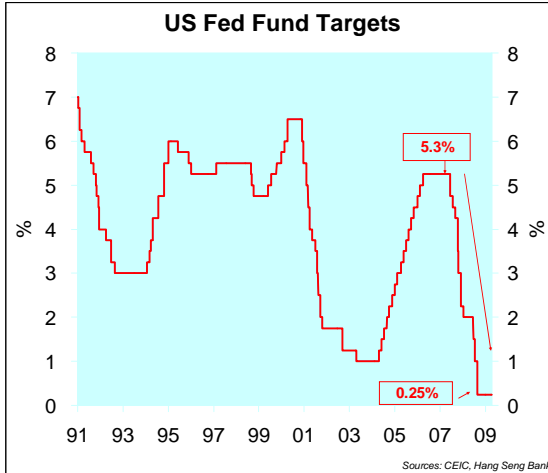


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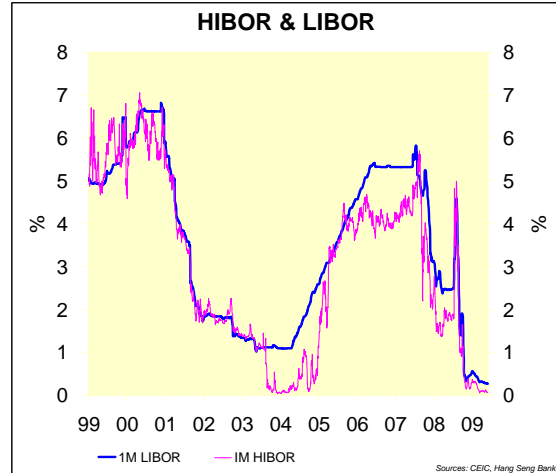


Exhibit 10

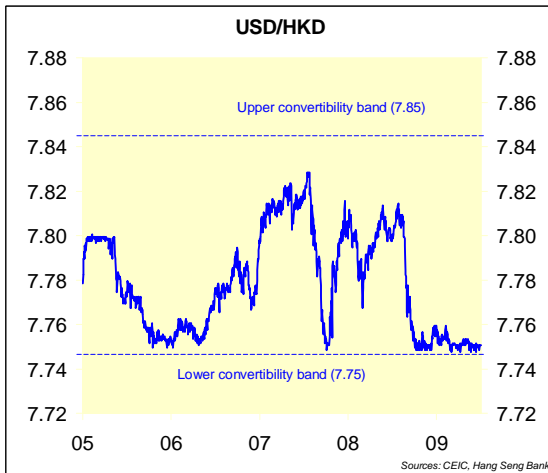
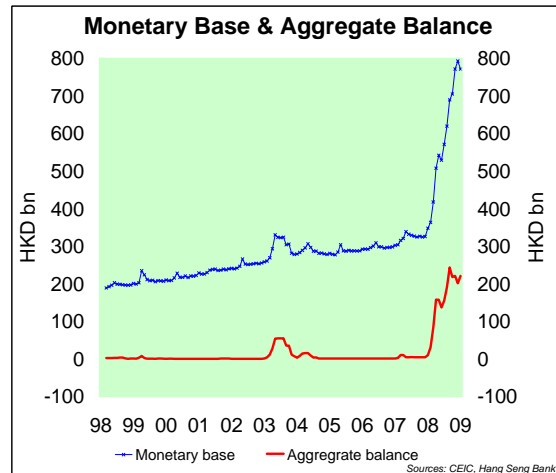


Exhibit 11



Asset Markets Runs Ahead of Economic Fundamentals

The influx of liquidity has been fuelling a stock and property market rally in Hong Kong. Property market activities picked up sharply in recent months, bouncing about 300% from the bottom. Stock market turnover also jumped over 80% from the trough. The Hang Seng Index has rebounded some 80% from its trough in October 2008. The property market has also recouped most of the losses suffered since Lehman's collapse last September.



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Exhibit 12

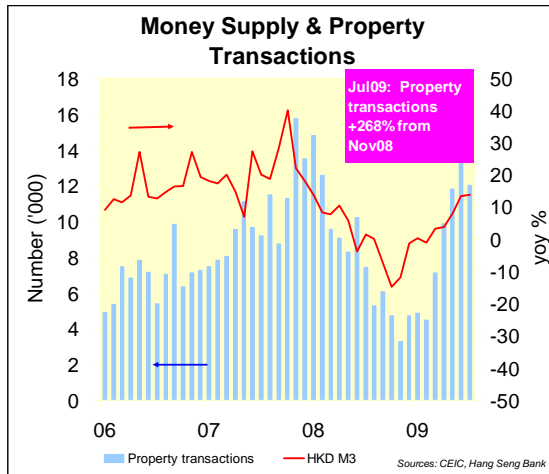


Exhibit 13

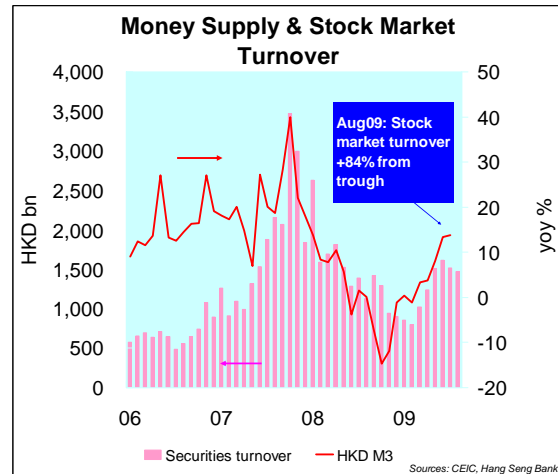
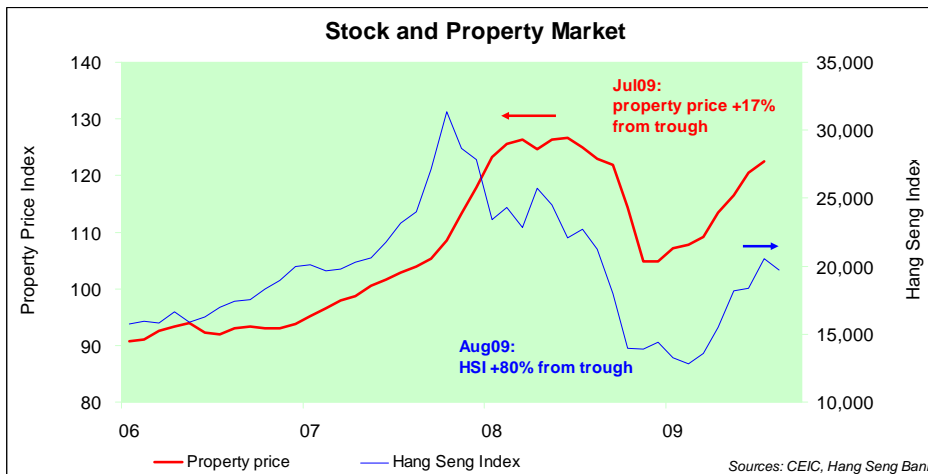


Exhibit 14



The asset market has rallied so fast that it can hardly be justified from the weak economic fundamentals. Many economies have recently revised upward the GDP forecast, as the unprecedented policy actions help stage a strong rebound in the second quarter, but World Bank, OECD and IMF still project the recovery to be weak and sluggish.

Exhibit 15: World Economic Outlook

yoy %	2009F	2010F
US	-3.0	1.8
Euro area	-4.5	0.5
Japan	-6.8	1.0
China	7.2	7.7
World	-2.9	2.0

Source: World Bank



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Exhibit 16

Alan Greenspan (former Fed Chairman)

- *“I accord a much larger economic role to equity prices than is the conventional wisdom They are not merely an important leading indicator of global business activity, but a major contributor to that activity”*
- *“That would bolster global balance sheets with larger amounts of new equity value and supply banks with the new capital that would allow them to step up lending.”*
- *“Higher share prices would also lead to increase household wealth and spending.”*

Sources: *Financial Times*, 25 Jun 2009

There is a debate that an asset market rally may actually stimulate consumer and business spending, as it helps rebuild private sector wealth. While this assertion is to be tested, a prolonged period of rapid money supply growth could lead to rising inflation risk.

The key question is when will the excess liquidity be withdrawn? Thus, central banks' exit strategy -- the timing and the scale of tightening is crucial.

Central Banks Have No Plans to Exit Quantitative Easing

Policy makers are unlikely to tighten any time soon, as growth is not solid, although they may refrain from further easing. There is increasing risk of asset market bubbles, as liquidity is likely to remain high for an extended period.

Exhibit 17: No Rush for the Exit

US

Fed kept interest rate near zero and said the rate would stay “exceptionally low” for an “extended period”, but would not increase the size of its debt purchase programme after the FOMC meeting in August.

Europe

European Central Bank (ECB) and Bank of England (BOE) also kept interest rates unchanged and signaled no signs of early exit of its strategy after their respective policy meetings in September. Bank of England kept its benchmark rate unchanged at 0.5% and did not raise its asset purchase target from GBP175 billion. At its regular meeting the ECB decided to maintain its key interest rates at 1%. The central bank chief Trichet indicated that there was no rush to withdraw its nonconventional easing measures and the bank would continue to provide its one year unlimited funds at a fixed rate of 1%.



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Double Dip Recession is Possible

The stock market balloons when money supply grows faster than economic needs. We had seen stock market bubbles in 1997, 2000 and 2007 when the growth of money supply was much faster the growth of nominal GDP. Property prices also tend to fluctuate in tandem with economic performance over a longer-term. It could not deviate too significantly from economic fundamentals. If history is any guide, there is increasing risk of asset market bubble.

Exhibit 18

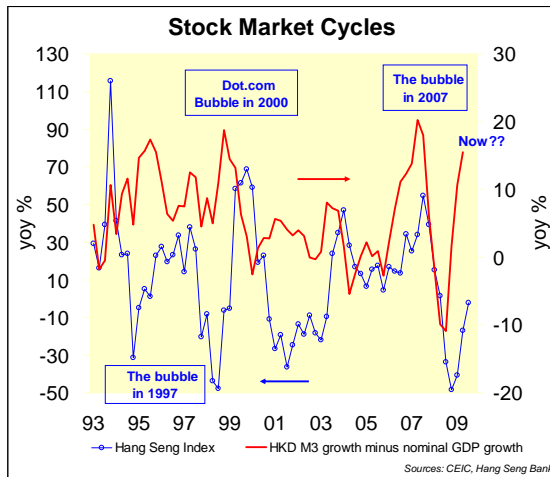
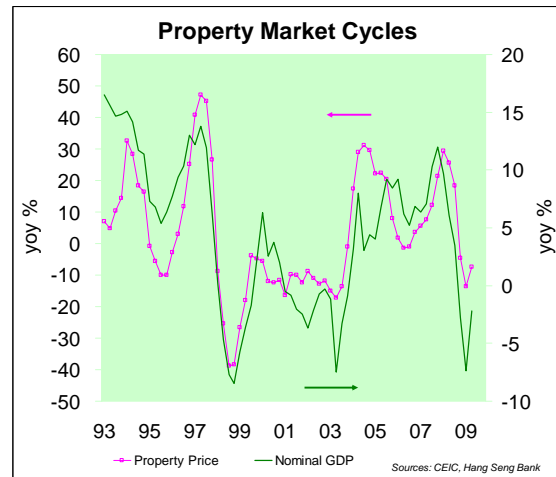


Exhibit 19



Economic Forecast

After aggressive moves by the government and central banks to ease stress in financial markets and revive growth, the worst of the recession seems to be over. Nevertheless, a sustained recovery cannot rely on government help, but on consumer and businesses. Consumers are still facing strong headwinds, as jobs are hard to come by. And businesses are hesitant to invest due to the uncertain economic outlook.

As such, we believe growth will only be tepid. We see less-severe contraction in the second half to give a full year contraction of 4%. Nevertheless, the local economy is not expected to stage a stronger rebound until the second half of next year. Thus, only a mild growth of 2.0% is projected for the full year of 2010. Central banks' adherence to their ultra-loose monetary policy posts a major downside risk to our forecast, as a bubble-burst double dip recession cannot be ruled out.

Exhibit 20: Hong Kong Economic Forecast

	Real GDP (yoy %)	CPI (yoy %)	Unemployment rate (s.a. %)
2007	6.4	2.0	4.0
2008	2.4	4.3	3.6
2009F	-4.0	0.5	5.5
2010F	2.0	1.5	6.0

Sources: CEIC, Hang Seng Bank



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