

ECONOMIC FOCUS

Treasury Division



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Hong Kong Economic Outlook: Tougher Times Ahead

Hong Kong economic growth moderated significantly to 4.2% in 2Q08 from a revised 7.3% in 1Q08 on unexpectedly sharp deceleration of the growth of consumption spending. Domestic demand, the key pillar for growth for the last few quarters, seemed no longer provide much buffer for the softening external demand.

The second quarter GDP figure sends a key message -- tougher times lie ahead. Trade performance is likely to be depressing, as the global economy is on the verge of a synchronized slowdown. Domestic demand will have to be the sole engine for growth, but it too is shifting to lower gears.

Consumption spending looks set to ease as soaring inflation is eroding consumers' purchasing power. The prolonged stock market correction and a less promising outlook for the property market could dampen consumer sentiment. At the same time, deteriorating business conditions are unlikely to stimulate investment demand, though the negative interest rate environment should lend some support to investment activities buffering a sharp deceleration.

Hong Kong economic growth is likely to decelerate sharply in the second half and possibly stay low for a greater part of 2009. We have thus revised downward the real GDP growth for the full year of 2008 to 4.3% from an initial estimate of 5%, that implies real GDP growth could slow to 3% in the second half, from 5.8% in the first half. Growth for 2009 is likely to go lower to 3.3%.

Exhibit 1

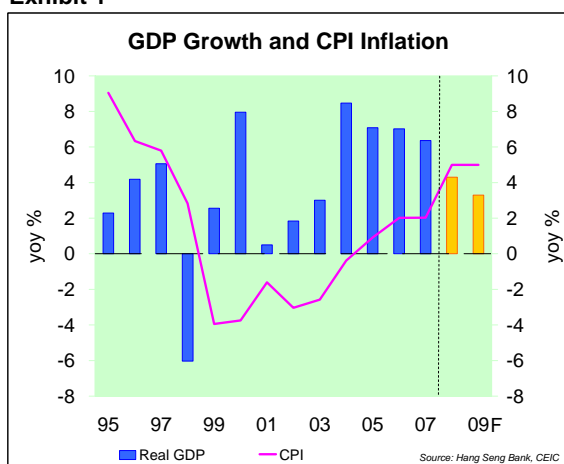
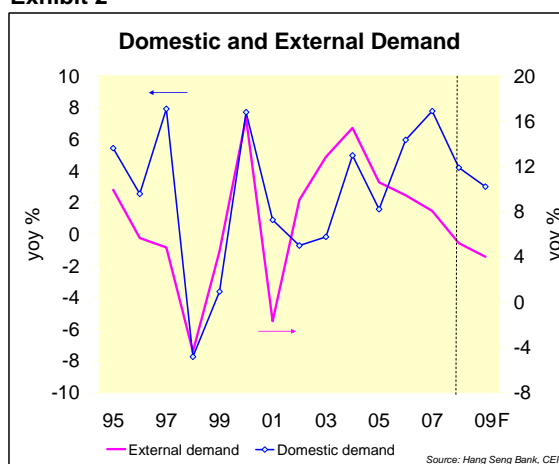


Exhibit 2



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Inflation Curbs Consumption

Hong Kong economic growth moderated significantly to 4.2% in 2Q08 from a revised 7.3% in 1Q08. The material moderation was due to a significant deceleration of growth in exports and unexpectedly sharp moderation of consumption and investment spending.

Domestic demand, the key pillar for growth for the last few quarters, could no longer provide much buffer for the softening external demand.

The second quarter GDP figure sends a key message -- tougher times ahead. Trade performance is likely to be depressing, as the global economy is on the verge of a synchronized slowdown. Domestic demand will have to be the sole engine for growth, but it too is shifting to lower gears.

The ease in consumption spending growth was due partly to the mounting inflationary pressure eroding consumers' purchasing powers. Consumer price inflation surged to an 11-year high of 5.7% in 2Q08. Though nominal wage growth also reached a nine-year high of 3.8% in 1Q08, real wages actually went negative exerting adverse impact on consumer spending.

The widening gap between the nominal and real consumption spending also provides some clues. The gap between nominal and real consumption spending growth more than doubled from 2% in 1Q07 to 5.1% in 2Q08.

Exhibit 3

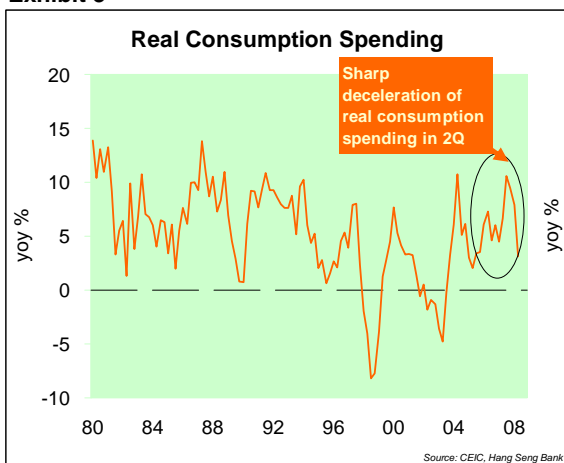
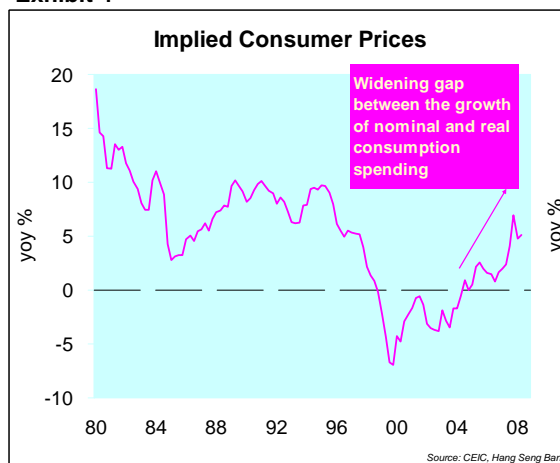


Exhibit 4



Prolonged Stock Market Correction Dampens Consumer Sentiment

The prolonged correction of the stock market has also dampened consumers' willingness to spend. The Hang Seng Index has been on a downtrend since the beginning of this year, plunging over 30% from its October 2007 peak, wiping out more than HK\$7 trillion of wealth.



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Earlier this year, the property market rally had offset the negative wealth effect of the stock market downturn. However, the latest property market transactions slipped and prices started to drop. The less promising outlook for the property market will give less support for the consumer, suggesting that consumer spending is likely to ease further.

Exhibit 5

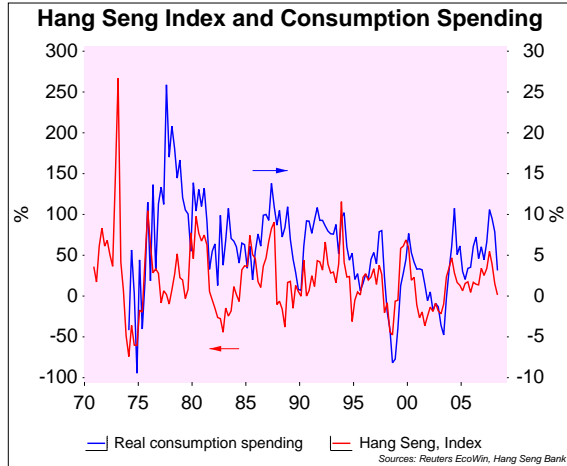
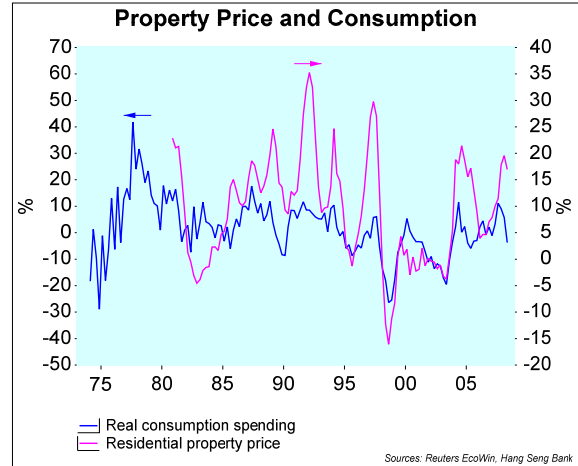


Exhibit 6



Negative Interest Rate Buffers Investment

Hong Kong's investment spending is highly correlated with the export performance, as a large part of the territory's services is to support trade and related activities. Going forward, the weakening exports performance is likely to weigh on investment spending. Nevertheless the negative interest rate environment should lend some support to investment activities buffering a sharp deceleration in investment spending.

Exhibit 7

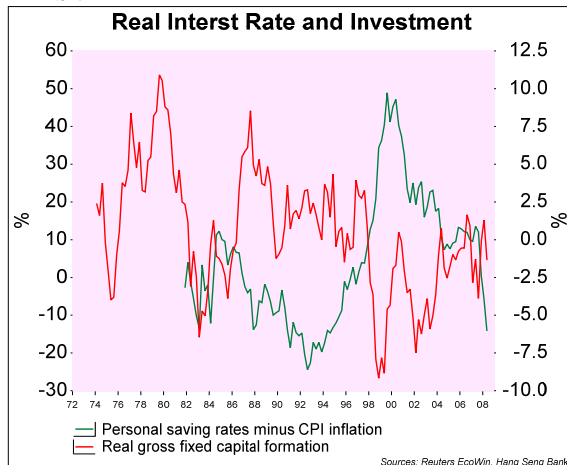
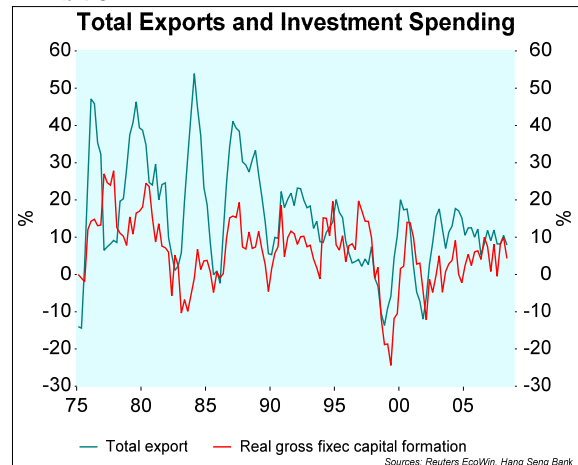


Exhibit 8



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Inflation Stays High

While Hong Kong's economic engine looks set to gear down, inflation stays high. Consumer price inflation crept up to a decade high of 5.7% in 2Q08 with surging global food and energy prices being the main culprits filtering through a wide range of consumer goods and services.

The pass-through is yet to be completed as international oil and commodity prices are still hovering at high level. Albeit easing from the peak of USD147 a barrel touching on 11 July, crude oil is traded around USD113 a barrel, about 25% higher than the start of the year. If history is any guide, Hong Kong's inflation is poised to stay high and real GDP growth to decelerate!

Exhibit 9

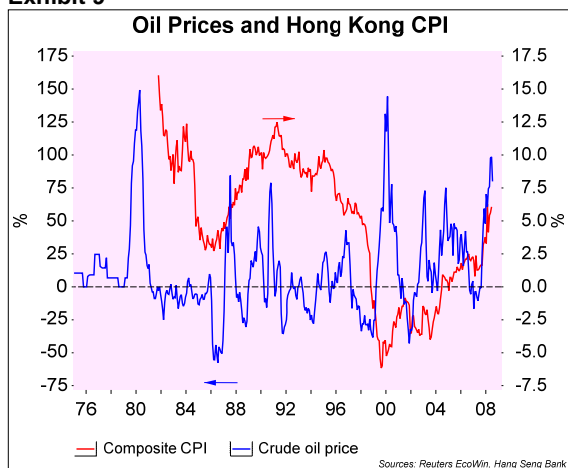
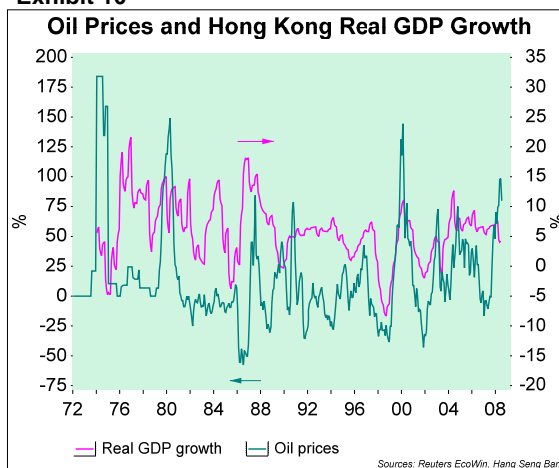


Exhibit 10



Forecast for 2008 and 2009

Hong Kong has just joined Japan and Singapore to have their economies contracted in the second quarter on a quarter-to-quarter basis. The IMF sees a significant global slowdown for 2008 and 2009, the Asian Development Bank also has revised downward its 2008 growth forecast for developing economies in Asia to a five-year low on more protracted US slowdown and elevated food and oil prices.

Exhibit 11: World Economic Outlook

(%)	2006	2007	2008F	2009F
World	5.1	5.0	4.1	3.9
US	2.9	2.2	1.3	0.8
Euro zone	2.8	2.6	1.7	1.2
Germany	2.9	2.5	2.0	1.0
UK	2.9	3.1	1.8	1.7
Japan	2.4	2.1	1.5	1.5

Source: IMF World Economic Outlook Update, July 2008



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Against this backdrop, the territory's economic growth is likely to decelerate sharply in the second half and possibly stay low for a greater part of 2009. Goods exports look set to be reined in further by waning global demand, as the US weakness seemed to have spread beyond the industrial world to major economies in Asia. Domestic demand will have to be the sole engine for growth. But the engine looks set to run on lower gears.

We have thus revised downward the real GDP growth for the full year of 2008 to 4.3% from an initial estimate of 5%, implying that real GDP growth could slow to 3% in the second half, from 5.8% in the first half. Growth for 2009 is likely to go lower to 3.3%.

Exhibit 12: Hong Kong Economic Forecast

	yoy % change		
	2007	2008F	2009F
Real GDP	6.4	4.3	3.3
Composite CPI	2.0	5.0	5.0
Unemployment Rate	4.0	3.8	4.2

Source: Census & Statistics Department, Hang Seng Bank

On the other hand, Hong Kong's inflation looks set to stay high if not to climb higher, as global oil and commodity prices are still hovering around high levels. Nevertheless, the government's relief measures of waiving property rates, providing electricity subsidies etc are likely to suppress headline consumer price inflation in the coming months, helping to keep the full year inflation rate at 5.0%.

However, the extended period of elevated oil prices means that inflation could stay high in 2009, though probably not skyrocketing, as a global downturn would eventually dampen oil demand, putting a lid on oil prices and taming inflation. We see 2009 inflation stay high at 5.0%.



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