Hang Seng Economic Monthly

Nov/Dec 2005

Continuation of Resilient Growth

Economic Outlook for Mainland China and Hong Kong in 2006

- *Mainland China's ability to simultaneously maintain rapid economic growth and low inflation should not be underestimated. Continuing demand for cheap manufactured goods, rapid industrialisation unleashing huge production capacity and ongoing cost advantages will all help to sustain the near double-digit real growth of the economy. The major challenge will be to further strengthen the Mainland's financial systems to support this rapid growth.*

- *Hong Kong's accelerating growth throughout the year despite rising interest rates was a pleasant surprise. The Mainland's stellar trade performance has definitely contributed, as has the improving labour market which has helped sustain private consumption. Growth could stay above trend, though moderating slightly, in 2006. The trend in interest rates will hold the key to the pace of growth.*

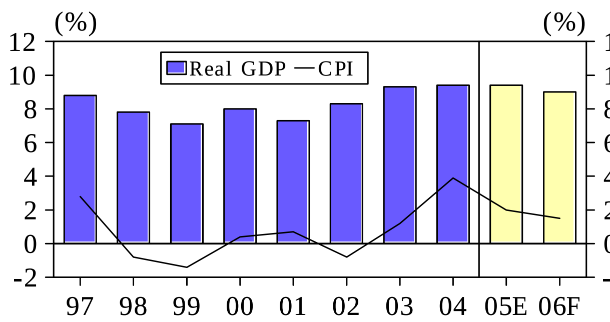
Mainland China

- The export and investment driven growth model is unlikely to show much change in 2006, given the Mainland's comparative advantages in exports and strong investment momentum driven by ample liquidity. Managing the widening trade surplus and rising foreign reserves are key to preventing the natural tendency to over-invest.

- A slight slowing to a still respectable 9% real GDP growth is expected, amid relatively loose monetary policies and administrative measures.

- There continues to be a lack of underlying inflationary pressure in the Mainland with capacity still chasing demand. Consumer price inflation of 1.5% is projected for 2006.

Mainland China's GDP Growth and Inflation



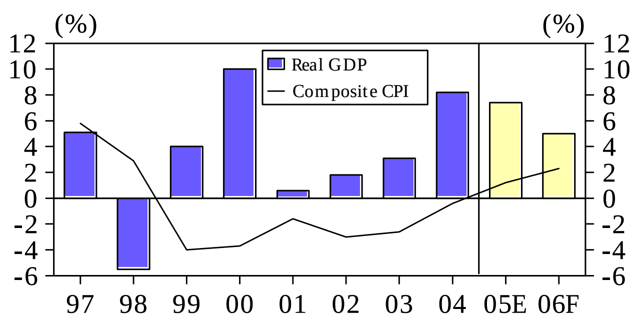
Hong Kong

- Hong Kong's closer economic relationship with the Mainland is crucial to maintaining growth in external trade in both goods and services, particularly financial services.

- Although interest rates in Hong Kong will follow the US rates up, which could restrain domestic activities, the impact will be moderated significantly by positive consumer confidence, underpinned by continuing improvement in the labour market.

- Assuming there is a pause in rate rises after the 50 basis point rate hike that is widely anticipated before January next year, Hong Kong is likely to achieve real GDP growth of 5.3% in 2006.

Hong Kong's GDP Growth and Inflation



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HANG SENG BANK

Mainland China — Fast Pace to Continue

The internal conditions that sustain fast growth are still intact due to an abundant labour supply and a substantial cost differential as compared with the rest of the world.

No Slowdown in 2005

China's rapid economic growth and low inflation in 2005 is a spectacular achievement. There were widespread expectations of an economic slowdown amid continued implementation of the government's tightening measures, but China's real GDP growth reached 9.4% in the first nine months of this year, beating even the most optimistic forecast, and 2005 is set to be the third consecutive year that China has attained 9%-plus growth. However, what is more striking is the declining inflation that has accompanied the rapid pace of economic growth. Consumer price inflation has edged down consistently from 5.3% in the third quarter of 2004 to 1.2% in October this year. Producer price inflation has also slipped from over 8% in October 2004 to 4% in October this year.

China's ability to achieve such an extraordinary pace of growth can be traced to its huge productivity gain after its entry to the World Trade Organisation (WTO) in late 2001. Many foreign manufacturers accelerated the pace of relocating their manufacturing facilities to China after its WTO entry, as evidenced by the massive foreign direct investment flows into its manufacturing sector during 2002-2004, which totalled US$117 billion — 50% more than during the preceding three years. As a result, China's export base has greatly expanded: exports grew by 31% in the first 10 months of 2005, following on from 35% growth in each of the previous two years. The rapidly expanding export base has given rise to an investment boom in a wide range of industries.

Table 1
China's Share in Major Export Markets

(%)

	00	01	02	03	04	Oct 04 - Sep 05
Japan*	18.2	20.7	22.7	24.9	26.5	28.0
US	8.2	8.9	10.7	12.1	13.4	14.4
EU 25	7.5	8.3	9.5	11.2	12.3	12.7#

*Notes: * China's products as share of Japan's non-oil imports.*
 # 1H 2005 figure for EU.

This expanding production capacity has also sown the seeds for the return of low inflation. China was in a deflationary environment during 1998-2002 due to widespread excess capacity in many downstream industries. Rising inflation in 2003 and 2004 was driven mainly by a surge in the price of grain and shortages in upstream industries amid an export boom. However, both consumer and producer price inflation have recently begun to soften, with grain production increasing and additional capacity in upstream industries coming on line following an investment boom that has lasted for three years.

Government policies have also contributed to the positive development. In the face of easing inflation, the government has relaxed administrative measures adopted to curb investment growth and refrained from further hiking interest rates. In the meantime, it has boosted investment in upstream industries where supply has struggled to keep up with the rapid growth in demand. These moves have helped maintain the momentum of the economy while mitigating industrial bottlenecks.

Sustainability of Growth

Despite China's enviable achievement, its growth model has been called into question by some observers. Such observers say China's development is not sustainable as it is too reliant on exports and investment for growth and that domestic consumption is still too weak to absorb the impact of any slowdown in these two drivers. Comparing 2001 to the first three quarters of 2005, the share of exports in GDP rose from 23% to 42%, and fixed capital formation as a share of GDP rose from 38% to an estimated 48%. Private consumption as a share of GDP declined from 47% in 2001 to 43% in 2004. The pessimistic view is that China's growth will collapse — resulting in immense excess capacity — if there is a synchronised slowdown in its export destinations.

Our view is that the Mainland's existing development strategy of relying on exports to drive growth is consistent with its comparative advantage. Some 47% of China's labour force still engages in primary industry and wages in the manufacturing sector are only 5% of those in the US and Japan. Abundant surplus labour in the agricultural sector and low per-capita income mean that the Mainland will have a comparative advantage in exporting labour-intensive goods for many years to come. In addition, China is home to one-fifth of the world's population but only accounts for around 8% of world exports. China's relatively small share in the global market and its sustained cost advantage mean that there is still much room to drive growth through expanding exports.

There is also huge pent-up demand for investment as China's industrialisation and urbanisation are

Chart 1
Exports, Investment and Consumption

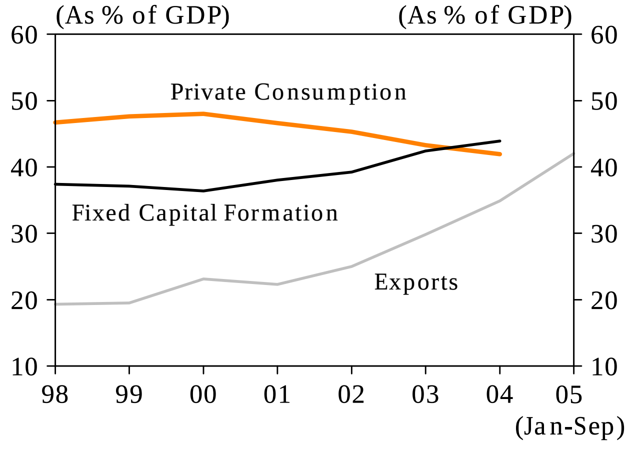
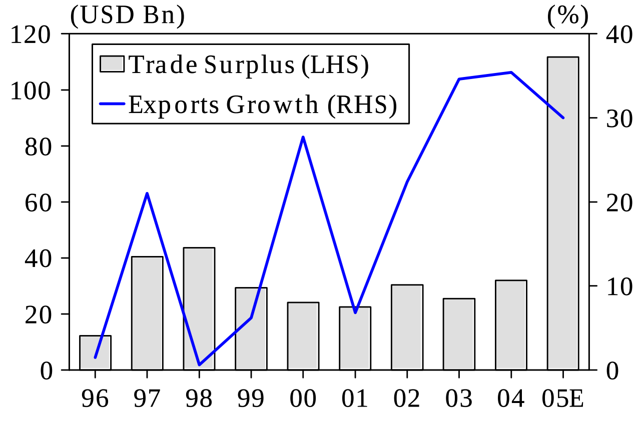


Chart 2
Export Growth and Trade Surplus



both still at an early stage. China is set to climb the value-added ladder and export increasingly sophisticated products in a growing number of industries. China will not have enough production capacity to meet the demand for its exports if it is not supported by adequate investment growth. China's infrastructure, particularly that in inland areas, remains underdeveloped, calling for enormous construction ranging from roads and railways to tap water supplies and telecoms networks. Moreover, more than half of the Mainland's population still resides in rural areas, and there is considerable scope for further urbanisation, which will require huge investment in the urban property sector.

Of course, China is not immune to the risks and volatility associated with its course of economic development. First, its export-oriented development strategy and success in substituting imports with domestic products have given rise to persistent trade surpluses and the rapid accumulation of foreign reserves. This has led to friction with its trading partners and pressure on its currency. Second, China is periodically plagued by imbalances arising from the fact that there is too much easy capital around and that many enterprises make investment decisions without fully regarding the potential risks. China needs to improve the efficiency of capital allocation and continue to reform state enterprises so that a balance in its investment structure can be achieved without constant government intervention.

Economic Outlook in 2006

China's economic engine will remain in high gear in 2006. On the demand side, exports will continue to be the key driver. Direct investment flows into China totalled USD48.4 billion in the first 10 months of 2005, close to the USD49.5 billion registered in the same period last year. Such strong direct investment inflows portend that China's export performance should fare well in the near future. Though external demand from the US is likely to weaken as rising interest rates take a toll on the housing market and private consumption, a recovery in Japan's economy and the firming momentum in the European Union should partly offset weaker US demand. China's export growth is projected to remain strong at 25% in 2006, compared with an estimated 30% in 2005.

Consumption growth will be sustained amid healthy income growth and government support. Consumer finance should take a step forward as the central bank has just established the first nationwide credit database - linking 127 banks - for individual borrowers. The threshold for paying income tax is likely to increase from RMB800 to RMB1,500, boosting the disposable income of the lower income classes. The government also intends to increase public spending on social welfare and the rural economy. Retail sales of consumer goods, the barometer of private consumption in China, are expected to grow by 14% in 2006, against an estimated 13.5% growth in 2005.

Table 2
The Mainland's Economic Forecast

(Yoy % Change)

	2004	2005E	2006F
Retail Sales	13.3	13.5	14.0
Fixed Asset Investment	25.8	25.0	22.0
Industrial Value-added*	16.7	15.8	15.0
Foreign Direct Investment	13.3	-2.0	5.0
Merchandise Exports	35.4	30.0	25.0
Merchandise Imports	36.0	17.5	25.0
Trade Balance (USD Bn)	31.9	111.7	139.7
Gross Domestic Product*	**9.5**	**9.4**	**9.0**
Consumer Price Index	3.9	2.0	1.5

*Note: * Real growth.*

The government is likely to adopt a relatively accommodative monetary policy in the coming year. Easing bottlenecks and low inflation should prompt policymakers to keep the benchmark interest rate unchanged. The latest money supply trend indicates there is already ample liquidity in the economy. The growth of M2 rose from 14% in early 2005 to 18% at the end of October. The government's accommodative policy coupled with ample liquidity in the banking system should lend support to investment growth in the coming year. Fixed asset investment is forecast to grow by 22% in 2006, not much below the estimated 25% growth this year.

Overall, China's real GDP growth is forecast to moderate slightly to 9.0% in 2006 from the estimated 9.4% growth in 2005. Inflation will remain low due to the large supply of labour, liquidity and physical capital stocks. Consumer price inflation is projected to be 1.5% in 2006, compared with the estimated 2.0% this year.

Conclusion

Rapid industrialisation in China is unleashing huge production capacity from the rural sector to the manufacturing sector, underpinning rapid export and economic growth. The internal conditions that sustain fast growth are still intact due to an abundant labour supply and a substantial cost differential as compared with the rest of the world. But as exports gradually account for a greater share of GDP, China's growth will inevitably become more influenced by the state of the global economy in the future. China's capital markets and macroeconomic policy framework should therefore be strengthened to meet the challenges created by swings in economic conditions.

Hong Kong — Impact of Rising Interest Rates

The Hong Kong economy will continue to exhibit a solid and broad-based upturn in 2006, though at a less rapid pace with interest rates at higher levels and the global economy flattening. Interest rate trends will hold the key to the pace of growth.

Strong Momentum Remains Intact

The Hong Kong economy remained strong in 2005, underpinned, as in 2004, by robust export growth and a steady increase in domestic demand. Rising oil prices and interest rate hikes, though instilling a sense of cautiousness, have failed to suppress the gaining momentum of the economy. Real GDP surged by an average of 7.3% in the first nine months of 2005 and is expected to grow by 7.7% in the last quarter. For 2005 as a whole, real GDP is projected to grow by 7.4%, following 8.2% growth in 2004.

The underlying drivers of the solid and broad-based economic upturn experienced since mid-2003 currently remain largely intact. On the external front, exports of goods and services are still growing at an upbeat pace, following strong growth of 11.1% and 8.5% respectively in the first nine months of 2005. Merchandise exports have been supported by the persistent expansion of the global economy and mainland China's strong trade flows, while exports of services have sustained their growth momentum through surges in offshore trade and use of logistic services, and the growing appetite of Mainland companies for Hong Kong financial services.

On the domestic front, consumer spending and investment are being supported by positive economic prospects and improved sentiment. The latest round of interest rate hikes, which began in March this year, have not yet had any significant adverse impact on domestic economic activities. The underlying robustness of consumer spending is also underpinned by the improving labour market. Since the economy started to recover in mid-2003, a total of 227,000 new jobs have been created, including 69,000 since the beginning of 2005. In October, the headline unemployment rate dropped to a four-year low of 5.3%. These developments, coupled with the average 2-3% pay rise in 2005, have helped sustain the upsurge in consumer spending. Rising property prices have also contributed significantly to the creation of a positive wealth effect. Although the property market has eased back modestly in recent months, average residential property prices are still up by around 10% since the end of 2004.

The resilience of the economy amid the persistent rise in interest rates is a pleasant surprise, but there is growing speculation over whether and how long this can last as rates are still on an uptrend. The US Federal Reserve has raised the Fed funds target rate by a total of 300 basis points in 12 consecutive 25 basis point hikes since mid-2004. The Hong Kong prime rate has followed this movement in US rates, rising by a total of 250 to 275 basis points so far this year. The market consensus is that the Fed funds target rate will go up by another 50 basis points and peak at 4.5% in January 2006. If US interest rate hikes go beyond the market expectation, the underlying momentum of the Hong Kong economy could be affected.

Impact of Rising Interest Rates

Higher interest rates in the US can theoretically affect Hong Kong in two ways. On the external side, global growth would likely decelerate if higher US interest rates trigger a major slowdown in the US economy. A slower global economy would moderate Hong Kong's trade performance. However, this is likely to be mitigated by the continuing strength of Mainland exports, which are sustained by the continuing relocation of foreign companies' production facilities to the Mainland. Thus, the impact of higher interest rates on Hong Kong's external demand is likely to be modest.

However, the negative impact of higher interest rates on domestic demand has the potential to be more profound. An increase in interest rates raises the cost of capital and this will have an impact on both consumption and investment. When interest rates go up, it encourages savings and businesses tend to slow down the implementation of their business plans.

The last interest rate up-cycle occurred in 1994 and 1995. During the period, the prime lending rate in Hong Kong went up by a total of 250 basis points from 6.5% to 9%. In response, real GDP growth dropped by 1.7 percentage points. This slowdown was mainly the result of slower domestic demand as external demand growth had actually increased from 9.7% in 1994 to 10.4% in 1995. In contrast, domestic demand and retail sales slowed by 4.4 and 7.2 percentage points respectively. This weaker consumer demand was likely attributable to the interest rate hikes during the period and the 12.3% drop in property prices. The unemployment rate also went up – from 1.9% in 1994 to 3.7% in 1995 – as employers became increasingly cautious after the successive rate hikes.

However, this is not the same economic cycle and there are several significant differences between now and the 1994-95 economic adjustment. First, interest rates are rising from a very low level. Prime rate is currently still more than one percentage point lower than the level reached in 1995. Moreover, liquidity in the banking sector has resulted in lower borrowing costs for both corporations and households. Second, the labour market is still buoyant and the property market recovery appears robust. Against this backdrop, the negative impact of rising interest rates in the current cycle is likely to be more moderate when compared with the historical experience during the 1994-95 cycle.

Forecast for 2006

Interest rates are likely to be the biggest influence on Hong Kong's economic performance next year. Our base case assumes that US interest rates will go up by another 0.5 percentage points from the present level to reach a peak in January next year. In this case, Hong Kong's prime lending rate will reach 8.0%. However, a new Fed chairman will take over in February next year. Coupled with the well-stretched interest rate hikes, this could mean that future Fed actions will be less predictable. The newly appointed Fed Chairman Ben Bernanke favours inflation

Table 1
Interest Rate Up-Cycles: 1994-95 vs 2004-05

	1994		1995	Change / Impact	2004 Actual		2005 Projection	Estimated Change / Impact
Interest Rate								
US Prime	6.0%	→	9.0%	+3.0p.p.	4.0%	→	7.25%	+3.25p.p.
HK Prime	6.5%	→	9.0%	+2.5p.p.	5.0%	→	7.75%	+2.75p.p.
Real GDP (Yoy % Change)	5.6%	→	3.9%	-1.7p.p.	8.2%	→	7.4%	-0.8p.p.
Property Price HK Class A (HKD/sq.ft.)	4,981	→	4,367	-12.3%	2,928	→	3,625	+23.8%
Retail Sales (Yoy % Change)	11.9%	→	4.7%	-7.2p.p.	10.8%	→	6.8%	-4.0p.p.
Domestic Demand (Yoy % Change)	11.0%	→	6.6%	-4.4p.p.	4.9%	→	1.7%	-3.2p.p.
Unemployment Rate	1.9%	→	3.7%	+1.8p.p.	7.3%	→	5.2%	-2.1p.p.

targeting – a practice that will generally leave less room for the Fed to resist rate increases when inflation trends up. There is still a risk that US inflation will gather pace on the back of higher oil prices and that US interest rate hikes will exceed the market's 50 basis points expectation.

The value of the US dollar is another factor that will affect Hong Kong's economy in 2006. The US dollar has appreciated 10-15% against most major currencies in 2005 to date and is likely to start weakening next year. Sentiment may change as favourable interest spreads for the US dollar begin to turn around or when the market again focuses on the huge current account deficit of the US. In general, a weaker US dollar improves the outlook for most Asian economies, including the Mainland and Hong Kong, as most currencies in the region closely follow movements in the US dollar.

Under such an external environment, the strength of Hong Kong's economy is likely to be maintained in 2006 and the pace of growth should stay above trend. Nonetheless, it is unlikely that the fast pace of growth in 2004 and 2005 can be maintained with interest rates at higher levels and the global economy flattening. In our base case forecast, the rising trend in US interest rates will end in January. Hong Kong is forecast to achieve GDP growth of 5.3% in 2006.

Exports of goods and services are expected to continue to benefit from the Mainland's strong trade performance and to register real growth of 8.5% and 6.4% respectively in 2006, slightly slower than the estimated 11% and 8% growth for 2005. As for domestic demand, after four quarters of inventory adjustment, businesses started to rebuild inventory again in the third quarter of 2005. This trend is expected to continue into next year. Together with an estimated 3% increase in private consumption, total domestic demand is projected to grow by around 3.5% in 2006, up from estimated growth of 1.9% in 2005.

However, should interest rates fail to peak in January 2006 and continue to go up, the impact on domestic demand will become more apparent. An extra one percentage point increase in interest rates from our base case assumption will likely pull real GDP growth down towards the 4% level.

Consumer prices will remain moderate with local demand likely to slacken a bit next year, but rising rentals will continue to push up overall price levels. The Composite CPI is forecast to rise by 2.3% in 2006, up from this year's estimated 1.2% increase. Meanwhile, the employment situation will continue to improve, albeit at a slower pace, with the unemployment rate projected to fall to 4.5% by the end of 2006.

Conclusion

With inflation creeping up and unemployment expected to fall below 5% next year, the Hong Kong economy is finally returning to a 'normal' pre-1997 Asian financial crisis condition. Challenges still persist, not least avoiding excessive volatility in the property market. As to the possible consequences of an 'Avian Flu' outbreak, it is beyond the prediction of any normal economic forecast. Experience of the SARS outbreak in 2003 suggests that the economic impact of a pandemic could be great, but that the rebound may be swift.

Table 2
GDP Forecast

(yoy % change)

	2004	2005E	2006F
Private Consumption	6.8	3.8	3.0
Government Consumption	0.7	-2.5	1.0
Gross Fixed Capital Formation	4.1	2.2	2.0
Exports of Goods	15.3	11.0	8.5
Imports of Goods	14.1	8.1	7.9
Exports of Services	15.3	8.0	6.4
Imports of Services	10.7	3.5	3.4
Real GDP	**8.2**	**7.4**	**5.3**
Domestic Demand	4.9	1.9	3.5
External Demand	15.3	10.5	8.1
Composite CPI	-0.4	1.2	2.3
GDP Deflator	-3.3	-0.5	1.0
Nominal GDP	**4.7**	**6.8**	**6.3**

MAJOR ECONOMIC INDICATORS

INDICATORS	Oct 05	Sep 05	YOY Change (%) Oct 05	YOY Change (%) Sep 05	YOY Change (%) 2004	YOY Change (%) 2003
REAL GDP (HKD Mn) (at constant (2000) market prices)	418,895*	386,033#	+8.2*	+7.3#	+8.2	+3.1
CONSUMER PRICE INDEX (1999/00=100)						
Composite CPI	93.6	93.3	+1.8	+1.6	-0.4	-2.6
CPI(A)	94.2	94.1	+1.7	+1.5	0.0	-2.1
CPI(B)	93.3	93.1	+1.9	+1.7	-0.5	-2.7
CPI(C)	93.1	92.8	+1.9	+1.7	-0.9	-2.9
EXTERNAL TRADE (HKD Mn)						
Domestic Exports	15,697	14,351	+27.6	+24.2	+3.5	-7.1
Re-exports	197,806	195,814	+10.5	+16.5	+16.8	+13.4
Imports	210,028	214,350	+9.7	+15.1	+16.9	+11.5
Trade Balance	+3,476	-4,185	—	—	—	—
EMPLOYMENT AND WAGES@						
Unemployment Rate (%)	5.3^	5.5	—	—	—	—
Underemployment Rate (%)	2.5^	2.6	—	—	—	—
Labour Force ('000)	3,609.0^	3,597.3	+1.3^	+1.2	+1.6	+0.3
Real Wage Index	116.2*	116.3#	-0.9*	-0.5#	-1.1	+0.1
MONEY AND BANKING (HKD Mn)						
Money Supply						
Total M1	445,202	431,190	-2.3	-3.1	+17.2	+39.8
HKD M1	359,427	350,711	-6.9	-5.5	+16.3	+36.8
Total M3	4,300,272	4,270,587	+7.1	+8.1	+8.6	+8.3
HKD M3§	2,286,848	2,294,675	+7.6	+10.1	+4.6	+5.9
Deposits						
Total	3,956,324	3,925,974	+7.0	+8.1	+8.4	+7.5
In HKD§	2,073,116	2,080,347	+7.7	+10.6	+4.5	+5.8
Loans and Advances						
Total	2,293,329	2,269,115	+9.7	+9.2	+5.9	-2.0
Trade Financing	147,465	147,460	+13.2	+14.4	+30.0	+10.2
Other Use in HK	1,908,260	1,887,422	+9.4	+8.8	+4.9	-2.0
Best Lending Rate (% pa)	7.00	6.82	—	—	—	—
EFFECTIVE EXCHANGE RATE INDEX	98.3	97.4	-0.1	-1.3	-2.4	-3.2
TOURIST ARRIVALS (NUMBER)	2,145,335	1,787,728	+6.4	+5.9	+40.4	-6.2
HANG SENG INDEX OF STOCK PRICES (31/7/64=100)						
High	15,394	15,431	—	—	—	—
Low	14,216	14,983	—	—	—	—
Close	14,386	15,429	+10.2	+17.6	+13.2	+34.9

@ *Monthly figures refer to the three-month period ending in the stated month*
§ *Adjusted to include foreign currency swap deposits*
^ *Provisional figure*
# *2nd quarter, 2005*
* *3rd quarter, 2005*

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