▪ Hong Kong

UOB Economics Projections	2006	2007	2008F	2009F
GDP	7.0	6.3	6.3	2.5
CPI (average, y/y)	2.0	2.0	2.0	4.1
Unemployment Rate (%)	4.2	3.2	3.2	3.8
Current account (% of GDP)	12.1	13.6	13.6	5.8
Fiscal balance (% of GDP)	4.0	7.7	7.7	-3.5

HKD has strengthened to the strong side of the trading band as the global credit crisis worsened since mid-Sep. It is worth noting that the USD/HKD forward markets are still relatively sanguine. We see little debate on the HKD exchange rate system for now but deflationary pressures are likely to see renewed question on the current arrangement. For now, lack of an alternative reserve currency would see USD/HKD continue to hover within the 7.75-7.85 range.

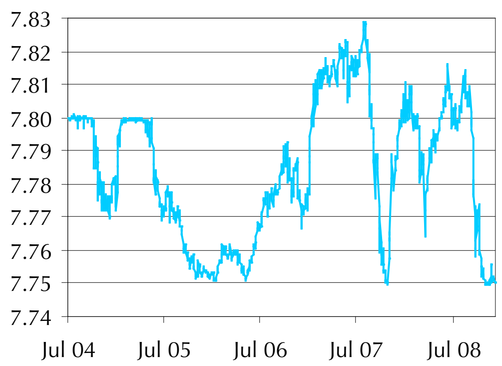
As in previous episodes of downturns, the plunge in end-demand from advance economies, due to the impact of the global credit crisis on the real economy, excess production capacity, and decline in commodities prices are certain to pressure on Hong Kong's consumer prices. We expect deflation to emerge by early 2Q09 and persist through at least 2010.

The downward pressure on consumer prices is reflected in weakness in domestic demand, which has contributed negatively in the 2Q/3Q period and is expected to drag on into 2009. We look for Hong Kong's headline GDP to contract for a period of 4 quarters before turning around in 4Q09.

HKD Pressing Against The Strong Side

With HKMA's frequent actions recently to keep USD/HKD from moving out the lower end of the convertibility band of 7.75-7.85, it should be noted that the HKD's strength is fairly recent and became more entrenched only since late October, as the global credit crunch began to exert its impact on the real economies. As recently as 12 Dec, HKMA injected about HK$3.1bn to keep the domestic current from strengthening past 7.75, following a HK$4.65bn injection in previous session. In all, HKMA has pumped in more than HK$80bn since September in these market operations to keep USD/HKD inside the convertibility undertaking of 7.75-7.85.

USD/HKD Trend

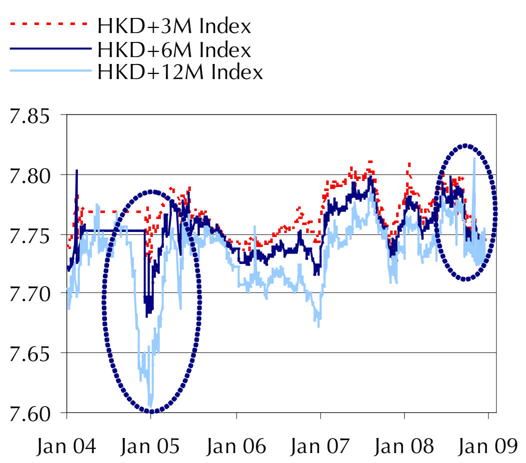


Source: CEIC, UOB

One key reason for the firm HKD is related to the unwinding of carry trade that accelerated since the bankruptcy of US investment bank Lehman Brothers and the near-collapse of US insurance giant AIG in mid-Sep. The resulting risk aversion and loss of confidence saw forced liquidation across all assets markets, and unwinding of "carry trade" i.e. selling of high yielders and buying of low yielding but safe currencies such as JPY and HKD. Beside the avoidance of risk, synchronized interest rate cuts in both advance and emerging economies to contain the global credit crisis also reduced returns from traditional high yielders, thus accelerating the selloffs in these heretofore attractive assets and generating unprecedented volatility in these markets.

Despite the continued upside pressure on HKD, it is worth noting that the financial markets are still relatively sanguine on the outlook for the HKD. The HKD forwards prices have been relatively "well behaved" so far, with relatively low probability priced in for a change in the USD/HKD peg. For instance, the 12-month USD/HKD forward prices are at around 7.75, within the HKD band and relatively muted. In contrast, in early 2007 the 12-month forward prices were as low as 7.68 as the RMB/HKD edged towards parity, causing widespread speculation of a change in the USD/HKD linked exchange rate arrangement.

USD/HKD Forwards



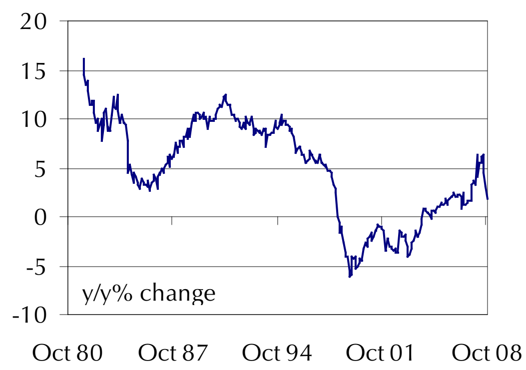
Source: CEIC, UOB

On our part, we deem the debate on HKD exchange rate system to be on the backburner for now given the extent of the volatility and uncertainty in the global financial markets. However, as deflationary pressure is expected to become critical going into 2009 and beyond (see section below for further discussion), it is likely that a firm HKD could become an issue by then. We look for the HKD peg of 7.75-7.85 to stay intact for now at least over the 12-24 months as RMB is not ready yet to replace the USD as a reserve currency.

Deflationary Pressure Setting In

Recent data releases globally show that inflationary pressures, a critical concern as late as 3Q08, has given way to fears of widespread deflation. Data from Hong Kong itself also show decelerating consumer prices, to around 1.8%y/y in Oct from as high as 6.3%y/y in July. The situation is a common thread that arises out of the sharp plunge in end-demand from advance economies (as seen in the unexpected contraction in China's total exports data in Nov) due to the impact of the global credit crisis on the real economy. Sharply weaker demand, excess production capacity, and plunge in commodities prices are certain to pressure on consumer prices worldwide at least for the near term.

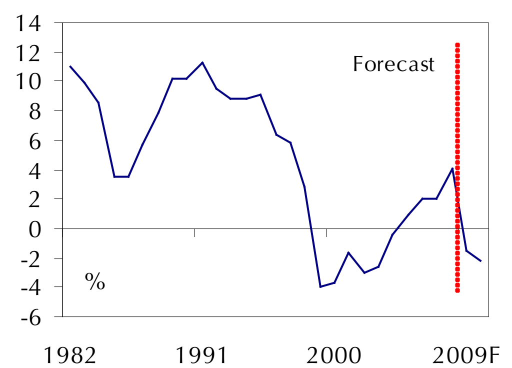
Monthly CPI



Source: CEIC, UOB

As for Hong Kong, this is the similar experience in 1997/98 Asian financial crisis and the global tech bubble burst in 2001 and SARS in 2003. In all domestic consumer prices saw more than 5 years of continuous y/y declines. A similar experience could be repeated in the current episode of global credit crisis which has yet to be resolved while the real economies continue to deteriorate. In addition, the severity of the current episode continues to be debated but the uncertainty of the depth and duration of the global recession suggests there is very limited room for optimism. As such, we expect consumer prices in Hong Kong to contract for at least the next 24 months, as we project a 1.6% decline in the headline CPI in 2009 and a further -2.2% in 2010.

Annual CPI



Source: CEIC, UOB

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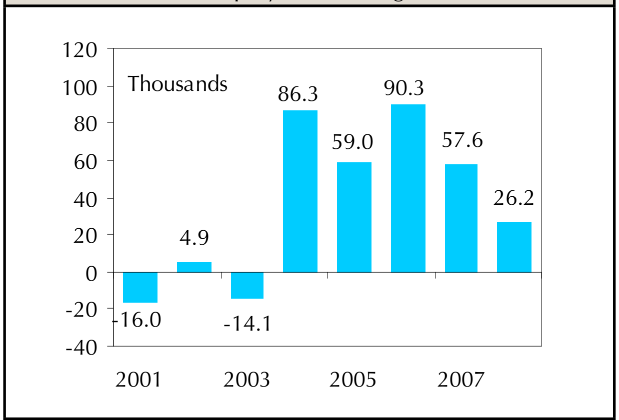
Output Contraction Likely in 2009

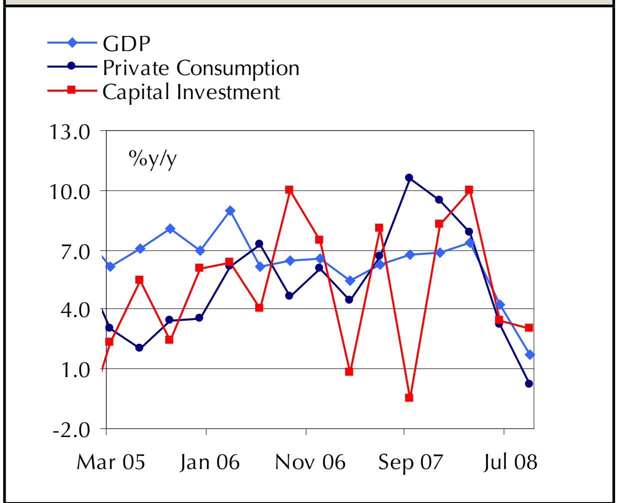
Hong Kong's 3Q08 GDP growth came in sharply lower at 1.7%y/y gain, compared to the 4.2% pace in 2Q08 and 7.3% rise in 1Q08. The significantly slower growth rate was driven largely by declines in domestic demand, which subtracted 0.6%pt and 3.4%pt in 3Q08 and 2Q08, respectively. One of the key drivers over the past two quarters has been govt spending, which was responding to the global crisis like most governments around the world. Another surprising element was net exports, which made positive contributions to the headline growth so far in 2008 although this is likely to turn into a negative contributor into 2009 and possibly in 2010 as well, as the global recession deepens.

Employment Change



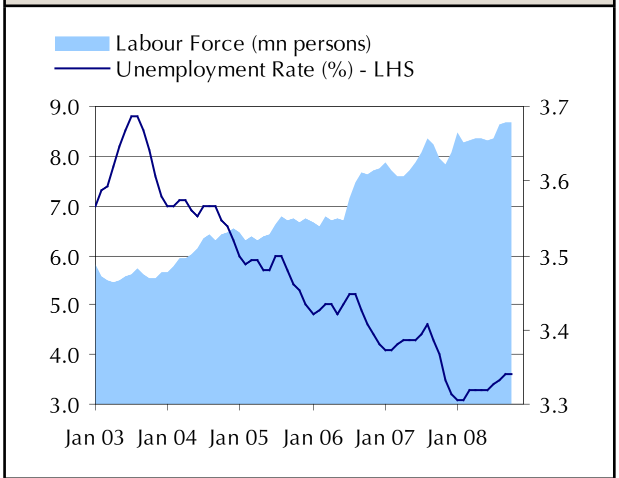
Source: CEIC, UOB

GDP Growth



Source: CEIC, UOB

Labour Market



Source: CEIC, UOB

The weak domestic economy is also reflected in the labour market, which created slightly more than 26,000 jobs so far in 2008, less than half the 57000 jobs in 2007 and the smallest since 2003 when the SARS-induced slowdown shed more than 14,000 jobs. Jobless rate is also seeing a steady climb as well, to 3.6% in Oct from cycle-low of 3.1% at the beginning of 2008. As in the previous downturns, the deterioration of demand for workers could see jobless rate doubling by late 2009/ early 2010.

As such, the overall economic outlook for HK would stay downbeat into 2009 at least. We are factoring in 4 consecutive quarters of y/y declines starting from 4Q08 through to 3Q09, before turning around in 4Q09. For 2009, we are expecting overall headline GDP contraction of 0.8%, from an estimated 2.5% growth in 2008. The latest Asia Pacific Consensus Forecast, which was released in mid-Dec, is looking for +2.9% for 2008 and -0.3% for 2009, and we expect to see further downward revisions to these figures as the conditions deteriorate.