▪ Hong Kong

UOB Economics Projections	2007	2008	2009F	2010F
GDP	6.4	2.4	-3.8	3.5
CPI (average, y/y)	2.0	4.3	-0.4	0.7
Unemployment Rate (%)	3.4	4.1	5.6	4.6
Current account (% of GDP)	12.1	14.5	10.5	7.3
Fiscal balance (% of GDP)	7.5	0.1	-3.9	-1.6

With recent broad USD weakness, HKMA remains active in keeping USD/HKD within range. Notwithstanding a change in the top HKMA post in Oct, we see little risk of a change in the peg near term especially in view of the uncertain prospects of global economic recovery. We continue to see HKD within the 7.75-7.85 range against USD, although near the strong side given USD weakness.

A consequence of the HKD peg regime is that HKD interest rates would move in tandem with USD interest rates. With the US Federal Reserve expected to maintain its loose policy at least until mid-2010, the 3-month HIBOR is likely to hover near its current level of 0.20% through to middle of next year.

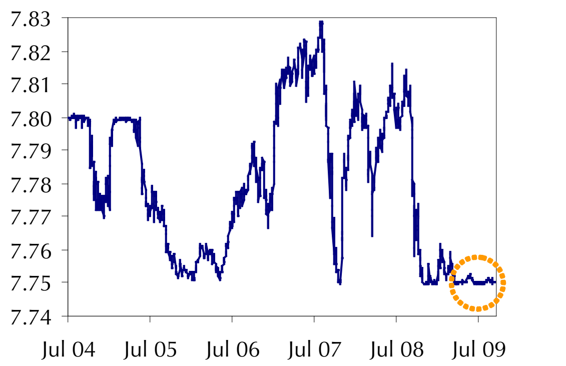
Like a number of Asian economies, HK has also moved past the worst point of the current cycle. It recorded its first positive reading of q/q growth in 2Q09, after four consecutive quarterly declines. On our part, we see domestic demand continuing to be the main driving forces in the next four quarters, especially with confidence returning. As such, we have revised up our GDP forecast for HK in 2009 to -3.8% from -5.0% earlier.

HKD Continues to Stay Firm

On the back of a broadly weaker USD and return of risk appetite since March, HKD continues to stay near the strong side of the USD peg range at 7.75. This has resulted in fairly active HKMA intervention (and liquidity injection) in most part of 2Q09 but activities have slowed significantly in 3Q09 as US dollar's weakness has turned out to be broad based. Nevertheless, HKMA still injected around US$10.5bn during 3Q09, which is nearly half the US$18.1bn injected in 2Q09 in buying USD/selling HKD to keep the USD/HKD peg within range.

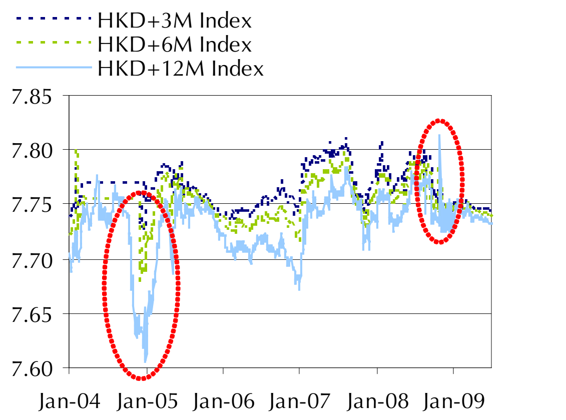
We continue to see little risk of a fundamental change in USD/HKD peg over the near term, despite earlier

HK: USD/HKD Trend



Source: CEIC, UOB

HK: USD/HKD Forward Prices



Source: CEIC, UOB

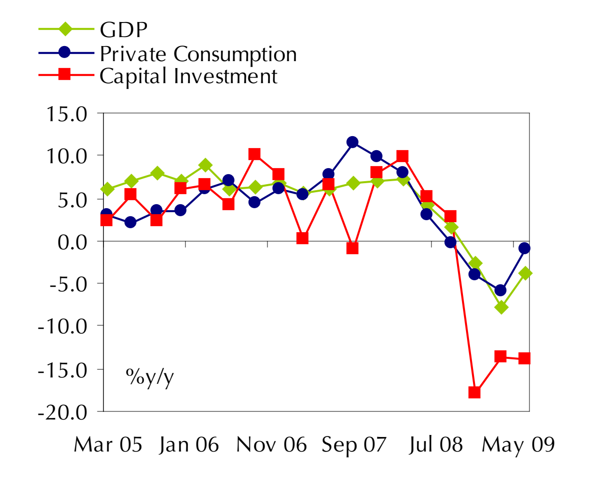
speculation that a change in the HKMA's top post could alter the view on the peg. Joseph Yam, the current chief of HKMA who participated in the peg's formation in 1983, will step down on 1 Oct and hand over the rein to Norman Chan. With the global economy and financial markets yet to settle on a firm footing during the current downturn, there is little incentive for central bank to make any bold policy move, which means HKMA would likely stay put. The other factor is that HKMA has stated before it lacks expertise in running an independent monetary policy regime, which essentially precluded a freely floating HKD. The USD/HKD forward markets are also pricing in very low probability of a change in the peg, which should see HKD hovering remaining with the 7.75-7.85 range.

However, one consequence of the HKD peg is that monetary policy in HK is dependent on the US Fed's policy direction. With the Fed keeping its policy interest rates at near zero and injection of liquidity through its various securities purchase programs, short term USD interest rates e.g. USD LIBOR have fallen to record lows level. 3-month USD LIBOR is currently hovering around 0.28% (25 Sep), which means that HIBOR interest rates also follow in tandem given their close correlation. Our regression of the 3-month USD LIBOR and HKD HIBOR yielded an R-squared of nearly 0.90 for the period between 1999 to 2007, and even higher R-squared was obtained for 2007 to 2009. As we expect the US Federal Reserve to move to tightening only in mid-2010, this means that the 3-month HIBOR would remain at current level of around 0.20% to persist through mid-2010 unless there is a spike in USD LIBOR before then.

Passing its Worst Point in the Cycle

Hong Kong's 2Q GDP saw a rebound of 3.3%q/q sa (13.9%q/q saar), its first positive reading after four consecutive quarters of contraction. This means that HK is likely to have marked the passing of the trough of current cycle, a phenomenon also experienced in a number of Asian countries such as China, Singapore, Taiwan, and South Korea. Contractions on a y/y basis have also narrowed, to -3.8% compared to the trough of -7.8% in 1Q09. The key drivers for the recovery from trough were government spending which also boosted private consumption, as well as slower pace of destocking activities. While capital spending continued to contract, improved sentiment and recovery of the broad economy is likely to see investment turning positive from second half of this year. Post the strong 2Q data, official GDP forecasts have

HK: GDP Growth



Source: CEIC, UOB

been revised upwards to -3.5% to -4.5% from the -5.5% to -6.5% range earlier. On our part, we see domestic demand continuing to be the main forces in the next four quarters, especially with confidence returning. External demand, especially via China, would also be key, and we should see this expressed through further inventory rebuilding in the quarters ahead. As such, we have revised up our GDP forecast for HK in 2009 to -3.8% from -5.0% earlier, with a view of a positive growth of 3.5% in 2010.

One key factor in driving sentiment as well domestic activities has been the relatively smaller damage to HK's labour market despite the sharp falloff in headline figures in GDP, exports, and others. As noted in our focus report on Asia's labour market, at this juncture jobless rates under our Asian coverage appear to be nearing the peak going by the experience in 1997/98 Asian Financial Crisis. In HK's case, jobless rate hit a seasonally adjusted 5.4% in August, and has risen for about five consecutive quarters. This pace is similar to those seen across Asia during the 1997/98 crisis. If a similar pattern holds, that means HK's jobless rate should hit its peak before end of this year. Another important note underpinning consumer confidence is that HK's job losses in the current crisis is far smaller at about 15,000 (cumulative since the beginning of 2008 when US recession official began), compared to the 106,000 jobs eliminated in 1998. The relatively mild impact on jobs, together with low interest rates and swift fiscal response, helps support the rise in property prices in HK (and also elsewhere in Asia), as shown in the following charts.

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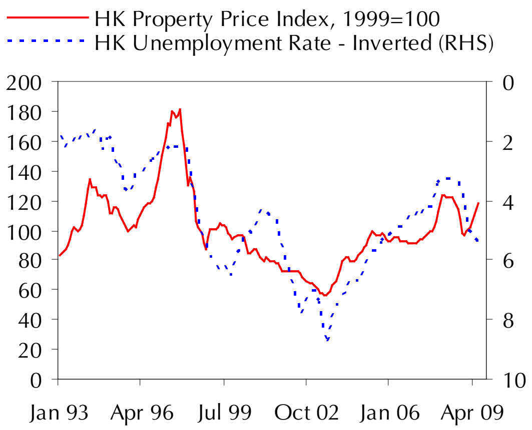
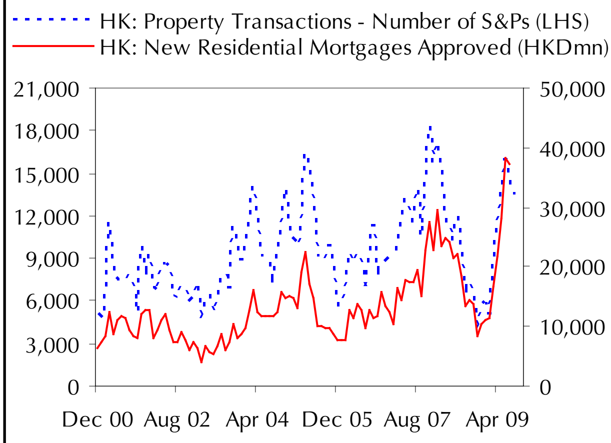
HK: Property Price and Labour Market Trend



Source: CEIC, UOB

HK: Property Transactions and Mortgage Volume



Source: CEIC, UOB