ECONOMIC FOCUS

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25 February 2009

Hong Kong 2009/10 Budget: No Quick Relief Measures

Grim Economic Outlook

The Hong Kong economy expanded 2.5% in 2008 but contracted by 2.5% in the final quarter. The Financial Secretary projected a contraction of 2% to 3% for 2009, in line with our estimate. The government also revised down the medium-range GDP forecast to 3.5% from 4.5%, which may be too optimistic, as the current recession is likely to be prolonged.

Key Measures to Tie Over the Bad Times

- **Boost consumption**
  - **An one-off rebate of 50% of the salaries tax paid, up to a maximum of HKD6,000**
  - **Exemption of property rates for the first two quarters of 2009/10, capped at HKD1,500 per quarter for each rateable unit.**
- **Reduce business costs**
  - **20% rental reduction for most government properties and short-term tenancies of government rents for three months**
- **Job creation**
  - **To create 62,000 jobs over three years on top of the previous pledge of adding 50,000-60,000 jobs this year.**

Can the Budget Boost Growth?

Overall speaking, the 2009/10 Budget offers a deficit spending of about HKD40 billion, which may help boost GDP growth by about one percentage point.

The Government Can Afford to Do More

Compared with other governments, Hong Kong's measures are relatively small in scale. The estimated 2009/10 deficit-spending is about 2.4% of Hong Kong's GDP, whereas the Mainland's package accounts for about 13.5% of its GDP and Singapore's about 8.5%.

Overall: No Quick Relief Measures

Overall, Hong Kong's 2009/10 Budget is relatively conservative, offering little quick relief measures amidst a global financial crisis and economic downturn. While the main theme of 2009/10 Budget is to create jobs, the timing and the scale will depend very much upon the response of the private sector.

Protracted Recession

The Financial Secretary, Mr. John Tsang delivered his second budget speech on 25 February 2009. Hong Kong ended the year 2008 with an average growth of 2.5% with the last quarter dipping deep into the negative region, contracting 2.5% as exports weakened and consumers pared spending. The latter was the worst performance in a quarter since March 1999.

The outlook is grim. Hong Kong is a small and open economy, with external demand being the major driver of growth. As such, the outlook for the Hong Kong economy largely depends on the state of the global economy.

While the government sees the economy contract by 2% to 3% in 2009, we reckon that the number might be nearer the low end of the range and see risk to the downside, as the world is on the brink of the worst economic slump in 60 years with nearly all major economies in recession.

The outlook may improve towards the latter part of the year when the fiscal and monetary stimulus measures being put in place by the advanced economies start to take effect and the global financial market resumes its functions. If the channel of financing remains blocked, it would become the major hurdle for economic recovery.

So far, there are no solid signs that the global financial system is recovering, and thus there is little hope for a global recovery in the near term. Even US Fed Chairman Ben Bernanke said that there might be no stronger rebound for the US economy until the second half of 2010.

The Financial Secretary is also less optimistic about the longer term outlook by revising down the medium-range GDP forecast to 3.5% from 4.5%. But this could still be too optimistic as the current recession is likely to be prolonged.

Exhibit 1: Real GDP Growth

	2008 (yoy %)	2009 Forecast (yoy %) Hang Seng Bank	2009 Forecast (yoy %) Government
Private Consumption	1.8	-3.6	---
Government Consumption	2.0	3.5	---
Gross Fixed Capital Formation	-0.3	-8.9	---
Export of goods	2.0	-8.0	---
Import of goods	1.9	-8.7	---
Export of Services	5.6	-3.9	---
Import of Services	3.2	-3.2	---
Real GDP	**2.5**	**-3.0**	**-2 to -3**
Domestic Demand	1.1	-4.5	---
Composite CPI	4.3	1.0	1.6
GDP Deflator	1.4	0.5	0.5
Nominal GDP	**3.9**	**-2.5**	**-1.5 to -2.5**

Source: Census and Statistics, Financial Secretary Office, Hang Seng Bank.

A Conservative Fiscal Package

Exhibit 2

	Key Measures
Reduce business costs	– 20% rental reduction for most government properties and short-term tenancies of government rents for three months
Job creation	– To create 62,000 jobs over 3 years including, – HKD3,000/HKD2,000 monthly internship subsidy for one year to employers hiring university graduates for jobs in the mainland/Hong Kong – Subsidies for building maintenance and cultural events, creating some 14,000 jobs in the next two years
Measures to boost consumption	– An one-off rebate of 50% of the salaries tax paid, up to a maximum of HKD6,000 – Exemption of rates for two quarters for 2009/10, capped at HKD1,500 per quarter for each rateable units. – Freezing government fees and charges until Mar 2010

Source: Financial Secretary Office, Hang Seng Bank.

Compared with other governments, Hong Kong's measures are relatively small in scale. The 2009/10 budget deficit is estimated to be about HKD40 billion or 2.4% of Hong Kong's GDP. In comparison, the Mainland's package (to be spent in two years) accounts for about 13.5% of its GDP and the Singapore's package about 8.5%.

The strong fiscal position should have provided more room for a substantial fiscal expansion to combat the downturn and revive growth amidst the fiercest economic crisis of the century.

Exhibit 3

Economies	**Size of fiscal stimulus**		**Share of GDP**
	Local currency	**USD billion**	
Hong Kong	HKD40 bn	5	2.4%
China	Rmb4 trillion (over 2 years)	585	13.5%
Singapore	S20.5 billion	14	8.5%
Taiwan	NTD417 billion	12	3.4%
South Korea	Won 33 trillion	22	4.0%
Japan	Yen 26,900 trillion	269	5.5%
Malaysia	Ringgit 7 trillion	2	1.1%

Source: Bloomberg, Reuters, UBS, Merrill Lynch, Hang Seng Bank

Can the Budget Help Boost Growth?

The 2009/10 Budget offers HKD40 billion of deficit spending to buffer the economic downturn, which is estimated to boost GDP growth by one percentage point.

Nevertheless, the impact may only be temporary. For instance, US GDP growth in 2Q08 was lifted by a USD170 billion (about 1% of GDP) fiscal package launched in

February, recording a quarter-on-quarter annualized growth of 2.8%. However, the impact faded with growth declining by 0.5% in Q3 and by 3.8% in Q4. As such, we do not expect substantial recovery of the Hong Kong economy until the global banking crisis is resolved, that is, after banks get their balance sheet repaired and have adequate capital to support lending activities.

Still, near-term measures are necessary to boost consumer and investor confidence. Most of the current measures may only have an impact on the economy in the latter part of the year or beyond. For instance, it may take 9 to 12 months before the real impact of massive infrastructure spending is filtered through the economy. More could be done to help households and businesses in the near term to cushion the impact of the global downturn.

Deteriorating Government Finance

Uncertainty about the future economic outlook and the prospect of larger budget deficits ahead have made the government reluctant to commit more. The government projects relatively large deficits for the next three consecutive years.

Exhibit 4

HKD billion	2009/10	2010/11	2011/12	2012/13	2013/14
Operating Accounts					
Revenue	234.2	235.3	253.7	273.5	290.0
Expenditure	244.0	249.4	258.1	267.1	276.4
Surplus	-9.8	-14.1	-4.4	6.4	13.6
Capital Accounts					
Revenue	27.5	44.3	52.1	53.7	56.3
Expenditure	54.1	55.2	69.6	68.9	71.2
Surplus	-26.6	-10.9	-17.5	-15.2	-14.9
Consolidated Surplus (Before Bond Repayment)	-36.4	-25.0	-21.9	-8.8	-1.3
Bond Repayment	3.5	--	--	--	--
Consolidated Surplus (After Bond Repayment)	-39.9	-25.0	-21.9	-8.8	-1.3
Budget balance as % of GDP	-2.4%	-1.5%	-1.2%	-0.5%	-0.1%
Fiscal reserves at 31 March (bn)	488	423.1	401.2	392.4	391.1
As a no. of months of government expenditure	18	17	15	14	14
As a% of GDP	27.2%	24.6%	22.3%	20.9%	19.9%

Source: Financial Secretary Office, Hang Seng Bank

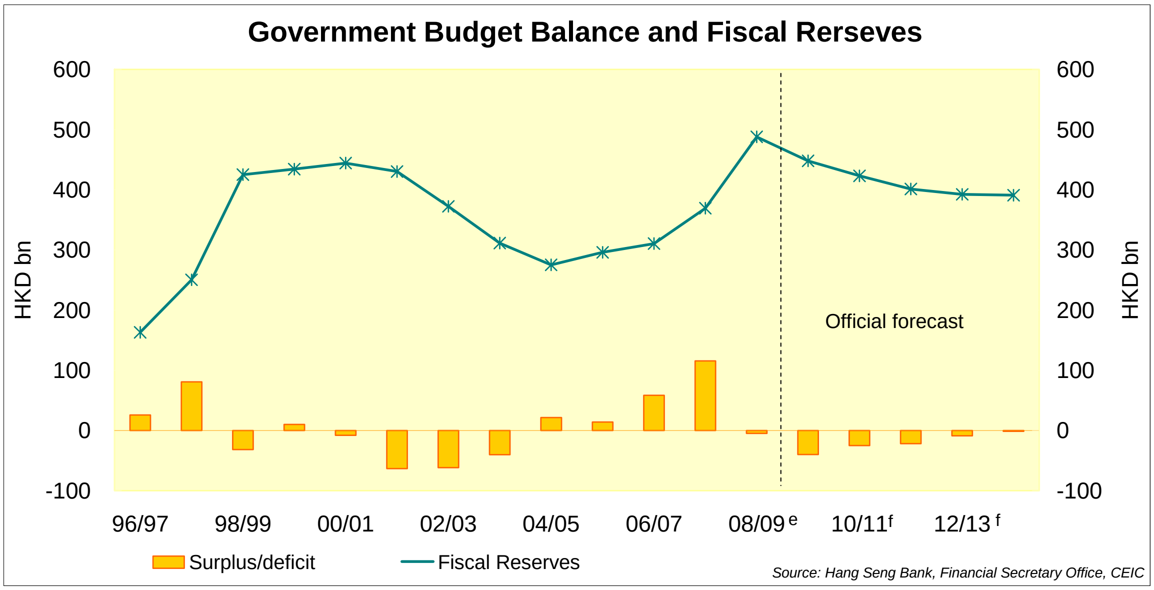
An Option is to Run Down Fiscal Reserve

With a large fiscal reserve, Hong Kong is in fact in a better position than many economies to run budget deficits to boost economic growth. In fact, there was a precedent for this. Huge government deficits resulted in a running down of the fiscal reserves by some HKD200 billion between 1998 and 2003, but the budget returned to balance subsequently. Singapore also decided to tap government reserves to pay for part of the stimulus package.

Hong Kong's fiscal reserves are projected to reach HKD448 billion by end-March 2009, equivalent to 18 months of government expenditure or 27% of GDP. But the government's medium range forecast projects sustained budget deficits and that the fiscal reserves would fall to about 14 to 17 months of government expenditure or 20% to 25% of GDP.

The scenarios still meet the government's guideline to maintain fiscal prudence by keeping the fiscal reserves at a level which covers at least 12 months of the government expenditure.

Exhibit 5



Source: Census and Statistics Department, 2008/09 Budget Source: Financial Secretary Office , CEIC

Budget/Tax Policy and Longer-term Economic Strategies

Sustained economic growth is the essence for future government revenue. To foster sustainable long-term economic development, the government reiterates the importance of consolidating Hong Kong's position as a financial centre and plans to issue sovereign debts to foster the development of Hong Kong's bond market, promoting tourism and creative industries.

The government should make increasing use of fiscal and tax policy to accompany economic policy to enhance the competitiveness of Hong Kong in achieving sustainable growth in the long term.

Hong Kong has been losing its appeal as a low tax economy, as many other economies have trimmed tax. For instance, Singapore has just announced to cut corporate tax rate from 18% to 17%, only slightly above Hong Kong's corporate tax rate of 16.5%.

There may be little room for further cut of the corporate tax rate, which is low by international standard. But, that does not mean nothing can be done. Hong Kong should consider offering preferred tax treatment to attract investment in identified industries, for instance tourism, trade and logistics, financial and professional services, the so-called pillar industries and encourage development of new sectors like creative and green industries would benefit Hong Kong's longer-term economic development.

Helping industries to move up the value chain or open up new sectors are the key for sustainable growth. Expanding research grants is on the right track. The government should also initiate more R&D spending via universities or Hong Kong Productivity Council. The lacklustre responses from private sector R&D spending may partly explain why only a few Hong Kong manufacturers/exporters have successfully moved up the value-chain. Guangdong Province has determined to upgrade its industry structure. The current crisis may delay the process, but these longer-term issues cannot be ignored.

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