

Impact of the Financial Crisis on Hong Kong and the Way Forward

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- ◆ Short-Term Impact
- ◆ Long-Term Impact
- ◆ Short-Term Measures
- ◆ Possible Long-Term Directions
- ◆ Concluding Remarks

Introduction

- ◆ The financial earthquake has affected all of the developed economies, especially the United States. While North America and Europe have gone into economic recession, it is not an ordinary recession, because it is accompanied by a serious breakdown of the capital and credit markets and bankruptcy, insolvency and illiquidity of many major financial institutions.
- ◆ Fortunately, in East Asia, despite the steep decline in the stock markets, the financial institutions remain relatively sound and financial stability is not seriously threatened.
- ◆ However, East Asian exports to North America and Europe has slowed, and export orders have fallen precipitously since mid-September, to the order of 50%, on an year-over-year basis.

Short-Term Impact

- ◆ The decline in the stock market—this is due primarily to three reasons: repatriation of capital back home by foreign investors; de-leveraging; and loss of confidence (irrational panic).
- ◆ The drying up of initial public offerings and other financial transactions.
- ◆ The reduction in wealth (even unrealized) also has a negative impact on domestic consumption and investment.
- ◆ The decline in exports by and export orders received by Hong Kong and Hong Kong-invested enterprises in the Mainland, and in re-exports through Hong Kong, with derivative declines in the demands for shipping, transportation, logistics and storage.

Short-Term Impact

- ◆ The decline in visitor arrivals, especially from North America and Europe.
- ◆ All this means a decline in the rate of growth of real GDP and a rise in the rate of unemployment in Hong Kong in the near term. The rate of growth has already turned negative for two consecutive quarters and is expected to remain negative for at least another two quarters. The unemployment rate is expected to edge up but will probably stop short of the high of 8% reached during the SARS period.

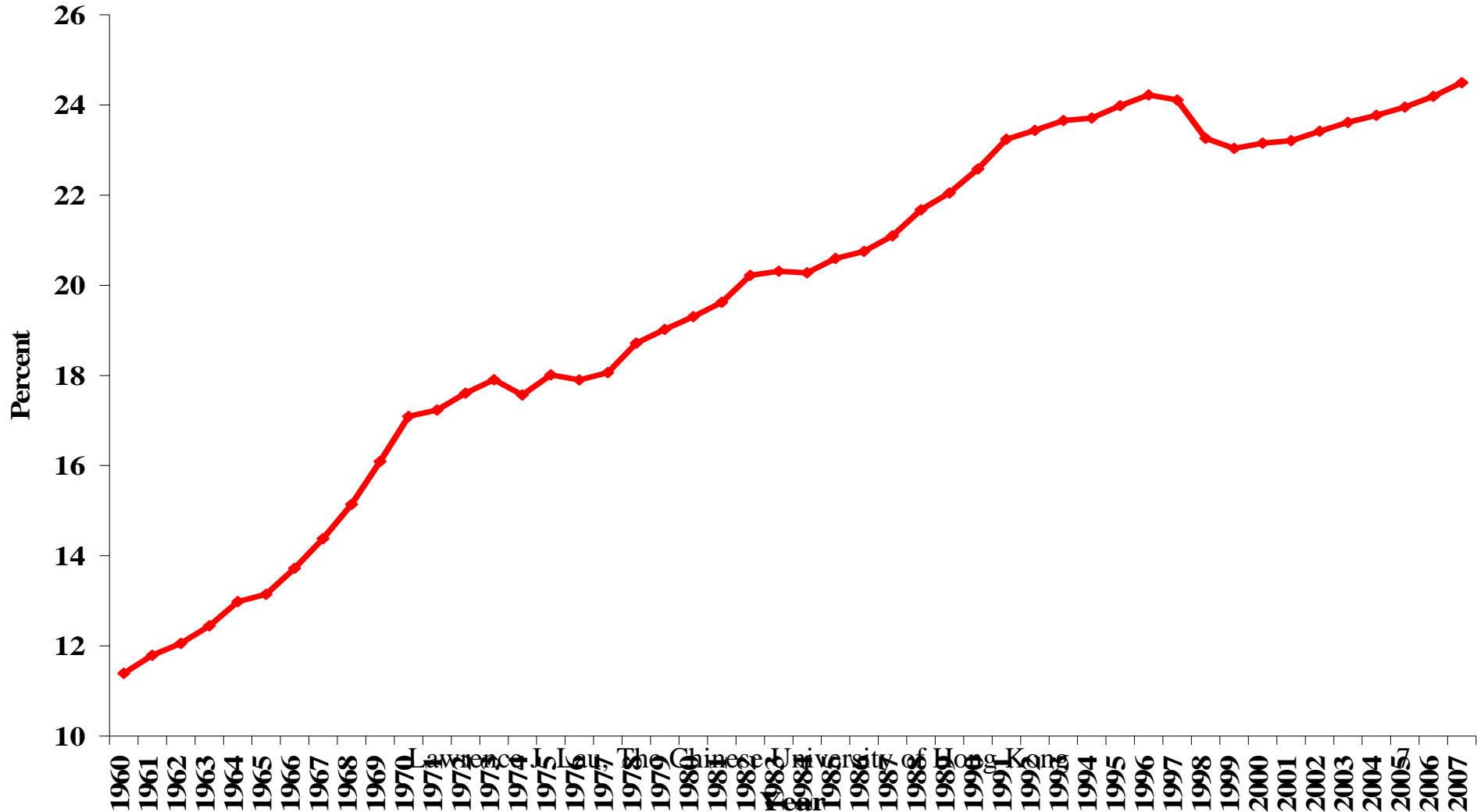
The De-Coupling Hypothesis

The Shifting Economic Center of Gravity

- ◆ The economic center of gravity of the world has been gradually shifting to East Asia from the United States and Western Europe and within East Asia from Japan to China.
- ◆ In 1960, East Asian GDP, comprising of the GDPs of ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China (Mainland only), Japan, and South Korea) was less than 12 percent of World GDP. Today, East Asian GDP accounts for approximately a quarter of World GDP.

East Asian Share of World GDP, 1960-present

East Asian Share of World GDP, 1960-present



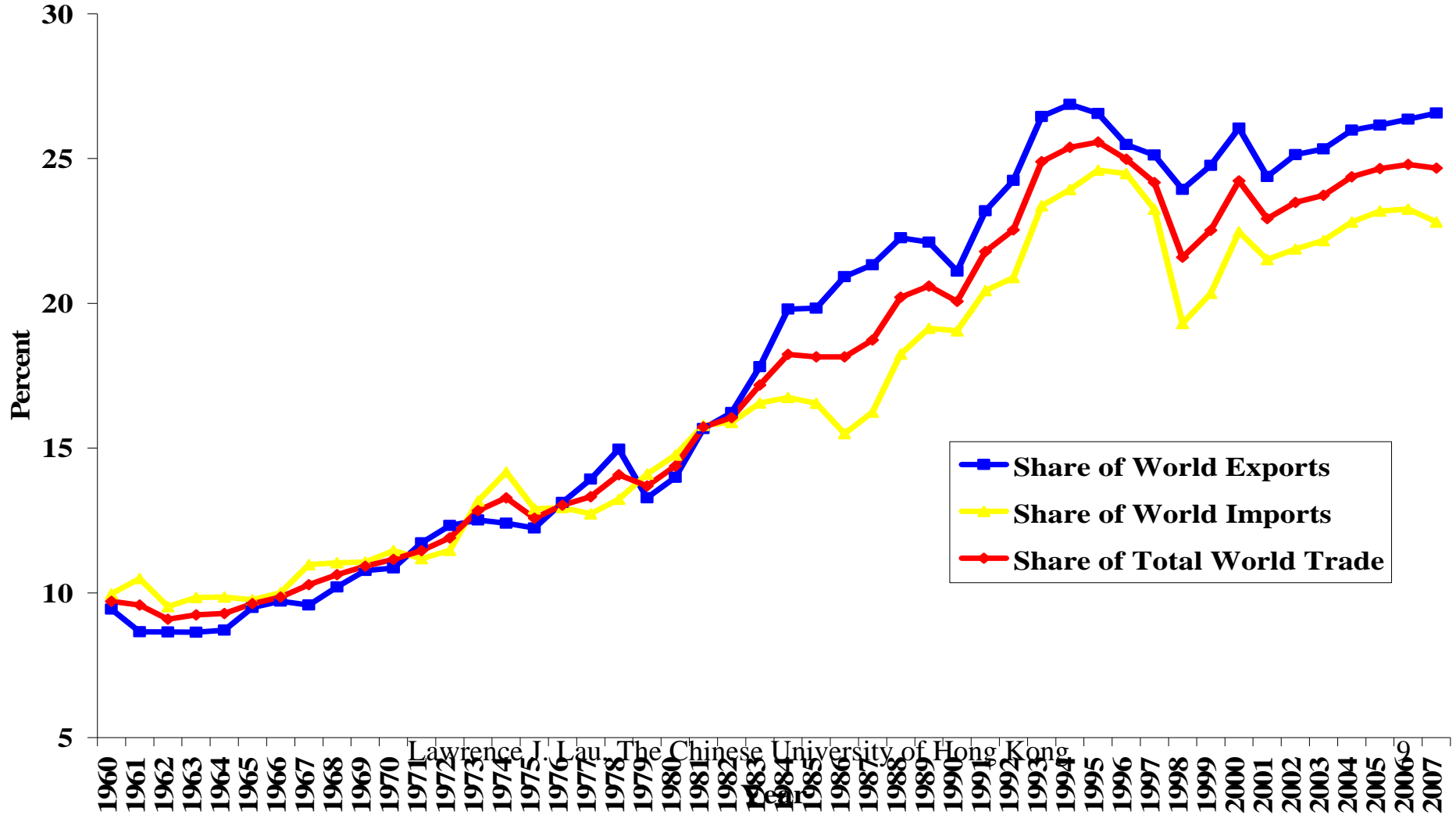
The De-Coupling Hypothesis

The Shifting Economic Center of Gravity

- ◆ East Asian shares of world exports, imports, and international trade have also grown from approximately 10 percent in 1960 to a quarter in 2007, paralleling the growth of East Asian share of world GDP.
- ◆ Because of the rapid economic growth of China and the rest of East Asia outside of Japan, and the demand and supply that such economic growth has generated, the East Asian economies now trade more with one another than with economies outside of East Asia, including the United States. Approximately half of East Asian trade is among East Asian economies. This is a sea change compared to say thirty years ago when most of the East Asian trade was between East Asia and the United States and Western Europe.

The Rising Ratio of East Asian Trade in Total World Trade, 1960-present

East Asian Share of Total World Trade, 1960-present



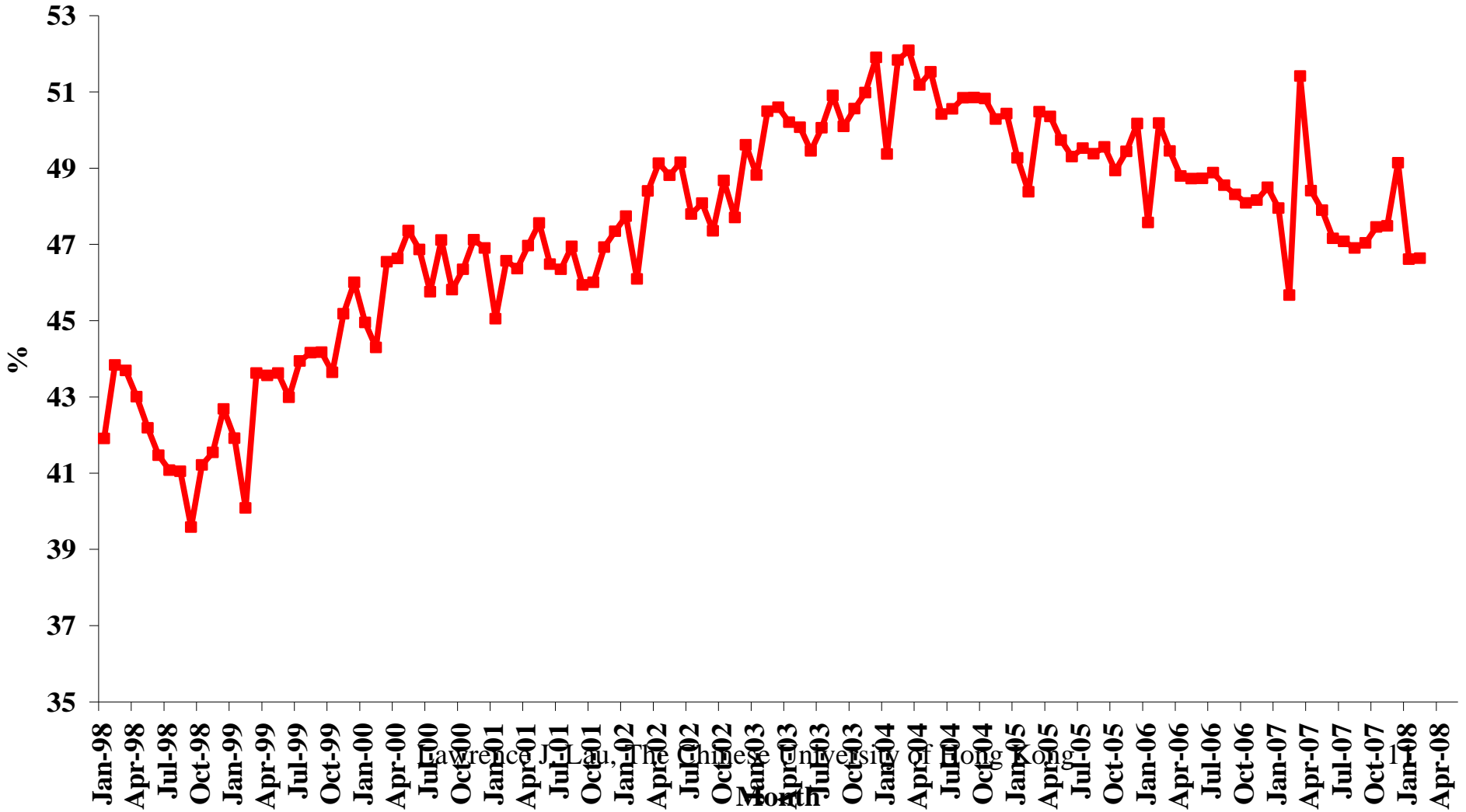
The De-Coupling Hypothesis

The Changing Pattern of World Trade

- ◆ Interdependence of the East Asian economies has been rising sharply over the years and East Asian dependence on the United States and Western Europe has declined.
- ◆ The ASEAN Free Trade Area as well as its variations (+1 (China); + 3 (China, Japan and South Korea)) are rapidly becoming a reality.
- ◆ This is what gives credence to the idea of partial “de-coupling” of the world economies—that the Chinese and East Asian economies can continue to do reasonably well despite the current economic problems in the U.S. and elsewhere. However, China and East Asia are not large enough to turn around the whole world.

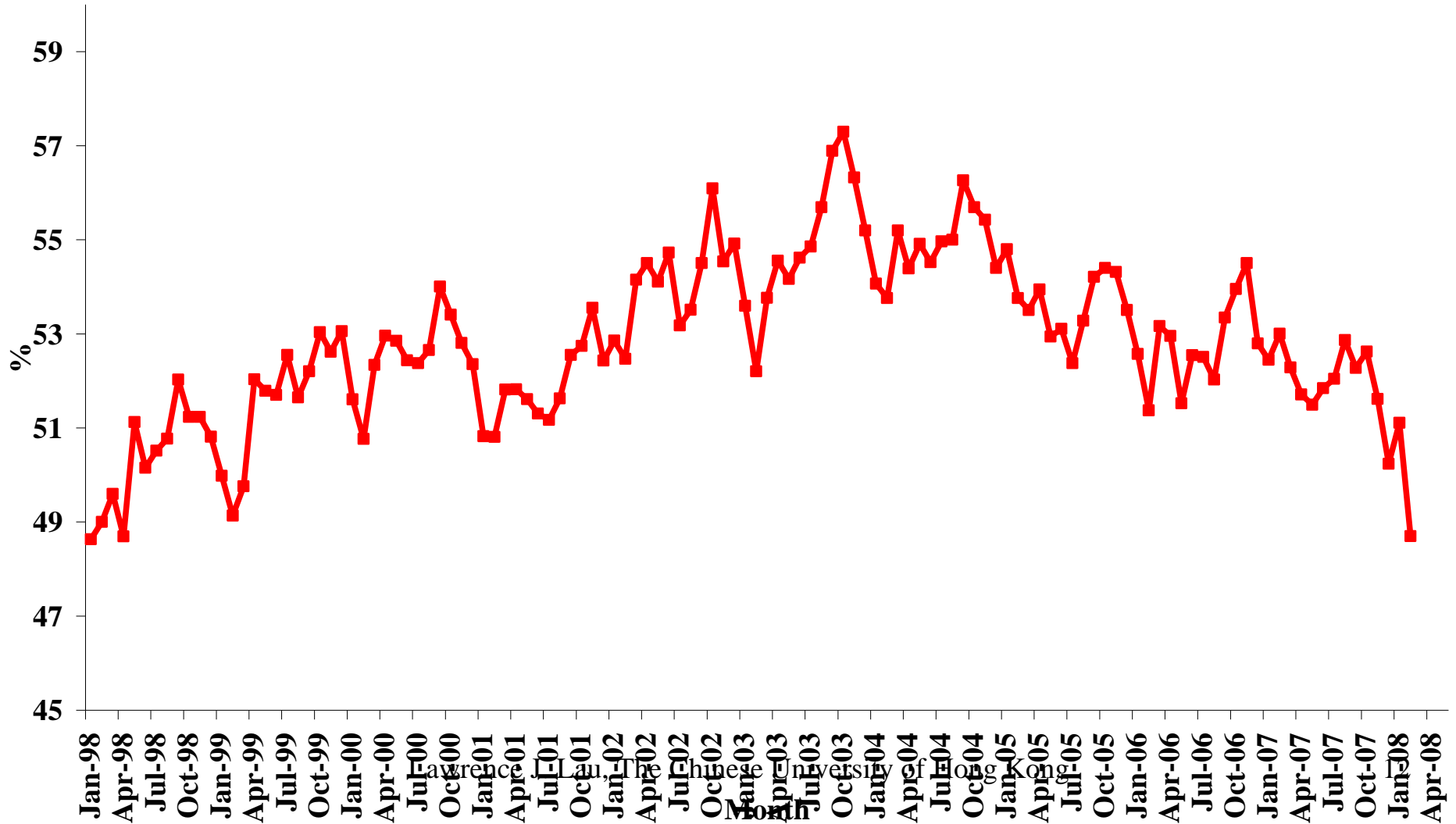
The Share of East Asian Exports Destined for East Asia

The Share of East Asian Exports Destined for East Asia



The Share of East Asian Imports Originated from East Asia

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De-Coupling from the U.S. Economy

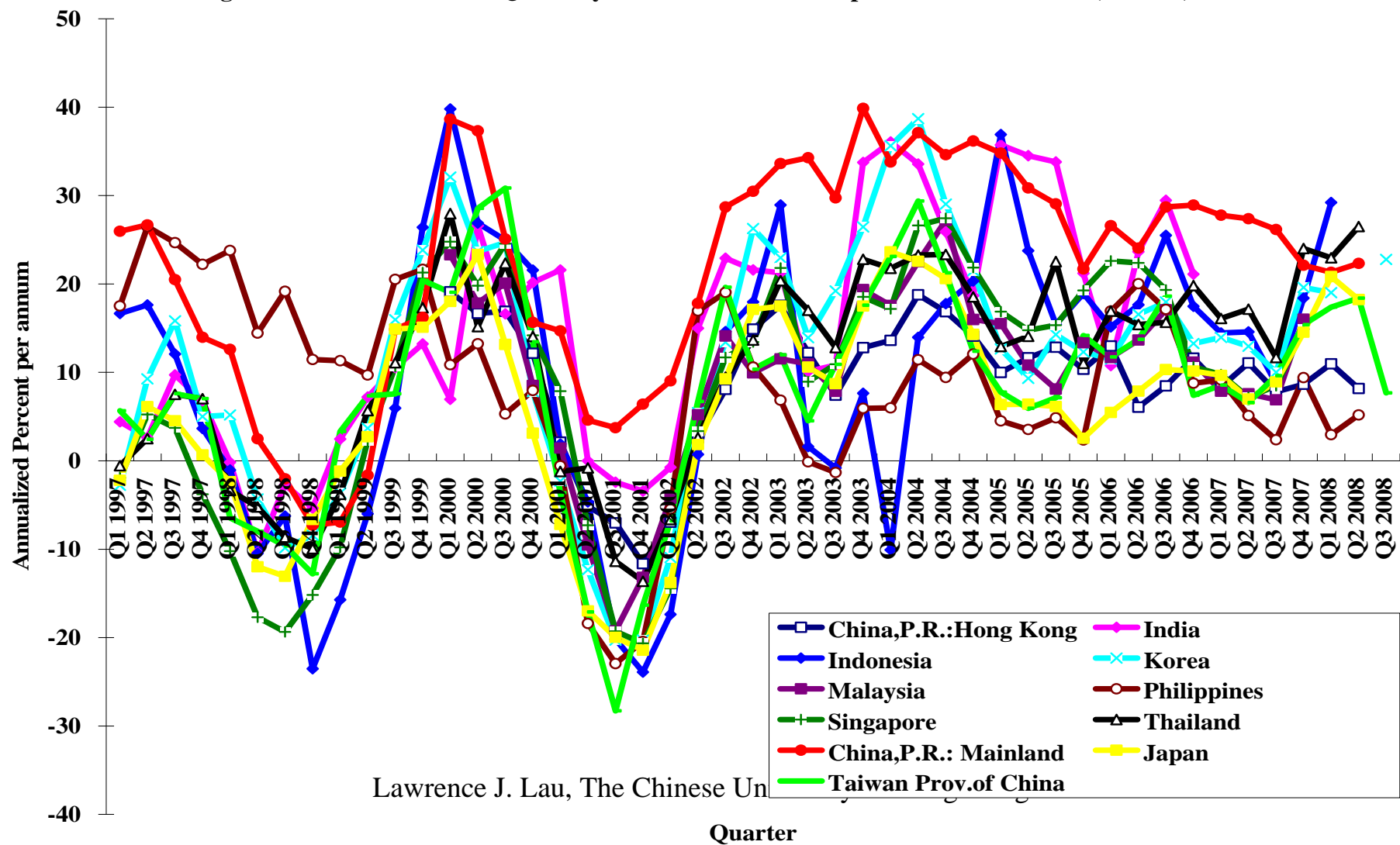
- ◆ In general, the phenomenon of (partial) “decoupling” is expected to be operative. Chinese economic growth will be largely unaffected by external developments, including an economic recession in the United States. The other so-called BRIC countries—Brazil, Russia and India—are even less dependent on exports, especially exports to the U.S. Brazil has recently discovered huge oil reserves and should be entering a new era of rapid economic development, financed by its new found oil wealth instead of foreign loans. Russia has benefitted from the high world price of oil (which has recently fallen back to more normal levels) and is not a major exporter of manufactured goods and hence will be relatively unaffected by the economic recession in the U.S. and elsewhere. India is also not a major exporter, except in computer software, and its economic growth is mostly internal-demand driven.

De-Coupling from the U.S. Economy

- ◆ The BRIC countries can be expected to continue growing, albeit at somewhat lower rates, and the rest of developing East Asia should be able to manage.
- ◆ The high domestic savings rate found in almost all of the East Asian economies is a major advantage of East Asia, making it independent of capital inflows from developed economies and hence de-coupling much more possible and likely.
- ◆ During the East Asian currency crisis of 1997-1998, the mutual impacts of the simultaneous downturns and upturns on the part of East Asian economies on one another were amply demonstrated. So long as they continue growing together, by creating demands for one another's exports, their collective growth can be more or less sustained.
- ◆ Through it all, the rate of growth of Chinese real GDP remained relatively stable even as its rates of growth of exports and imports fluctuated widely.

Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies

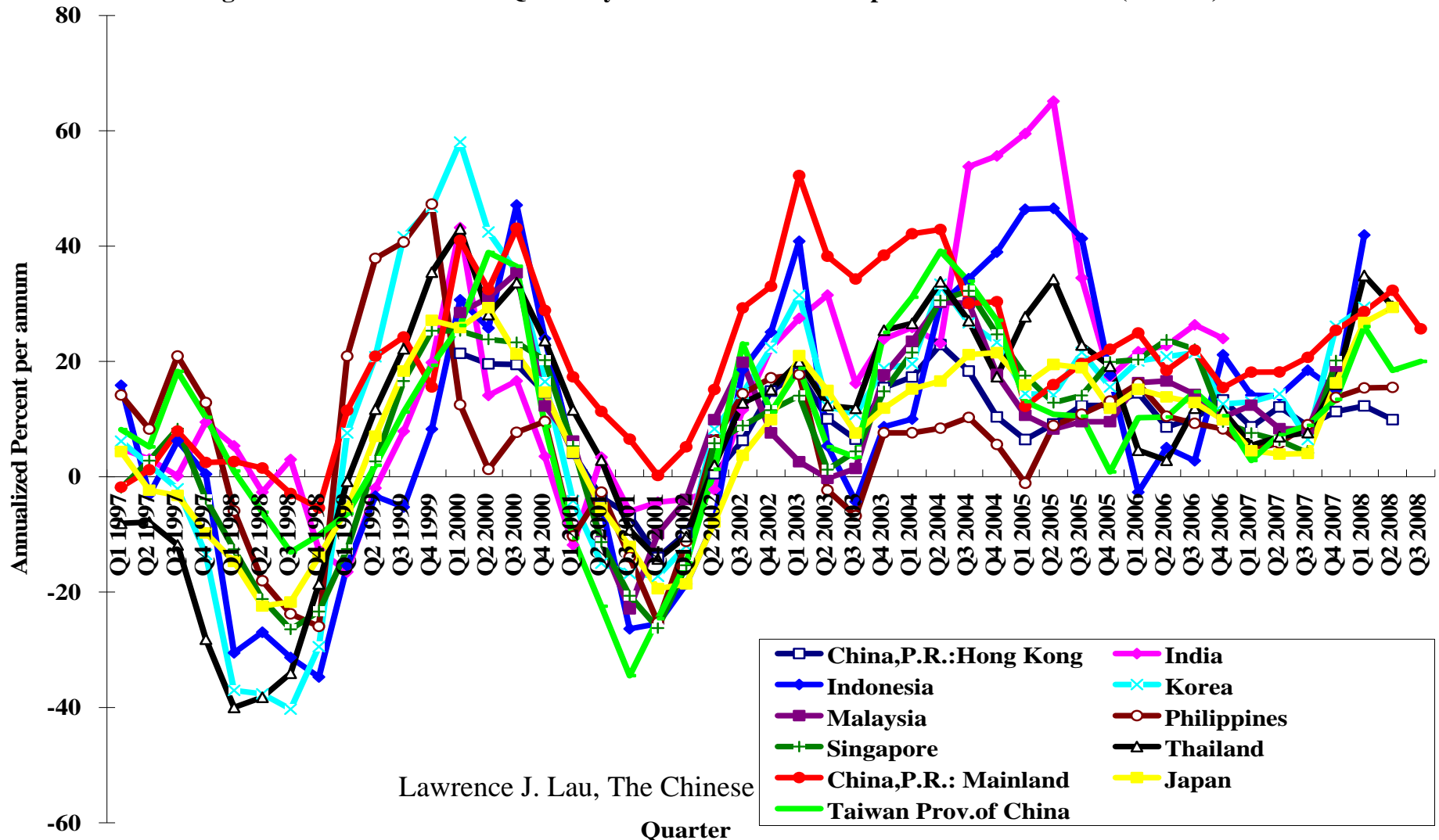
Figure 3.2: Year-over-Year Quarterly Rates of Growth of Exports of Goods in US\$ (Percent)



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Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies

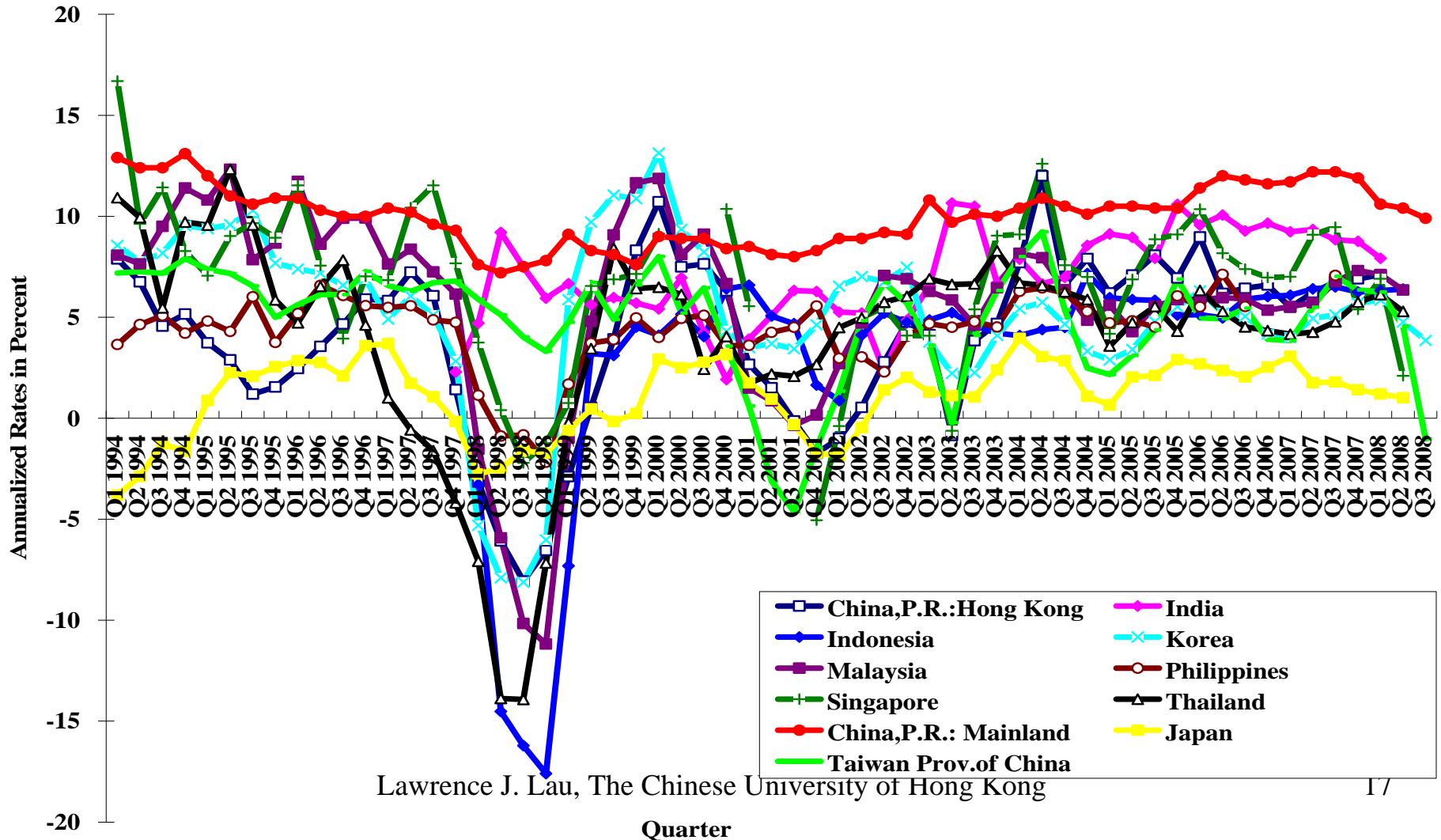
Figure 3.3: Year-over-Year Quarterly Rates of Growth of Imports of Goods in US\$ (Percent)



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Quarterly Rates of Growth of Real GDP: Selected East Asian Economies

Figure 3.1: Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies



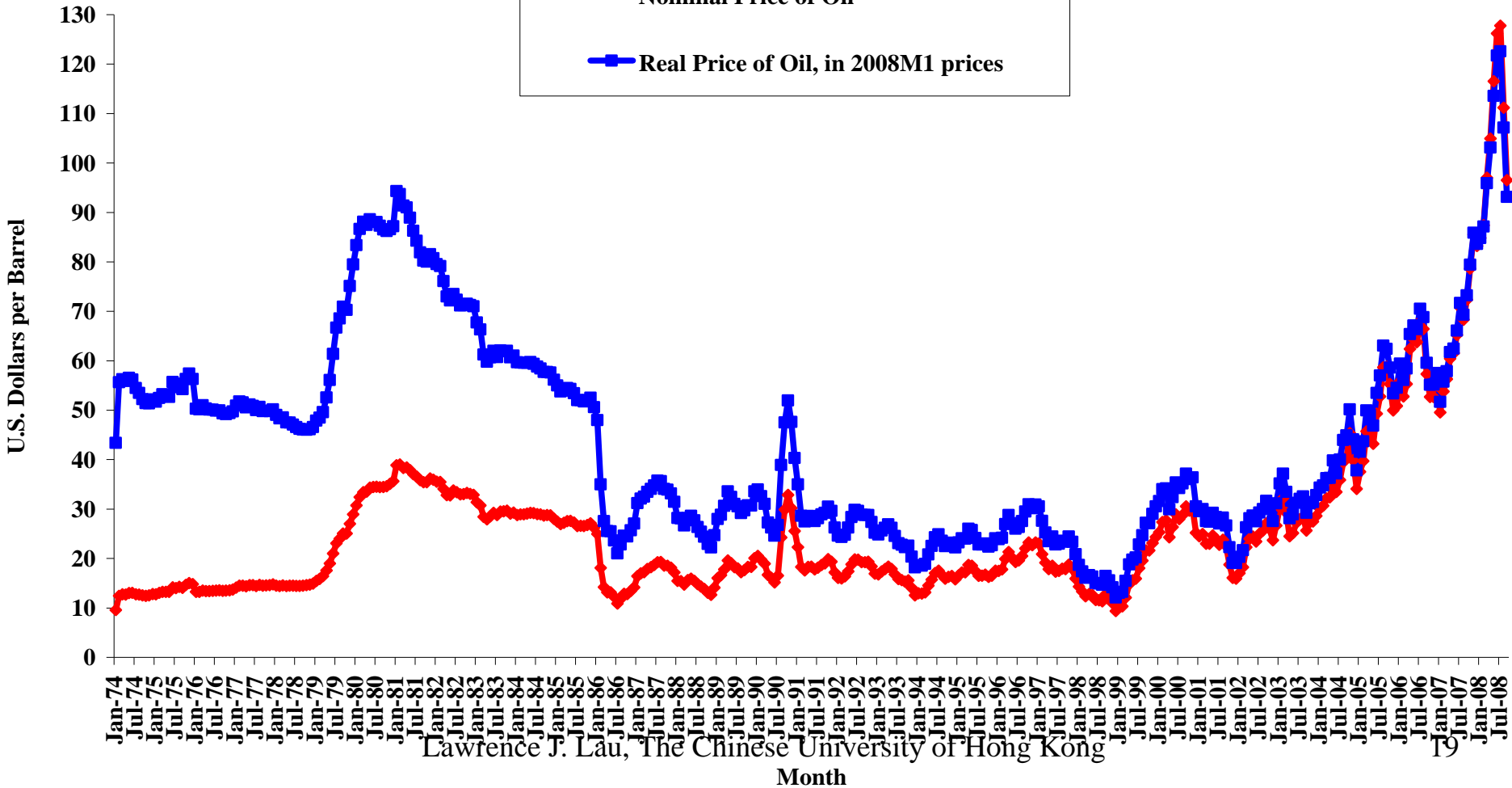
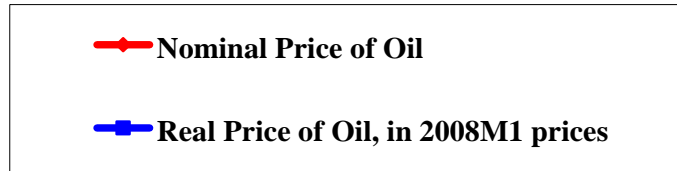
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The World Price of Oil

- ◆ The world price of oil has begun to return to more normal levels. The world price of oil, in real terms, is not significantly different from the price of oil prevailing in the early 1980s. It has the room to fall further to about US\$40 a barrel in 2008 prices which was the upper range of the price of oil between 1987 and 2004.

The Nominal and Real World Prices of Oil (2008 prices)

Nominal and Real Price of Oil



The Impact of the Economic Recession in the World on Chinese Exports

- ◆ Chinese exports have been expected to slow down not only because of the economic recession in the U.S. and elsewhere in the World but also because of many other factors such as the revaluation of the Renminbi by 20% since July 2005, the intensified enforcement of environmental regulations, the unification of the tax rates for domestic and foreign-invested enterprises which raises the taxes on foreign-invested enterprises, and the implementation of the new labor law, all of which preceded and were independent of the global financial crisis.
- ◆ However, the decline in export orders received by Chinese exporters of almost 50% year-over-year since September took almost everyone by surprise. While it is true that export orders have been expected to decline and have been declining, but not to this order of magnitude.

The Impact of the Economic Recession in the World on Chinese Exports

- ◆ Why was there such a large, precipitous decline? This was principally caused by the importers in the U.S. and elsewhere having their access to bank credit frozen. Importers cannot get their bankers to issue letters of credit to the Chinese exporters, or if they can, these letters of credit may not be accepted by the Chinese commercial banks. For those importers with impeccable reputation whose orders would be accepted by Chinese exporters even without a letter of credit, such as Hewlett-Packard, Nike and Wal-Mart, the problem has to do with the ability to finance their inventory with bank loans from their U.S. banks. As the availability of such credit dwindles, they also reduce their orders and wait until the inventory is exhausted. The net result is a huge reduction in orders for Chinese exports.

The Impact of the Economic Recession in the World on Chinese Exports

- ◆ It is, however, important to realize that this is not the result of a reduction in the expected demand for Chinese exports of this magnitude, but the result of the credit freeze in the U.S. It is also not the result of Chinese exports being too expensive, and thus a devaluation of the Renminbi and/or an increase in the proportion of Value-Added-Tax (VAT) rebate on exports are also not likely to be effective.
- ◆ According to the historical experience of the U.S. economy, real personal consumption is a much smoother series than real GDP or real personal income. Since 1949, the worst quarterly decline (at annualized rates) of personal consumption was 12% and since 1952 was less than 10%.

The Impact of the Economic Recession in the World on Chinese Exports

- ◆ Imports of consumption goods would therefore be expected to decline with personal consumption, but probably at no more than double the rate of decline of real personal consumption. For Chinese exports, which consists of mostly daily consumption goods targeted at the low-price market, the effect should be much smaller, as consumers switch from high-price to low-price items in an economic downturn. (Furniture and large appliances, such as television sets, that relate to housing, are exceptions.)
- ◆ So the expectation is that much of the lost export orders would bounce back in a quarter or two, and that much of this decline in export orders is only temporary and basically represents a delay or postponement of the demand by a quarter or two for Chinese exports, as opposed to a permanent reduction. Thus, the decline in Chinese exports, when averaged over a whole year, should not exceed 20%. In terms of GDP, the impact should be a reduction on the order of 1.5%, a significant but still manageable amount.

The Impact of the Economic Recession in the World on Chinese Exports

- ◆ The Chinese Government can however shorten the delay or postponement of demand by allowing the Chinese commercial banks to finance the exports of long-term seasoned exporters to their long-term customers so that they can ship their goods on a consignment basis and allow payment terms of 6 months after receiving the goods. This will allow Chinese export enterprises to continue their production with minimal interruption and layoffs of workers. To make this happen, the Chinese Government may need to guarantee these loans in whole or in part, possibly through the Export-Import Bank of China—otherwise the Chinese commercial banks may not be willing to extend such credit to the Chinese exporters.

Long-Term Impact

- ◆ The Continuing Shift in the Economic and Financial Center of Gravity
 - ◆ U.S. and Europe gradually lose their pre-dominance.
 - ◆ There is a relative redistribution of wealth in favor of East Asia.
- ◆ New Global Financial Architecture and Regulatory Regime
 - ◆ The global financial system will have to be restructured to limit the spillover effects.
 - ◆ The global financial markets will be reorganized and reoriented, with new, hopefully safer products.
 - ◆ The use of leverage, which used to be a substitute for savings, will be greatly reduced.
- ◆ Cash and Savings are King
 - ◆ Savers will own the world

Long-Term Impact

- ◆ The Critical Importance of the Mainland to the Hong Kong Economy is Now Even More Apparent.
 - ◆ Hong Kong can take advantage of the fact that the Mainland is a huge source of savings that can be used to finance investment worldwide.
- ◆ Can Hong Kong Continue to be Internationally Competitive?
 - ◆ Hong Kong needs to re-examine its cost structure, whether with its high land prices and double taxation, it can remain internationally competitive. It also needs to consider how to avoid the volatility of its revenue stream going forward—how it can smooth its revenue and expenditure. This may require a rethink of the revenue base.
- ◆ Beyond Renminbi Convertibility
 - ◆ With the U.S.\$ likely to devalue over the intermediate to long term, despite its short-term strength, Hong Kong must prepare for the arrival of the full convertibility of the Renminbi.

Short-Term Measures

- ◆ Maintaining Internal Demand and Employment
- ◆ Sustaining External Demand

Maintaining Internal Demand and Employment

- ◆ The Chief Executive has already announced measures to increase public expenditures (e.g., through accelerating the construction of public works projects), to maintain and create employment, and to provide credit assistance to small and medium enterprises. These measures will both boost confidence as well as help maintain the aggregate demand in the Hong Kong economy.
- ◆ The Government can encourage large employers to consider alternatives to lay-offs such as reduction of work hours coupled with a corresponding reduction of pay during this difficult period. This is a method tried in many U.S. employers to retain the labor force in an economic downturn. **Everyone can come out ahead.**

Maintaining Internal Demand and Employment

- ◆ The Government can also encourage the hiring of new entrants into the labor force by large firms on a trial basis, e.g., new graduates from universities and high schools, by sharing the cost of employment for the first full year (with the employers being reimbursed at the end of the first year). Ideally this should apply only to “net new hires,” that is, new hires over and above what the firm would have hired anyway, but in practice it is difficult to determine what is and is not “new new hires,” and one may have to settle for new hires. Even in the latter case, it is less costly and more productive than the creation of temporary public service jobs.
- ◆ The Government can consider providing unemployment benefits sufficient for subsistence to those workers who become newly unemployed.

Maintaining Internal Demand and Employment

- ◆ The Government can promote longer-term owner-occupied residential mortgage loans to enable the average citizen to purchase their own homes or to reduce their monthly payments through refinancing—by lengthening the maturity of such loans to say 35 years to 15 years, the monthly payments can be reduced by more than 50%, releasing purchasing power for either new homes or current consumption. (Such government-supported long-term mortgages can be subject to various ceiling restrictions as to cost and size—the objective is to help the average household in Hong Kong.)
- ◆ Long-term mortgage loans can also be considered for owner-used premises for small and medium enterprises to enhance their long-term economic viability and sustainability and to insulate them to some extent from the volatility of commercial rents in Hong Kong.

Sustaining External Demand

- ◆ Hong Kong should request the extension of the “individual visit scheme” (個人遊) to include Mainland citizens from more provinces and cities to replace the lost travellers from North America and Europe and from the now economically depressed areas in Guangdong, Shanghai, Jiangsu and Zhejiang.
- ◆ The Government can consider the facilitation of visitors from Taiwan by granting them the privilege of “instant visa” (落地簽證) which Hong Kong citizens already enjoy going to Taiwan. This should also be helpful to Cathay Pacific Airways and Dragonair as cross-strait air traffic becomes increasingly direct.

Sustaining External Demand

- ◆ The Government can also consider the facilitation of visitors from Shenzhen by granting the residents there with proper household registration (戶口) the privilege of visiting Hong Kong on demand through an identification card system (e.g. “Hong Kong visit card” (訪港證)) similar to the “home return card” (回鄉證). The number of Shenzhen citizens who can qualify is a little over 2 million, out of a total permanent population estimated to be over 8 million and a total population, including floating population, that has been estimated to be as high as 17 million. With a per capita GDP approaching U.S.\$10,000 for this group of residents, their visits to Hong Kong should be helpful to the tourism-related and retail and service businesses in Hong Kong.

Sustaining External Demand

- ◆ The Government can consider helping long-term exporters to finance their exports to long-term customers in the U.S. and elsewhere who are unable to issue letters of credit or carry their inventories because of the credit freeze in North America and Europe. This can take the form of export loan guarantees so that the Hong Kong exporters can ship their goods in part on consignment to their overseas customers and wait to receive payments in up to six months.

Possible Long-Term Directions

- ◆ Hong Kong's Long-Term Comparative Advantage
 - ◆ International links and bilingualism and biculturalism
 - ◆ Academic freedom, freedom of information
 - ◆ Rule of law and civil liberties
 - ◆ Proximity to China, a huge market and a huge source of savings
 - ◆ An entrepreneurial environment
 - ◆ World-class research-oriented universities
 - ◆ Geographically well located at the junction between Mainland China and the ASEAN region
- ◆ Hong Kong's Vulnerabilities
 - ◆ Volatility of government revenue and narrow tax base
 - ◆ High cost structure for international business
 - ◆ Insufficient support for higher education and for R&D

Possible Long-Term Directions

- ◆ Intensified Cooperation with Guangdong and the Pearl River Delta Region
- ◆ Economic Integration with Shenzhen
 - ◆ Complementarities
 - ◆ Specialization and division of labor
- ◆ Cooperation and Specialization and Division of Labor with Shanghai
 - ◆ Dual listing of stocks in both Hong Kong and Shanghai
 - ◆ Comparative advantages
- ◆ Serving East and Southeast Asia
- ◆ Education and R&D Hub of the Region

Concluding Remarks

- ◆ If the Chinese economy continues to grow in the 8% range in the next couple of years, the Hong Kong economy will be able to do reasonably well. I am confident that China will be able to grow at approximately 8% and that Hong Kong will be able to survive the financial earthquake relatively unscathed.
- ◆ In the longer term Hong Kong needs to reposition itself as a financial, insurance, logistics, design, education, R&D, tourism center serving not just China but also East Asia as a whole.