

**THE HONGKONG ECONOMY:
THE FLOWERS THAT BLOOM IN THE SPRING, TRA LA !**

Just how long the spectacular and prolonged growth of the economy of the People's Republic of China (PRC) will be able to act as a type of buffer for the lack of growth of the economy of the Hongkong Special Administrative Region (HKSAR) of the PRC is going to be an important issue for investors, both locally and internationally.

Probably, this concept of the PRC's economic-buffer effect, shielding the HKSAR from a financial amyotrophy, has not entered into most economists' formulae for the future economic course of the HKSAR, at this time, at least, but it shall be a factor in due course, of that there can be no argument.

The HKSAR Government's pencil pushers are feeding the world with financial statistics in respect of the 416 square miles that constitute the territory, indicating that things are improving apace, but it is that which is not mentioned in these statistics that may be considered very worrying to the more sagacious economists and business people on studying the HKSAR's economy.

In the first quarter of 2006, the HKSAR's real **Gross Domestic Product** (GDP = The total value of all goods and services, produced within a country in a year, minus net income from investments in other countries) increased, Year-On-Year, by about 8 percent.

In the second quarter, the GDP slipped to a growth rate of about 5.20 percent, Year-On-Year.

The second-quarter's growth rate was the slowest level of growth in the GDP since 2004.

The GDP's slowdown was due, in large part, to the pace (or the lack of pace) of exports.

The Year-On-Year growth in HKSAR exports fell from about 9.90 percent in August 2006 to about 4.70 percent in September.

Strangely, the Government of the HKSAR has determined not to mention this little statistic or, if the Government has mentioned it, it was purposely buried amid a plethora of other statistics.

It is very clear that most, if not all, of the HKSAR's Legislative Councillors either are unaware of the situation or, alternatively, don't give it the importance that it, clearly, deserves.

The reason for the slowdown in exports from the HKSAR is due, principally, to the slowdown in the economy of the territory's largest single customer: The United States of America.

Most of the HKSAR's industrial base has moved up north, across the border of the HKSAR and into the PRC, proper, where labour is more plentiful than in the HKSAR and where it is, still, relatively cheaper than in the territory.

Also, real property remains considerably less expensive in the PRC, proper, than in the former British Crown Colony of Hongkong.

This situation has caused the HKSAR to rely heavily on re-exports as opposed to domestic exports, for obvious reasons.

Re-exports, now, account for about 90 percent of all exports from the HKSAR.

The near-term outlook for the HKSAR's export market is not good, according to the latest batch of economic statistics, researched and collated by **TARGET** ().

Due to the fact that 90 percent of the HKSAR's exports are first imported into the territory, a study of imports is essential in order to understand what is, really, happening.

Imports into the HKSAR, during the second quarter of 2006, increased by about 6.80 percent, Year-On-Year.

But in the first quarter of 2006, imports into the HKSAR increased by about 13 percent, Year-On-Year.

In the month of September, the growth of imports into the HKSAR was about 8.20 percent, Year-On-Year.

That little September statistic compared with the growth in HKSAR imports of about 12.30 percent in August.

The above statistics were all gathered from the records of the HKSAR Government.

As such, one would assume that there can be no question as to their accuracy.

The economy of the HKSAR is dependent, today, on the economic success of the PRC and, of course, its largest single customer: The United States of America.

Thus, the HKSAR is especially vulnerable should either the US or the PRC falter, economically.

And the US is overdue for more than a bit of an economic correction, in **TARGET**'s opinion.

Also, as the economy of the PRC gathers pace, or even only maintains its present growth rate, naturally, it will cut into the growth of the economy of the HKSAR.

The Macau Special Administrative Region (MSAR) of the PRC, on the other hand, is, now, the Las Vegas of Asia and, as such, its industrial base is being chipped away on a daily basis as the service industry '*steals*' staff from factories and offices with promises of much-higher wages and much-better, employee benefits.

MSAR industries cannot match that which is being offered by the casino bosses and so industry loses out to the service industry of this little, former Portuguese colony.

TARGET suspects that the MSAR's industrial base will be almost non-existent in a very short space of time.

The HKSAR has little ability to compete with the MSAR; horse-racing and Disneyland will not fill the bill.

As for shopping, the MSAR can easily compete with the HKSAR as the new hotels are resplendent with spanking new shopping arcades ... with more to come.

Hongkong will, in due course, be relegated to a position of a financial centre, in the short term, but even that is under threat as the economy of the PRC's major cities – Shanghai, Beijing, Shenzhen, etc – continue to knock nails into the financial coffin of the territory.

As can be seen by the **TARGET**'s reproduction of the HKSAR's export/re-export/import statistics, above, there has been a decided downturn in the economic growth of the territory and, as the PRC develops more ports and their attendant infrastructure, it will whittle away further at the HKSAR's ability to compete.

The GDP of the HKSAR will fall further, no doubt, and a fair guesstimate is that, in 2007, it will be less than 5 percent.

The Wealth Effect

Many people in the HKSAR, today, are mesmerised by the strength of the key indices of the HKSAR's equity market which, of late, have hit record highs, thanks to the successful launchings of Initial Public Offerings (IPOs) of PRC-domiciled banks, in the main.

The resultant wealth effect has caused a surge in consumer spending and relatively high employment figures.

But the IPOs of PRC-domiciled banks cannot last for very long ... and, then, the penny will drop.

At this time in the history of the HKSAR, the territory is important to Beijing since it is a virtual city of gold, where dollars can be plucked off the city's trees and put into the coffers of the PRC's banks and other infrastructural companies, controlled by Beijing, many of which have been badly infested with corrupt practices in the past.

Tourism in the HKSAR has, historically, contributed about 20 percent of total retail sales, annually, but tourism is sharply lower, now, as the MSAR has become more of a drawing card than the HKSAR.

The following statistics are copied from HKSAR Government's survey in respect of visitor arrivals and hotel occupancy levels:

Month	Visitor Arrivals	Average Hotel Occupancy Rate ^{Note 1}
September 2005	1,787,728	82%
October 2005	2,145,335	88%
November 2005	2,061,493	95%
December 2005	2,198,938	90%
January 2006	2,188,816	85%
February 2006	1,934,666	86%
March 2006	2,102,768	91%
April 2006	2,127,254	86%
May 2006	1,955,615	82%
June 2006	1,888,126	84%
July 2006	2,185,610	88%
August 2006	2,358,932	89%
September 2006	1,830,189	82%

It is estimated that private consumption spending in the HKSAR for 2007 will fall from the growth rate of about 4.20 percent of 2006, Year-On-Year, to about 3.80 percent in 2007 – or even lower.

As may be seen from the HKSAR's statistics, there has been little change in the visitor arrivals between 2005 and 2006.

To stand still is to retreat, according to a maxim of economics.

The Problems In The United States

The problems with regard to the US economy will visit the HKSAR, to be sure.

The question is not when the problems in the US will be exported to the HKSAR, but by how much will the problems of the largest single economy of the world cut into the GDP of the PRC, proper, and that '*pimple*' on the bottom of the Middle Kingdom, known as the HKSAR.

As this medium has stated on many occasions, the bursting of the US housing bubble is the biggest single concern at this time.

TARGET continues to maintain that position.

Since the beginning of this year, things have not ameliorated in respect of the US housing problem.

They have, in fact, gone from bad to worse.

There is a number of factors, which have recently materialised and which have become only too apparent, that make **TARGET**'s chief financial analyst feel that, contrary to prognostications to the contrary, the developed world could well experience the backlash of the bursting (or the deflationary effect) of the US housing bubble.

Those factors are, inter alia:

1. The US Federal Reserve's policy of an expansive monetary policy;
2. US mortgage banks' aggressive lending policies, aimed at competing with the mounting domestic and international competition in spite of falling margins of profit;
3. Increased speculation in the commercial sector of US, real-estate markets;
4. Foreign investors, looking for short-term gains, thus driving up prices to higher levels in certain segments of the US property markets; and,
5. Increases in valuations of real property in order to justify lending practices, based on suggested (and, often, unrealistic) future valuations.

When The Fed determines that inflation is a potential threat to the US economy, a threat that has to be tackled, immediately, interest rates will be raised and the squeeze on speculators will drive down prices to much-lower levels.

Many economists and stock-market gurus are betting, today, that, at the December 12, 2006, Open Market Committee Meeting of The Fed, interest rates will not be increased and, if anything, The Fed may well consider a 25, basis-point cut.

TARGET says: Fat chance!

Any increase in interest rates will, definitely, cut into US consumer spending.

The last thing that US home-owners want is to lose is the roof over their heads.

High Street spending will be curtailed in order that there is sufficient money in the monthly budget to keep mortgage banks happy.

To say that the situation in the US is explosive may be going a little too far, at least, at this time, but it may not be too far off.

The situation in the US, as **TARGET** sees it, is much more precarious than in the past few years.

According to statistics, recently released by The Fed, consumer credit in the US increased at an annual rate of about 3.50 percent in the third quarter of this Fiscal Year.

The Fed said, inter alia, that in September, consumer credit decreased at an annual rate of 0.50 percent, as an increase in revolving credit was offset by a decrease in non-revolving credit.

(Non-revolving credit includes loans for motor vehicles and all other loans which are not included in revolving credit, such as loans for mobile homes, education, boats, trailers and/or vacations. Such loans may be secured or unsecured.)

The average cost for total consumer credit in the US in 2005 was standing at about 4.10 percent per annum, seasonably adjusted.

For August 2006, the average cost for total consumer credit in the US was standing at about 4.60 percent per annum, seasonably adjusted.

The average cost for revolving credit in 2005 was standing at about 3 percent per annum, seasonably adjusted, and, in August 2006, the average cost for revolving credit was standing at about 6.70 percent per annum, seasonably adjusted.

In a period of 8 months, therefore, the cost of borrowing in the US had risen by about 123 percent.

As for non-revolving credit, in 2005, it was costing, on average, about 4.70 percent per annum, seasonably adjusted.

In August 2006, non-revolving credit was costing about 3.50 percent per annum, seasonably adjusted.

In Detroit's panic to put its motor vehicles on US highways, it has had to dangle multiple 'carrots' in front of prospective, US buyers.

This is very apparent by studying the statistics with regard to new, motor-vehicle loans, afforded to US consumers by finance companies, owned and operated by Detroit-based entities.

In 2005, motor-vehicle finance companies were charging 5.46 percent per annum for a new, motor-vehicle loan with a maturity of the loan, being 60 months.

The Loan-To-Value Ratio in 2005 for new, motor-vehicle loans was about 88 percent.

In August 2006, interest rates for new motor vehicles, afforded by motor-vehicle finance companies, had dropped to about 3.69 percent per annum, for a maturity of 62.90 months, with a Loan-To-Value Ratio, rising to about 91 percent.

For commercial banks, on the other hand, new, motor-vehicle loans were being charged at the average rate of 7.95 percent per annum for a period of just 24 months.

Turning to The Bureau of Economic Analysis, a division of the US Department of Commerce, it, recently, released the following:

'Personal Income and Spending

'Personal income, a broad measure that includes all sources of income, rose 0.5 percent in September, after increasing 0.4 percent in August.

'Wages and salaries, the largest component of personal income, increased 0.5 percent after increasing 0.2 percent. Growth turned up in private industries, reflecting an upturn in service industries.

'The upturn in real consumer spending reflected upturns in spending for durable and nondurable goods.

'Prices

The Personal Consumption Expenditures (PCE) price index decreased 0.3 percent in September, reflecting a decline in energy prices. In August, the PCE price index rose 0.3 percent.'

Lastly, according to US Government statistics, construction spending in September was off by about 0.30 percent, Month-On-Month.

As for private construction, September's statistics indicate that it fell by about 0.70 percent, Month-On-Month.

Private construction is that segment of the US economy, heavily reliant on residential construction.

For private, residential construction in the US, the month of September represented the sixth consecutive month of declines.

Housing starts in the US have fallen, consistently, for the past 8 months.

As the US economy continues to decelerate, so the situation in the housing market will be adversely affected, with more problems, visiting themselves upon US consumers.

Nearly every segment of the US economy will be affected, one way or another, directly or indirectly.

That is a given.

It will affect imports, to be sure.

The Fed is in for a sticky time because, on the one hand, it cannot continue with an expansive monetary policy and, on the other hand, to raise interest rates could well force bankruptcies to escalate with the resultant ripple effect.

Wall Street's bullish run cannot continue for long, it would appear, logically.

And neither, it would appear, can the gains in key indices of The Stock Exchange of Hongkong Ltd.

In the words of Nanki-Poo (from the operetta, *'The Mikado'*):

*'The flowers that bloom in the Spring,
Tra la,
Breathe promise of merry sunshine
As we merrily dance and we sing,
Tra la,
Of a summer of roses and wine,
And that's what we mean when we say that a thing
Is welcome as flowers that bloom in the Spring.
Tra la, tra la la la la la, etc.'*

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