

ECONOMIC FOCUS

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Hong Kong's Inflation Outlook

The mounting inflationary pressure has changed the economic landscape significantly recently. Inflation in Hong Kong surged to 11-year highs, spreading beyond food to other consumer goods and services. Non-food inflation jumped from around 2% at the beginning of the year to 4.5% in June. What are the main culprits?

A softening currency exposes the highly import-dependent Hong Kong economy to imported inflation. Hong Kong's trade weighted real effective exchange rate has depreciated 13.7% since November 2005. According to a government study, a 10% appreciation of the Hong Kong dollar may help push down inflation by 0.6%. In other words, the 13.7% depreciation is likely to have lifted Hong Kong inflation by less than 1%.

Inflation seems to stem more from soaring oil prices. At today's prices, if adjusted for inflation, oil has already surpassed the 1980-peak. Similar pace of oil price rises was also seen in previous oil crises, in 1973/74, 1979/80 and 1999/2001. What does that mean for Hong Kong? History seems to suggest that Hong Kong's inflation is poised to jump and the real GDP growth to decelerate! What matters more may be the magnitude of the downturn.

Projecting on the trajectory of oil prices, we see three possible scenarios – namely “global stagflation”, “global slowdown” and “industrial world downturn”. At this stage, we do not see a 1970s-style global stagflation as a likely scenario, unless the outbreak of wars or other disruptions threaten oil supply, leading to a further spike in oil prices.

Likewise, the “industrial world downturn” scenario seems increasingly a scene of the past. Latest indicators show that the US weakness seems to have spread beyond the industrial world. The Asian Development Bank has just revised downward its 2008 growth forecast of developing economies in Asia to a five-year low on a more protracted US slowdown and elevated food and oil prices. The global economy seems to be on the verge of a “synchronized slowdown”.

Against this backdrop, Hong Kong's inflation looks set to climb. Nevertheless, the government's newly proposed HKD11 billion relief measures is likely to suppress headline consumer price inflation in the coming months, helping to keep the full year inflation rate at 5.0%. Elevated oil prices would mean that inflation could stay high in 2009, but probably not skyrocketing, as a global downturn would eventually dampen oil demand, putting a lid on oil prices and taming inflation. We see 2009 inflation stay high at 5.0%.



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Mounting Inflationary Pressure Changes the Economic Landscape

The mounting inflationary pressure has changed the economic landscape significantly recently. Central banks around the world have to deal with rising inflation risks as energy prices scale new heights. Hong Kong's consumer price inflation crept up to 6.1%¹ in June – the highest since August 2007. What is of greater concern is that the rise in prices has become more broadly-based.

Earlier this year, food-driven inflation was the main cause of concern, but the disruption to food supply was deemed to be temporary. That view might have to be revised. Food prices have been rising at double digits for nine consecutive months since September 2007 and there are no signs of reversal in the near term.

Inflation has also spread beyond food. Non-food inflation surged from around 2% at the beginning of the year to over 4% in recent months. What are the main culprits driving non-food inflation higher? A softening Hong Kong dollar, or surging global oil prices?

Exhibit 1

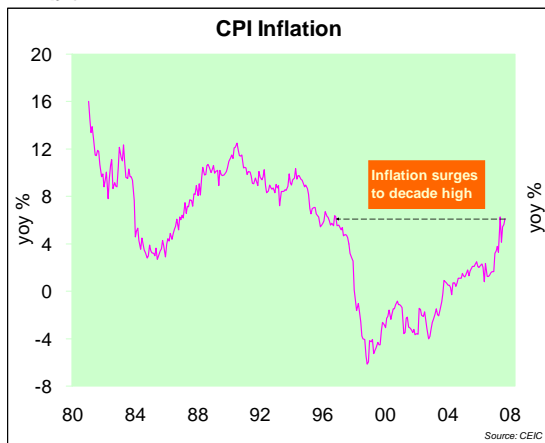
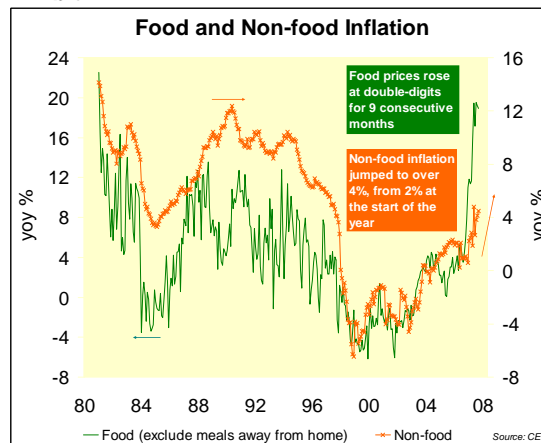


Exhibit 2



What is to Blame?

Softening currency

A softening currency exposes the highly import-dependent Hong Kong economy to imported inflation. For instance, Hong Kong's retained imports of foodstuffs and fuels amounted to HKD 77 billion and HKD 88 billion respectively in 2007. The share of retained imports of "foodstuff" and "fuels" in their corresponding values of total imports were 77% and 95% respectively. Prices of retained imports rose 6.5% in the first quarter this year, the biggest jump since September 2005. How does that translate into our inflation figures?

¹ Changes throughout the report are on year-on-year basis unless otherwise stated.



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Hong Kong's trade weighted real effective exchange rate has been dropping fast this year, tracking the decline of the US dollar to which the Hong Kong dollar is linked, and has depreciated 13.7% since November 2005. According to a government study, a 10% appreciation of the Hong Kong dollar may help suppress inflation by 0.6%. In other words, the 13.7% depreciation is likely to have lifted Hong Kong inflation by less than 1%.

In addition, a study conducted by the Hong Kong Monetary Authority showed that fluctuations in foreign prices (or the exchange rate) on average explained less than one-third of the changes in Hong Kong's consumer price inflation, whereas domestic demand and properties prices explained more than two-thirds of the changes in prices in the last two decades.

According to these studies, the impact of a softening currency on Hong Kong's inflation is relatively limited. Hong Kong's recent inflation seems to stem more from soaring oil prices.

Exhibit 3

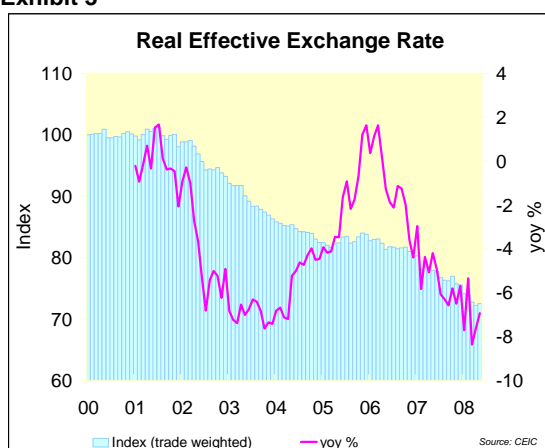
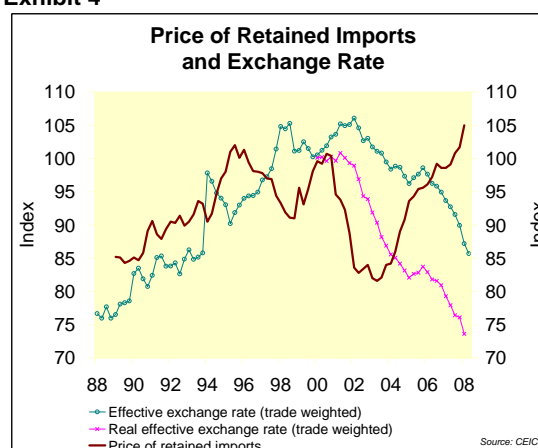


Exhibit 4



Surging oil prices

Crude oil prices have gone up by over 40% since the start of the year. Hong Kong is fully exposed to gyrations in global supply-demand dynamics, as the territory has to rely heavily on imports for energy. The surge in oil prices appears to be filtering through to other sectors leading to a noticeable increase in utilities charges and transport costs in recent months.

The pass-through is yet to end, as surging oil and commodities prices may not have found their peaks in the international market. The price of crude soared to a historical peak of above USD147 a barrel on 11 July and is still hovering near record levels. Generally speaking, the higher the absolute price of oil, the greater will be the adverse impact on oil importers like Hong Kong. At today's prices, if adjusted for inflation², oil prices have already surpassed the 1980-peak.

² Adjusted for US Jun 2008 CPI inflation.



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Also, the larger and more sustained the oil price increase, the bigger will be the adverse impacts. Since the 1970s, there has been a number of oil crises. Similar pace of oil price rise was also seen in 1973/74, 1979/80 and 1999/2001, but this time the increase is more prolonged. What does that mean for Hong Kong?

Exhibit 5

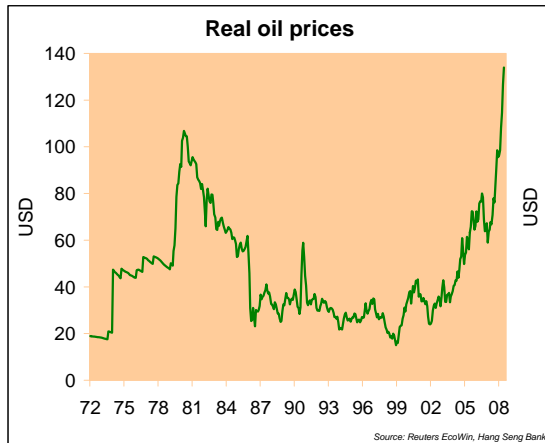
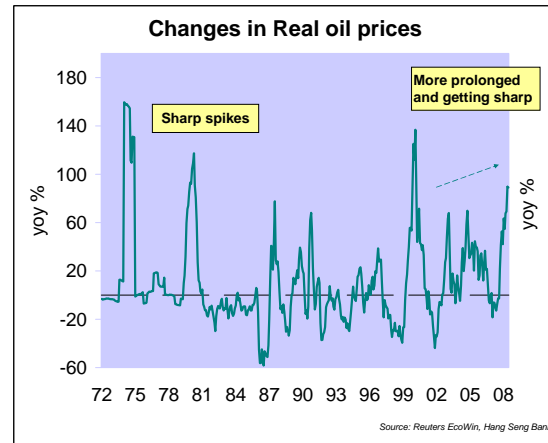


Exhibit 6



Where is Inflation Heading?

If history is any guide, Hong Kong's inflation is poised to jump and real GDP growth to decelerate! What matters more may be the magnitude of the downturn. The global economic outlook and monetary policy responses are now all projected on the trajectory of oil prices. While there is no consensus on where oil prices will settle, oil forecasts from various sources have been revised steadily upwards. We see three possible scenarios, namely, "global stagflation", "global slowdown" and "industrial world downturn".

Exhibit 7

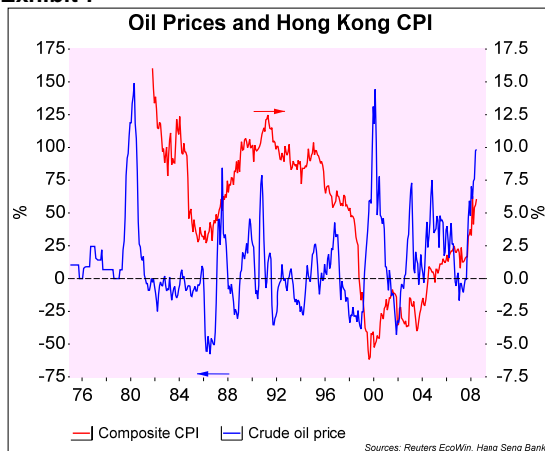
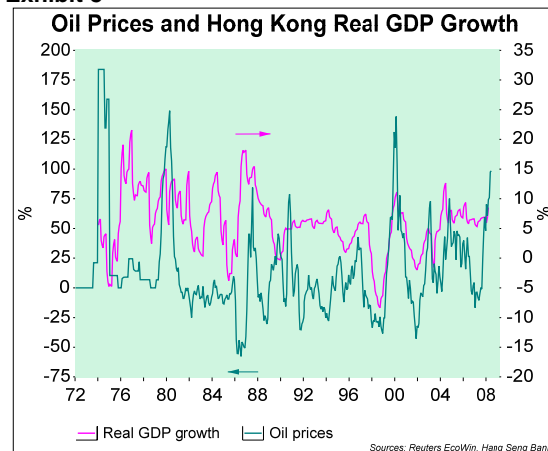


Exhibit 8



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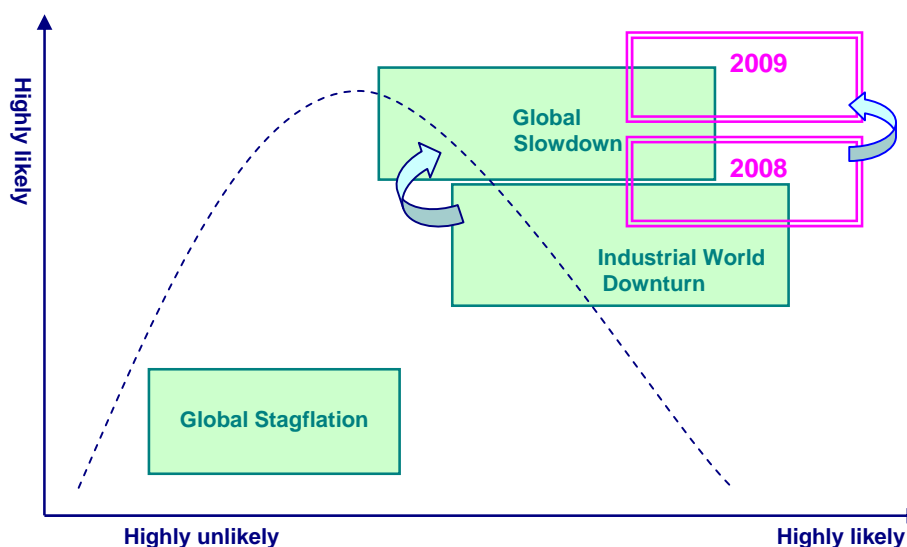
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Three Possible Scenarios

Exhibit 9

	Characteristics	Economic Landscape
Scenario 1	<p>Industrial World Downturn</p> <ul style="list-style-type: none"> – Decoupling – Emerging world remains intact 	<ul style="list-style-type: none"> – World economic and trade growth remain solid – Mild inflation
Scenario 2	<p>Global Slowdown</p> <p>According to the IMF, "there is a 25% chance that the global economy will record 3% or less growth in 2008 and 2009, equivalent to a global recession."</p>	<ul style="list-style-type: none"> – World economic and trade growth decelerate sharply – Inflation climb higher before easing on waning demand
Scenario 3	<p>Global Stagflation</p> <p>Outbreak of war trapping the globe in stagflation</p>	<ul style="list-style-type: none"> – World recession – Skyrocketing inflation



Hong Kong's Inflation to Remain High

Although inflation seems to be tracking oil prices closely, triggering some central banks to tighten monetary policy in recent months, we do not see a 1970s-style "global stagflation" as a likely scenario at this stage, unless the outbreak of war or other disruptions threaten oil supply, leading to a further spike in oil prices.



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Likewise, the industrial world downturn scenario seems increasingly a scene of the past. Latest indicators show that the US weakness seems to have spread beyond the industrial world.

Mainland China's GDP growth has already shown signs of decelerating on a US-led slowdown. The Mainland's June export growth slowed sharply to 17.6%, from 28.1% in May, which is one of the key factors contributing to the easing of real GDP growth to 10.2% in the second quarter.

Greater spillovers were seen in smaller economies in Asia. Hong Kong's June exports actually declined 0.6%, from a growth of 10.3% in May, as exports to the Mainland dropped 6.2%, exports to the US continued to be weak and shipments to major European and Asian economies decelerated sharply. Singapore's non-oil exports also dropped 3.5% in June. The country's real GDP growth slowed to 1.9% in the second quarter, from 6.9% in the first quarter, affected by the deteriorating external environment, according to the advance estimates by Singapore's Ministry of Trade and Industry.

The Asian Development Bank has also revised downward its 2008 growth forecast of developing economies in Asia to a five-year low on more protracted US slowdown and elevated food and oil prices. We are most probably heading to a "global slowdown" scenario.

Exhibit 10: Hong Kong's Inflation Forecast

	CPI Inflation
2007	2.0%
2008F	5.0%
2009F	5.0%

Source: Census and Statistics Department, Hang Seng Bank

Against this backdrop, Hong Kong's inflation looks set to climb higher. Nevertheless, the government's newly-proposed HKD11 billion relief measures will help suppress headline CPI in the coming months, keeping the territory's full year inflation at 5.0%.

Looking further ahead, elevated oil prices are likely keep inflation at relatively high levels in 2009, though prices are unlikely to skyrocket as a global downturn would eventually dampen oil demand, putting a dent in oil prices and taming inflation. We see 2009 inflation at 5.0%, the same as that for this year.



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