

Hong Kong

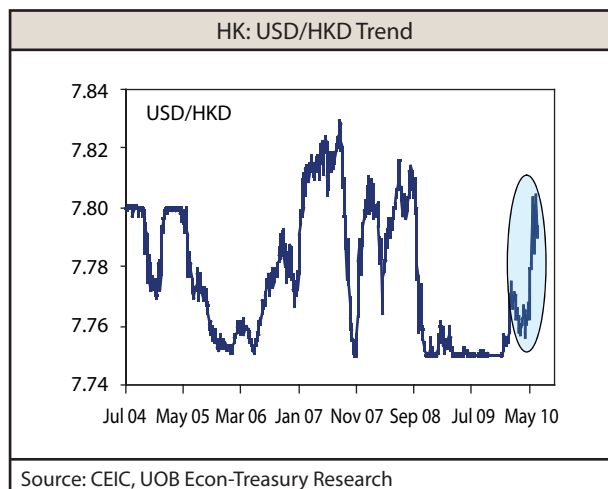
Hong Kong	2008	2009	2010F	2011F
GDP	2.4%	-2.7%	5.5%	4.5%
CPI (average, y/y)	4.3	0.5	2.7	3.0%
Unemployment Rate (%)	4.1	4.9	4.2	3.8
Current account (% of GDP)	14.2%	9.0%	6.8%	8.7%
Fiscal balance (% of GDP)	0.1%	1.6%	0.8%	0.5%

Summary

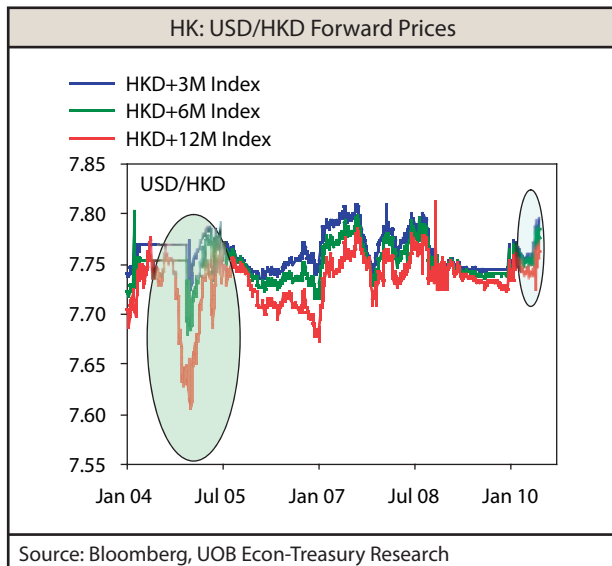
- Recent USD/HKD actions have been subdued as USD strengthened across the board on the back of risk aversion. Forward prices are also relatively calm, despite expectations of a change in China's FX policy. Given the USD reserve currency status, we expect HKD peg to remain unchanged despite the shift in China's FX policy on 19 Jun.
- As we expect the US Federal Reserve to begin tightening only in early 2011, this means that the 3-month HIBOR should remain at relatively low level of about 0.5% at end-2010, and then rising to 2% by end-2011, assuming 3-month USD LIBOR rising to 0.7% at end-2010 and to 2.4% by end-2011.
- We remain positive on Hong Kong, given favourable domestic conditions. The key is its labour market which has recovered sharply from the global recession. With the boost from 1Q10, we have revised up our GDP forecast for Hong Kong to 5.5% for 2010, from previous projection of 4.0%.

HKD Peg To Stay Intact from Potential Change in RMB Policy

In a risk aversion environment, USD/HKD moved back toward the middle of its 7.75-7.85 band after the stock market peaked in mid-Apr. This is a reflection of a firmer USD as funds flow to safe haven assets during period of uncertainty, with the latest being the Eurozone's debt crisis. YTD, the USD index (DXY) has gone up by about 11%, reversing almost all its 17% loss during the equity market rebound between Mar 2009 to end-2009. The USD/HKD forward market has also stayed relatively subdued, with 12-month discount at about 300bps, largely in line with average of 230bps so far this year, despite an anticipated change in China's FX policy, which was finally announced on the evening of 19 Jun (please refer to section on China in the report for details).



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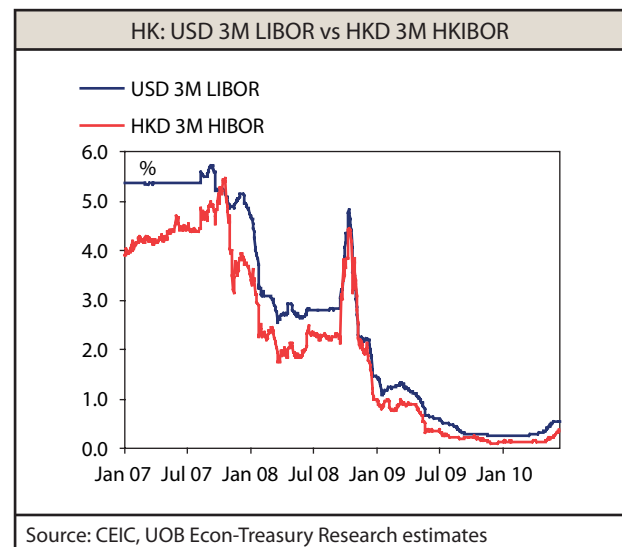


We see very little risk of a knock on effect on the HKD peg after China shifted its policy stance on 19 Jun to allow for more flexibility. Until there is a full liberalization/capital account opening in China, and as long as the USD is still a reserve currency, there is not much of a catalyst for Hong Kong to alter its currency peg arrangement. However, the Agricultural Bank of China's upcoming IPO is a significant step towards the eventual opening of China's capital account, as AgBank is the last major piece of puzzle that will complete the picture for China's banking sector. That will pave the way for China's eventual capital account opening (and RMB liberalization), most likely within the space of next ten years. For now, we see status for the HKD peg to remain unchanged.

However, one consequence of the HKD peg is that monetary policy in HK is synchronized with the US Fed's policy direction, regardless of domestic economic conditions and pace of economic activities. While the USD LIBOR rates have been rising in recent months in response to the uncertainty and risk aversion over Europe's debt crisis, they remain near record lows. The benchmark 3-month USD LIBOR rate has risen to around the 0.54% level (as at 15 Jun), more than doubled the historic low of 0.25% at end-Dec but still below the 1% level seen around Mar 2009 before the rebound in global equity prices. In response to the recent spike, 3-month HKD HIBOR also rose, to about 0.37% from record low of 0.099% late 2009.

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 (just prior to the onset of the global financial crisis), and even higher R-squared was obtained for 2007 to 2009. As we expect the US Federal Reserve to

begin tightening only in early 2011, this suggests that the 3-month HIBOR should still remain at relatively low level of about 0.5% at end-2010 and to about 2% by end-2011, assuming 3-month USD LIBOR rising to 0.7% at end-2010 and to 2.4% by end-2011.



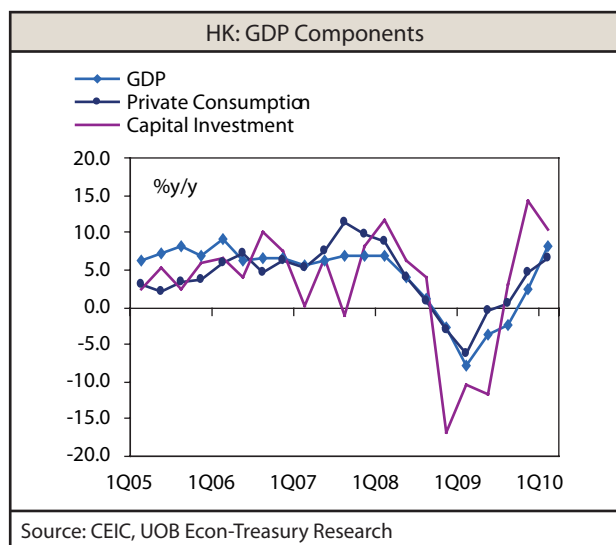
Raising Full Year Growth Target

Hong Kong's 1Q10 GDP surprised on the upside, with an 8.3%/y pace, sharply higher vs 2.5% growth in 4Q09. On a seasonally adjusted q/q saar basis, the pace was equally strong at nearly 10%, despite an already exceptional 9.8% annualized growth in 4Q10.

One noteworthy development in the recent growth reports is that there has been a broadening domestic demand story, as both private spending and investment regained ground after nearly a year of declines. However, net exports contributed significantly to Hong Kong's 1Q10 growth, accounting for nearly 80%. This surge in net exports trend is unlikely to continue and we expect the external trade component to moderate in the quarters ahead, against the backdrop of Europe's debt crisis and the related austerity measures that are gradually taking effect.

Our recent study (see "Estimating the Real Economy Fallout in Asia from the European Debt Crisis" in this Quarterly) shows that Eurozone's direct impact on Asia is not negligible, which channels through both output and price effects. We estimate very 10% decline in exports to Eurozone would result in a direct 0.2%-0.8% decline of headline GDP growth for a number of key Asian exporters. This has yet to take into account indirect effect, e.g. intra-regional Asian trade, as well as impact via third country e.g. via the US.

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Nevertheless, we remain positive on outlook for Asia and particular for Hong Kong, as domestic conditions are still favourable. The key is its labour market which has recovered sharply from the global recession, with jobless rate falling to 4.4% and gradually returning towards pre-recession period low of 3.3%. Given the boost from 1Q10, we have revised up our GDP forecast for Hong Kong to 5.5% for 2010, from 4.0% previously. Note that official forecast remains unchanged at 4-5%.

Against a backdrop of firm external demand and an improving domestic labour market, inflationary pressures are steadily building but should remain contained for now given excess capacity that is still the norm globally. Headline April CPI rose 2.4%/y/y from 2.0% in Mar. Ex-government relief measures, the underlying inflation rate rose to 1.3%/y/y vs. 0.8% in Mar, averaging just about 0.9%/y/y in the first four months of 2010. As in the case of China and elsewhere, food prices have been the key driver in headline number, with food component rising 1.9%/y/y vs. 1.3% gain in Mar. While pricing pressures are expected to continue to head higher in the months ahead due to domestic activities, uncertainty of the external environment is likely to be one key offsetting factor. As such we do not expect inflationary pressures to rise significantly in the near term. We look for full year Hong Kong headline inflation rate at 2.7% for 2010, which is still manageable considering the 0.5% rise in 2009.

