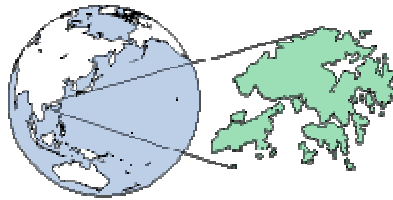


# COUNTRY REVIEW

## Hong Kong



8 June 2009

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**EULER HERMES COUNTRY RISK GRADE: A**

Country Risk Grades are on a scale of AA, A, BB, B, C, D  
where AA is the lowest and D the highest risk.

## Strengths

- Strongly pro-market, pro-business environment with a good record of dynamic growth
- Gateway to China and close ties help Hong Kong to capitalise on competitive advantage in finance and services
- Strong external liquidity and public debt position
- Sound banking system and proven monetary framework

## Weaknesses

- Long term role vis-à-vis mainland competitors such as Shanghai
- Vulnerability to political developments in Mainland China
- Vulnerability to external economic shocks

## Key Risks

- **Recession**

## Country Risk Assessment

Ratings	Hong Kong		Median Grade A	Singapore	Peers	
	Latest	Previous			UAE	Taiwan
<b>Systemic Political Risk:</b>	<b>P2+</b>	<b>P2+</b>	<b>P2+</b>	<b>P1</b>	<b>P2+</b>	<b>P2+</b>
<b>Systemic Economic Risk:</b>	<b>E2</b>	<b>E2</b>	<b>E2</b>	<b>E2</b>	<b>E2</b>	<b>E2</b>
ME rating:	ME2	ME2	ME2	ME2	ME2	ME2
<i>Structure</i>	3.3	3.3	3.3	3.3	5.0	4.0
<i>Policy</i>	1.9	1.0	2.3	3.8	3.8	2.8
<i>Solvency</i>	1.0	1.0	1.0	1.3	1.0	1.0
<i>External Liquidity</i>	4.2	3.8	2.3	2.3	1.3	2.8
SBE rating:	SBE1	SBE1	SBE2	SBE1	SBE2	SBE2
<b>COUNTRY GRADE:</b>	<b>A</b>	<b>A</b>	<b>A</b>	<b>A</b>	<b>A</b>	<b>A</b>

### Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

## ECONOMIC STRUCTURE

### Country Profile

Capital city:	Hong Kong
Population:	6.95 mn (2007)
GDP:	USD 207025 mn (2007)
Currency:	Hong Kong dollar HKD)
Form of state:	Special Administrative Region (SAR) of China
Head of government:	Chief Executive Donald Tsang
Next elections:	2012 (Legislative Council)

### Major Industries (% of GDP at market prices, 2007)

Agriculture	0.1%
Mining & manufacturing	2.5%
Utilities	2.6%
Construction	2.6%
Services	92.3%

### Global Assumptions

	2008	2009
Real GDP grth (% yr/yr) *	0.7	-3.0
Inflation (% , av) *	3.4	1.0
Dated Brent (USD/b)	98	50
* Major economies		

### Main Exports (% of total, 2008)

Domestic	3.2%
Re-exports	96.8%
Raw materials & semi-manufactures	35.0%
Consumer goods	31.7%
Capital goods	33.3%

### Main Imports (% of total, 2008)

Foodstuffs	3.2%
Consumer goods	26.8%
Raw materials & semi-manufactures	36.1%
Fuels	3.0%
Capital goods	30.1%

### Lead Export Markets (% of total exports, 2008)

China	48.5%
US	12.7%
Japan	4.3%
Germany	3.3%

### Lead Import Markets (% of total imports, 2008)

China	46.6%
Japan	9.8%
Singapore	6.4%
Taiwan	6.3%

## Basic indicators

Selected economic indicators	2005	2006	2007	2008f	2009f
Nominal GDP (USD mn)	177,832	189,882	207,025	215,616	204,513
Population (mn)	6.88	6.92	6.95	6.98	7.01
GDP per capita (USD)	25,848	27,440	29,788	30,891	29,174
Real GDP growth (% yr/yr)	7.1	7.0	6.4	2.4	-6.5
Inflation (% , eop)	1.3	2.3	3.8	2.1	0.4
Fiscal balance (% of GDP)	1.0	-0.1	2.2	0.1	-3.6
Current account balance (% of GDP)	11.3	12.1	12.3	14.2	10.3
External debt/GDP (%)	247	272	345	305	320
External debt/Exports of goods & services (%)	124	132	166	144	169
Interest payments/Exports of goods & Services (%)	6	6	8	10	8
Foreign exchange reserves (USD mn)	124,240	133,170	152,640	182,470	200,000
Import cover (months)	4.5	4.3	4.5	5.0	6.4
Exchange rate assumption, HKD:USD (av)	7.78	7.77	7.80	7.79	7.75
f: CRU central forecast		Note: HK is a net external creditor			

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

## Political Stability

Hong Kong has been a Special Administrative Region of China since 1997 when it was handed back to China by the UK. The constitutional relationship with China is enshrined in the Basic Law, which provides for the preservation of Hong Kong's capitalist system and way of life for 50 years and a high degree of autonomy within China's concept of "one country, two systems". According to the Basic Law the legal system is to remain intact, as are basic individual freedoms and Hong Kong is to remain a free port, a separate customs territory and an international finance centre with free flow of capital and the right to manage and issue its own currency. There is limited democracy, but the Hong Kong government is neither fully accountable nor fully representative. The head of government is a chief executive who is elected indirectly by an 800-strong election committee, top officials are appointed and the legislative council (Legco) is only partially elected. Hong Kong may develop economic and financial ties in its own right, but Mainland China has responsibility for foreign policy and defence.

**There are inherent tensions in the 'one country, two systems' approach as enshrined in the Basic Law but the Chinese leadership is generally thought to value the preservation of Hong Kong's status and so seeks to preserve a good deal of autonomy.** At the same time, however, Beijing seeks to curb any potential threat to the mainland's political system and has adopted a cautious stance on the contentious issue of universal suffrage in Hong Kong. At the end of 2007 the Standing Committee of the People's National Congress set 2017 as the earliest date for universal suffrage for the election of Chief Executive and 2020 as the earliest for the legislature. Pro-democracy groups will continue to press for greater electoral participation, yet they probably lack sufficient support to challenge the Executive to the point where either social breakdown or, more likely, a security clampdown by Beijing would be threatened. This is also a high-income, well developed economy, without a tradition of popular representation, which further mitigates the threat of violent social discontent.

The current Chief Executive Donald Tsang is a well-respected, long-serving civil servant, former chief secretary to the administration who won a second term in March 2007 securing the overwhelming support of the electoral committee in what were the first contested elections. Chief Executive Tsang seems to retain the backing of Beijing, but his popularity has been dented by the recession. In the September 2008 LegCo elections the government retained a majority, but pro-democracy groups won enough seats to allow them to continue to veto constitutional reform.

Although the 'one country, two systems' approach provides some safeguards, were there to be a breakdown in systemic political stability or radical policy shift in Mainland China (though both are low risk in the short term) it is hard to see how Hong Kong would be unscathed. Further, the international community would be unlikely to intervene directly and, as Beijing is responsible for foreign affairs (though not trade) disagreements between the Mainland and third countries could impact Hong Kong. **Consequently, systemic political risk mirrors China's to a considerable extent.**

## Economic Stability

Hong Kong is a high income, open economy, where exports of goods and services are around 200% of GDP. The economy is also highly dependent on Mainland China. In the past decade there has been sweeping structural change in which manufacturing declined from 18% of GDP in 1990 to just 2.5% in 2007 while services increased to 92% from 74%. This reflects the transfer of manufacturing capacity to Mainland China and Hong Kong's development as a service provider, particularly to companies doing business with the mainland. **This structure makes the economy highly vulnerable to external shocks.** Annual average growth of real per capita GDP was a relatively strong 4.2% during the past ten years.

Real GDP increased by an annual average 7.3% in 2004-07, but slowed to 2.4% in 2008 with a contraction in output (qtr/qtr) from Q2 that intensified sharply in Q1 2009 when real GDP fell by 4.3% qtr/qtr or 7.8% yr/yr. Exports and imports collapsed, adding to the collapse in fixed investment already evident in Q4. Private consumption has also contracted sharply. **There are tentative signs that global demand may be stabilising and with growth picking up in Mainland China the outlook for Hong Kong is improving, though in calendar 2009 we expect real GDP to contract by 6.5%. In 2010 GDP should increase by 2.5%.** An important contributor to medium-term growth is the Closer Economic Partnership Arrangement with Mainland China, implemented fully from 2004 and extended in 2005 and 2006, which gives Hong Kong exports preferential access to mainland markets.

Several stimulus packages have been introduced to counter the impact of falling global demand on the

economy—amounting to 4% of GDP—and consequently increased spending combined with falling revenues will lead to a fiscal deficit around 3.5% of GDP in 2009, after several years of rough balance or small surpluses. **Fiscal deficits, however, are not a problem as there is very little public debt and a substantial fiscal reserve fund (just under 30% of GDP).** Hong Kong also has a good record of clawing back deficits in the upturn of economic cycles.

Monetary policy is determined by the currency board that pegs the Hong Kong dollar exchange rate to the USD. Accordingly, interest rates track those of the US, implying an expansionary monetary policy for some time. **The currency board was established in 1983 and having survived all the various emerging market crises since then should continue to prove durable** (though it is not enshrined in the Basic Law). Foreign exchange reserves are more than 200% of the monetary base, the banking system is basically sound—though credit has been squeezed and there were some scares over certain institutions at the height of the global financial crisis—and the fiscal deficit does not create undue pressure. Inflation fell to 0.6% yr/yr in April 2009 and we expect it to be close to zero at end-2008 before picking up slightly in 2010 as domestic demand recovers modestly. **However, Hong Kong suffered continuous deflation from 1998 until mid-2004 and the re-emergence of deflation is a serious risk.**

**The current account is typically in surplus as net services earnings more than offset the trade deficit. Moreover, as re-exports account for more than 90% of total exports while less than 30% of imports are retained for domestic end-use, there is a strong self-correcting element in the trade balance.** In 2009 Q1 both exports and imports fell dramatically (in excess of 20% yr/yr) and both will be down 15-20% for the calendar year, leaving the trade surplus more or less the same as in 2008 in dollar terms and slightly higher as a proportion of GDP. However, with the income balance likely to deteriorate moderately (profits and dividend net earnings) the **current account surplus will fall to just over 10% of GDP from 14% in 2008.** FDI inflows are in excess of 20% of GDP, though as outflows are equally strong the net position oscillates between small surpluses and small deficits. Foreign exchange reserves provide around six months import cover.

Total external debt is high at around 300% of GDP, based on official data, but as a percentage of exports of goods and services is a much lower at 140-160% (a comfortable ratio). Moreover, these data includes short term banking sector liabilities, which are more than covered by banking sector short term assets and, **indeed, Hong Kong is in a net creditor position overall. Further, public debt is a very small proportion of the total debt stock.** External debt servicing requirements are relatively low

**Overall, Hong Kong is experiencing a severe recession, but has sufficient leeway to provide offsetting expansionary fiscal policy. Wider systemic failure/collapse is unlikely given relatively large foreign exchange reserves, low debt ratios and a relatively sound banking system.**

## Structural Business Environment

**The Structural Business Environment is very strong, ranking 11 out of 210 economies in our ratings.**

The World Bank's 2009 Ease of Doing Business survey ranks Hong Kong 4 out of 181 surveyed, while the Heritage Foundation 2009 Index of Economic Freedom puts it first out of 179 and Transparency International's Corruption Perception Index, 2008 places it 12 out of 180.

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**Charts**

