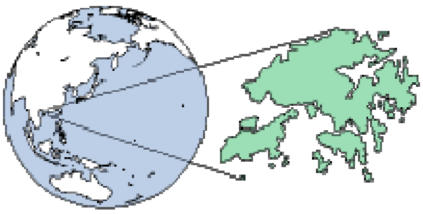
COUNTRY REVIEW

Hong Kong



8 November 2010

ANALYST: David Atkinson

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

Country Risk Assessment

Ratings	**Hong Kong**		**Median**	**Peers**		
	Latest	**Previous**	**Grade A**	**Singapore**	**Taiwan**	**Chile**
Systemic Political Risk:	**P2+**	**P2+**	**P2+**	**P1**	**P2+**	**P2+**
Systemic Economic Risk:	**E1**	**E2**	**E2**	**E1**	**E2**	**E2**
ME rating:	ME2	ME2	ME2	ME1	ME2	ME2
Structure	*2.1*	*2.1*	*3.3*	*2.6*	*3.3*	*4.0*
Policy	*3.2*	*2.8*	*2.2*	*1.7*	*1.9*	*2.2*
Solvency	*1.9*	*1.9*	*1.9*	*1.3*	*1.0*	*2.3*
External Liquidity	*2.8*	*2.8*	*2.8*	*1.3*	*1.3*	*2.9*
SBE rating:	SBE1	SBE2	SBE2	SBE1	SBE1	SBE2
COUNTRY GRADE:	**A**	**A**	**A**	**AA**	**A**	**A**

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:	7.02 mn (2009)
GDP:	USD 201581 mn (2009)
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, 2009)	
Agriculture& fishing	0.1%
Manufacturing	2.5%
Utilties	2.5%
Construction	3.1%
Services	92.0%

Global Assumptions	2010	2011
Real GDP grth (% yr/yr) *	3.3	2.9
Inflation (%, av) *	1.2	1.4
Dated brent (USD/b)	75	70

* World

Main Exports (% of total, 2009)	
Domestic	2.3%
Re-exports	97.7%
Raw materials & semi manufactures	34.0%
Capital goods	32.7%
Consumer goods	29.7%

Main Imports (% of total, 2009)	
Consumer goods	25.6%
Foodstuffs	3.9%
Raw materials & semi manufactures	36.5%
Fuels	3.3%
Capital goods	30.6%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	207,025	215,102	201,581	228,102	243,385
Population (mn)	6.95	6.98	7.02	7.06	7.10
GDP per capita (USD)	29,788	30,817	28,715	32,309	34,280
Real GDP growth (% yr/yr)	6.4	2.2	-2.8	6.7	4.3
Inflation (%, eop)	3.8	2.1	1.3	2.6	2.7
Fiscal balance (% of GDP)	1.5	0.1	0.8	1.4	1.2
Current account balance (% of GDP)	12.3	13.6	8.7	7.7	6.2
External debt/GDP (%)	344	307	320	302	286
External debt/Exports of goods & services (%)	165	144	165	138	130
Interest payments/Exports of goods & services (%)	10	8	6	5	5
Foreign exchange reserves (USD mn)	152,640	182,470	255,770	265,000	275,000
Import cover (months)	3.9	4.2	5.6	6.2	5.9
Exchange rate assumption, NTD:USD (av)	7.80	7.79	7.75	7.79	7.79
f: CRU central forecast					

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 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. 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.

Modest reforms were approved in June 2010. The LegCo is to be expanded at the 2012 elections to 70 seats from the current 60, and all ten additional seats will be elected by popular vote, though five of the ten are functional constituencies. Presently 30 seats are directly elected (geographical constituencies and 30 are elected indirectly by social and business interest groups (functional constituencies). Consequently for the first time a majority of seats in the LegCo will be elected by popular vote, which should favour pro-democracy groups, but is unlikely to herald major change.

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 2009 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 3.5% during the past ten years.

Real GDP increased by an annual average 7.3% in 2004-07, but slowed to 2.4% in 2008 and contracted by 2.8% in 2009 under the impact of the global financial crisis and recession. Recovery began in Q2 2009. Full year 2010 growth should be around 6.7%, after Q3 growth of 6.8% yr/yr, before easing to 4.3% in 2011. Growth will be supported by relatively low unemployment, which will help consumption, loose monetary policy, a pick-up in tourist arrivals and continued strong growth in Mainland China. An important contributor to medium-term growth is the Closer Economic Partnership

Arrangement with Mainland China, which gives Hong Kong exports preferential access to mainland markets.

Several stimulus packages were implemented to counter the impact of falling global demand on the economy but nonetheless and despite falling revenues the consolidated fiscal balance remained in small surplus in 2009 of 0.8% of GDP, maintaining a run of rough balance or small surpluses evident for several years. Official projections earlier in 2010 were for the budget to dip into small deficit in 2010, but as the government tends to be conservative on its revenue assumptions and given stronger than expected economic growth, the fiscal balance may remain in surplus in 2010 and 2011. Public debt is low and there is a substantial fiscal reserve fund (just under 30% of GDP).

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 just under 200% of the monetary base, the banking system is basically sound and the fiscal balance should not create undue pressure, though capital inflows will complicate policy as asset prices are likely to rise. Inflation has picked in 2010 and is likely to be around 2.6% at end-year and edge slightly higher in 2011.

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 both total export earnings and total import earnings fell, but as the latter declined by less the current account surplus eased to 8.7% of GDP from 13.6% in 2008. In 2010 both exports and imports have recovered strongly and the current account surplus should be 7.7% of GDP, easing to 6.3% in 2011. 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 more than 300% of GDP, based on official data, but as a percentage of exports of goods and services is a much lower 140% (a comfortable ratio). Moreover, these data include 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. Estimates of external debt servicing requirements are relatively low.

Structural Business Environment

The Structural Business Environment is strong, ranking 6 of 212 in our ratings.

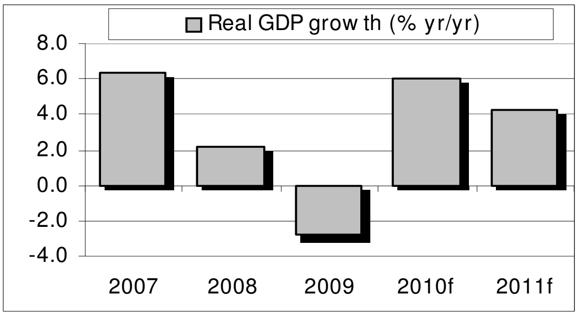
The World Bank's 2010 Ease of Doing Business survey ranks Hong Kong 2 of 183 surveyed. Based on data and definitions from the World Bank's 2010 Doing Business Survey, of ten areas surveyed, all were above average.

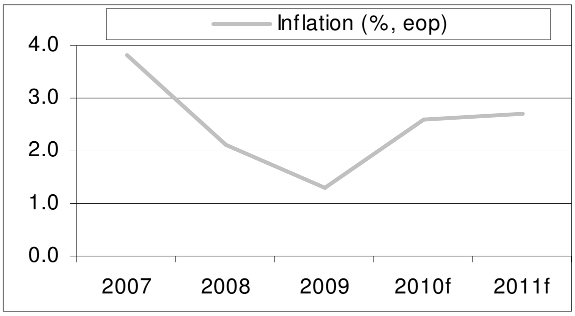
The World Bank Institute's Governance Research Indicator 2009 puts regulatory quality, control of corruption and the rule of law all well above average for the East Asia region and the High Income group of economies.

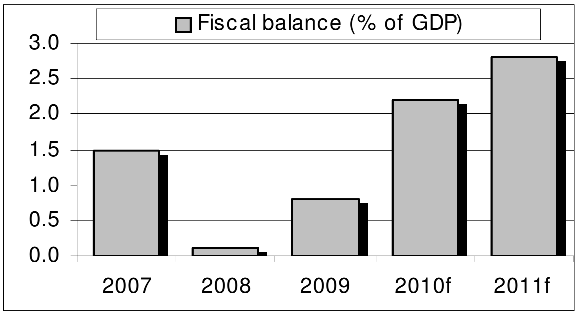
Transparency International's Corruption Perception Index, 2010, assigns Hong Kong a score 8.4—on a scale of 1 (bad) to 10 (good)—and a ranking of 13 out of 178. As a broad measure of the pro-business environment The Heritage Foundation 2010 Index of Economic Freedom ranks Hong Kong 2 out of 183.

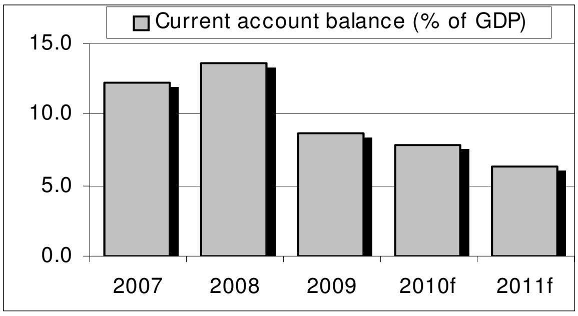
David Atkinson **London: +44 (0)20 7860 2807**

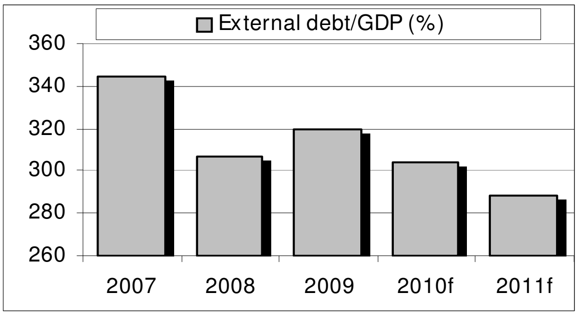
Charts


Real GDP grow th (% yr/yr)
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
2007
2008
2009
2010f
2011f

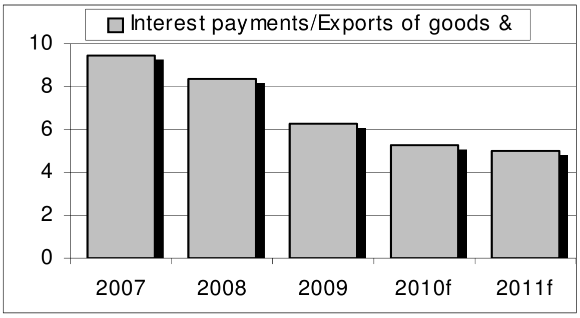

Inflation (%, eop)
4.0
3.0
2.0
1.0
0.0
2007
2008
2009
2010f
2011f

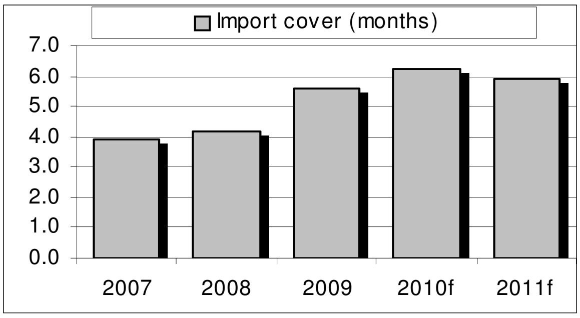

Fiscal balance (% of GDP)
3.0
2.5
2.0
1.5
1.0
0.5
0.0
2007
2008
2009
2010f
2011f


Current account balance (% of GDP)
15.0
10.0
5.0
0.0
2007
2008
2009
2010f
2011f


External debt/GDP (%)
360
340
320
300
280
260
2007
2008
2009
2010f
2011f


External debt/Exports of goods & services (%)
200
150
100
50
0
2007
2008
2009
2010f
2011f


Interest payments/Exports of goods &
10
8
6
4
2
0
2007
2008
2009
2010f
2011f


Import cover (months)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
2007
2008
2009
2010f
2011f