

**BACKGROUND PAPER FOR 72ND INTERNATIONAL BUSINESS
COMMITTEE MEETING**

Global and Regional Economic Outlook

INTRODUCTION

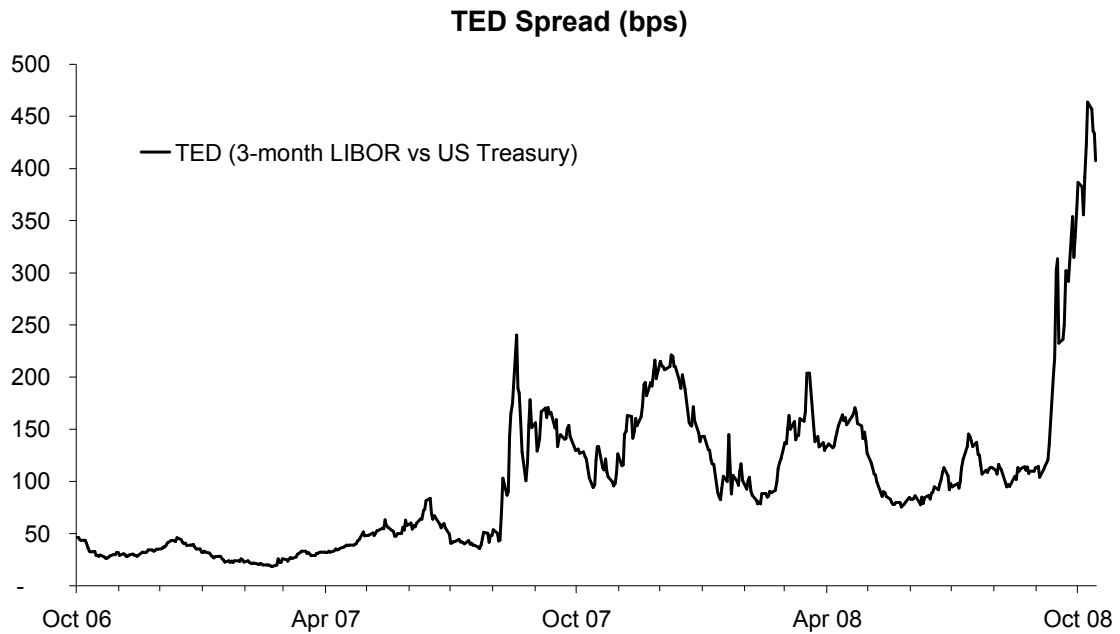
This paper reviews the recent global economic situation amidst the financial crisis, and gives a brief analysis of the global and regional economic outlook.

RECENT FINANCIAL MARKET AND ECONOMIC DEVELOPMENTS

2. The financial turmoil triggered by the outbreak of the US sub-prime mortgage problem in August last year has deepened distinctly since early September this year, following such events as the US government's takeover of Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, the US government's partial takeover of AIG and the failures of several European financial institutions. The series of financial meltdowns has evolved into a full-scale confidence crisis, clogging credit markets, especially in the advanced economies, and increasing markedly the systemic risks to the financial systems around the world. As an indication, the rate that banks charge each other, the London Interbank Offered Rate (Libor), has been trading so high above three-month US Treasury-bill rates (on 10 October it was 4.82% vs. 0.18%, giving a TED spread of 464 base points) that lending among banks have virtually come to a halt (*Chart 1*). This so-called TED spread signals the health of credit markets and has rarely been over 100 basis points.

3. The huge liquidity injections into the banking systems over the past months, the US's original US\$700 billion rescue plan as well as plans to purchase commercial papers to reactivate the credit markets, and the joint interest rate cut by major central banks in early October all appears to have failed to unclog the credit markets and restore confidence in the financial systems. Yet, following the G7 meeting on 10 October, the governments of the advanced economies have become more inclined to rely on equity injection as a means to recapitalize the banks and other financial institutions, an approach first adopted by the UK government. Following similar plans announced by the European governments, the US government also announced on 14 October to inject US\$250 billion directly to strengthen banks' capital base and to encourage banks to lend more actively.

Chart 1 : Credit markets under severe strains



4. At the time of writing, the response of the financial markets to the various newly initiated rescue plans has been largely positive. Fears about a global financial meltdown have reduced. In particular, the stock markets saw a notable rebound, although they retreated later on concerns about an anticipated global economic downturn (*Chart 2*).

Chart 2 : Stock markets fluctuated widely amidst the financial crisis



5. However, credit markets are still under severe strains. The TED spread remains elevated and has yet to show a more notable improvement (on 16 Oct it edged slightly down to 408 base points). Meanwhile, risk aversion and financial market contagion have led to severe strains on economies with large current account deficits or problematic financial systems. At this juncture, the financial crisis is still unfolding and markets are unsettling. There is a large degree of uncertainty over when the crisis will eventually come to an end.

6. The housing downturn in the US and several other European economies, the earlier run-up of international commodity prices, and the credit tightening amidst the financial crisis had already put a significant drag on activity in the advanced economies well before the recent escalation of the financial crisis. In the EU and Japan, economic growth became well below-trend in the second quarter of 2008 (even negative on a quarter-to-quarter basis). In the US, although GDP growth remained positive in the second quarter, unemployment went up notably and consumer spending slowed markedly. In the advanced economies, consumer and investor confidence have fallen to the lowest levels in years. By mid-2008, they were basically on the brink of recession (*Chart 3 and Table*).

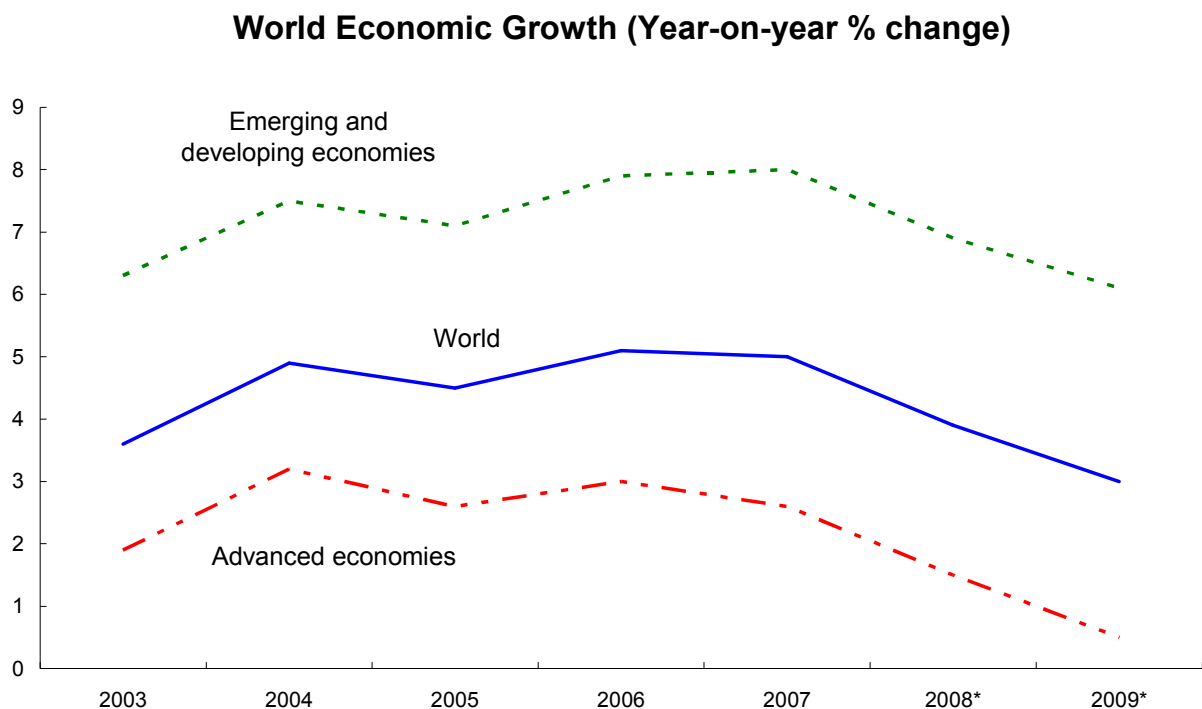
7. By comparison, the emerging economies have fared notably better than the advanced economies as a whole. However, with the advanced economies slowing markedly, emerging economies in Asia, which are generally export-dependent, have been facing weaker external demand. As a result, economic growth in the emerging economies in Asia also slowed by varying degrees in the second quarter (*Table*).

8. The mainland China economy, which has been the driving force in this part of the world, also saw some mild moderation in economic growth. While the Mainland economy is facing a more challenging external environment, its domestic demand has continued to hold up well. GDP growth, having slowed from 11.9% in 2007 to 10.6% in the first quarter of 2008 and further to 10.1% in the second quarter, remained fairly strong. With consumer price inflation coming down in recent months after reaching a peak in February, there should have greater room for accommodative policies for the Mainland to maintain the growth momentum.

9. Inflationary pressures in economies around the world over the past year, due to the earlier surges in international food and oil prices as well strong global demand, are receding as commodity prices ease and as economic growth slows.

10. As to Hong Kong, economic growth also moderated after a prolonged period of robust expansion. In the second quarter of 2008, the Hong Kong economy grew moderately by 4.2% over a year earlier. This followed a 7.3% growth in the first quarter and a 6.4% growth in 2007. This indicated that the headwinds from the financial crisis and the slowing global economy had increasingly been felt. The weaker external demand from the advanced economies and the less robust growth in intra-regional trade led to slower growth in Hong Kong's total exports. The asset market corrections and the dimmer global economic prospects also put a dent on consumption spending.

Chart 3 : Global economic growth to slow further in 2009



Source: IMF World Economic Outlook October 2008
* Forecast from the IMF

GLOBAL AND REGIONAL OUTLOOK

11. The International Monetary Fund (IMF) issued its latest World Economic Outlook on 8 October. With the financial turmoil having evolved into “the most dangerous shock in mature financial markets since the 1930s”, the IMF projects the world economic growth to moderate to 3.9% in 2008 and 3.0% in 2009 from the 5.0% in 2007 (*Chart 3 and Table*). The immediate policy challenge is to stabilize financial conditions, while nursing economies through a period of slow growth and keeping inflation under control.

12. The slowdown will be particularly notable in the advanced economies, as their recovery will be held back by continued financial market deleveraging. Economic growth in the advanced economies is projected to slow from 2.6% in 2007 to 1.5% in 2008 and further to only 0.5% in 2009. Specifically, the IMF projected the US to grow by 1.6% in 2008 and 0.1% in 2009, the worse performance since 1991 when the economy registered a year-on-year contraction. The advanced economies would be in or close to recession in the second half of 2008 and early 2009, and the anticipated recovery will be exceptionally gradual by past standards.

13. Affected by the adverse global economic environment, growth in emerging Asian economies is also projected by the IMF to moderate, from 10.0% in 2007 to 8.4% in 2008 and 7.7% in 2009. Yet the IMF remained relatively optimistic on the economic prospect of the Mainland of China in view of its strong domestic demand. The Mainland economy is projected to grow at 9.7% in 2008 and then slightly decelerate to 9.3% in 2009.

14. Given the deepening financial crisis, the economic situation is exceptionally uncertain and subject to considerable downside risks. IMF's baseline scenario assumes that the US and European governments would succeed in stabilizing financial market conditions and that the US housing market would bottom out in 2009. The biggest risk for the advanced economies, in particular the US and some other western European economies that are experiencing housing market downturn, is a negative feedback loop between financial market strains and housing market falloff, mutually reinforcing each other to a downward spiral of balance sheet adjustments, tighter credit conditions, lower asset prices and further financial market strains. The risks to the emerging economies stem mainly from their exposure to slower global trade and tighter external financing conditions, while their domestic demand could be adversely affected by deteriorating conditions in financial markets and by corrections in asset markets. All these suggest that the risk of the global economy experiencing a longer and steeper downturn than that projected by the IMF is considerable.

15. With the global economy being subject to significant downside risks, the near-term prospects of the Hong Kong economy, being highly externally-oriented, will unavoidably be affected. While Hong Kong's exports will be facing an increasingly difficult external environment, the asset market corrections and dimmer global economic outlook will also weigh heavily on the consumer and business sentiments in the period ahead. Economic growth is expected to moderate further in the second half of 2008 and probably in early 2009.

Nevertheless, the sustained growth of the Mainland economy will continue to provide support to the Hong Kong economy going forward.

16. As to the near-term inflation outlook, the upside risks to inflation in the global economy and also the regional economy appear to have receded somewhat, on account of the retreat of food and oil prices in the international markets and the weaker global demand conditions. In this context, inflationary pressure in Hong Kong can likewise be expected to recede in the period ahead.

Economic Analysis and Business Facilitation Unit
Financial Secretary's Office
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Table: World Economic Performance
(year-on-year rate of change)

	Real GDP growth									Consumer price inflation					
	2007					2008		Forecast*		2008					
	2007	Q1	Q2	Q3	Q4	Q1	Q2	2008	2009	2007	Q1	Q2	Q3	Aug	Sep
Selected industrialised economies															
US (s.a.)	2.0	1.3	1.8	2.8	2.3	2.5	2.1	1.6	0.1	2.9	4.1	4.4	5.3	5.4	4.9
EU	2.9	3.5	2.7	2.8	2.6	2.0	2.0	1.7	0.6	2.4	3.5	3.9	4.3	4.3	4.2
Euro area	2.6	3.2	2.6	2.6	2.2	1.9	2.1	1.3	0.2	2.1	3.4	3.6	3.8	3.8	3.6
Germany	2.5	3.4	2.5	2.4	1.6	1.8	3.1	1.8	0.0	2.3	2.9	2.9	3.1	3.1	2.9
UK (s.a.)	3.0	2.9	3.0	3.3	2.9	2.3	1.5	1.0	-0.1	2.3	2.4	3.4	4.8	4.7	5.2
Japan	2.1	3.2	1.8	1.7	1.6	1.2	0.7	0.7	0.5	0.1	1.0	1.4	n.a.	2.1	n.a.
Major Emerging economies															
China	11.9	11.7	12.6	11.5	11.3	10.6	10.1	9.7	9.3	4.8	8.0	7.8	n.a.	4.9	n.a.
Russia	8.1	7.4	8.0	7.3	9.5	8.5	7.5	7.0	5.5	9.0	12.9	14.9	n.a.	n.a.	n.a.
India	9.3	9.7	9.2	9.3	8.8	8.8	7.9	7.9	6.9	6.4	6.3	7.8	n.a.	9.0	n.a.
Brazil	5.4	4.4	5.4	5.6	6.2	5.9	6.1	5.2	3.5	3.6	4.6	5.6	6.3	6.2	6.3
Selected Asian economies															
Hong Kong	6.4	5.5	6.2	6.8	6.9	7.3	4.2	4.1 [#]	3.5	2.0	4.6	5.7	n.a.	4.6	n.a.
Singapore	7.7	7.0	9.1	9.5	5.4	7.0	2.3 [@]	3.6	3.5	2.1	6.6	7.5	n.a.	6.4	n.a.
Taiwan	5.7	4.2	5.2	6.9	6.5	6.3	4.3	3.8	2.5	1.8	3.6	4.2	4.5	4.7	3.1
Korea	5.0	4.0	4.9	5.1	5.7	5.8	4.8	4.1	3.5	2.5	3.8	4.8	5.5	5.6	5.1
Malaysia	6.3	5.5	5.7	6.7	7.3	7.1	6.3	5.7	4.8	2.0	2.6	4.9	n.a.	8.5	n.a.
Thailand	4.8	4.2	4.3	4.8	5.7	6.1	5.3	4.7	4.5	2.2	5.0	7.5	7.2	6.4	6.0
Indonesia	6.3	6.1	6.4	6.5	6.3	6.3	6.4	6.1	5.5	6.4	7.6	10.1	12.0	11.8	12.1
World (IMF data)	5.0	---	---	---	---	---	---	3.9	3.0	3.8	5.4	5.8	n.a.	n.a.	n.a.

Notes: (*) Economic forecasts are for reference only. They are based on IMF's latest update of World Economic Outlook (October 2008).

(#) The latest forecast GDP growth announced in August 2008 by the Government is 4 - 5% for 2008.

(@) Advanced estimates from the Singaporean government showed that Singapore's real GDP declined by 0.5% in the third quarter of 2008 over a year earlier.

n.a. Not yet available