

General Political Environment:

Hong Kong is a Special Autonomous Region (SAR) of the People's Republic of China (PRC). Under this arrangement, the SAR government's policymaking autonomy encompasses all but security, defense and international relations matters. These come under the auspices of the Chinese central government. The Basic Law of 1985 serves as a quasi-constitution for Hong Kong. It states that the SAR will maintain a "high degree of autonomy" for 50 years but will be ruled by a chief executive (CE) acceptable to China.

Donald Tsang, a longtime Hong Kong civil servant, was elected CE in March 2007 after having been appointed to the position in 2005 following his predecessor's forced resignation stemming from the Chinese leadership's discontent with his performance.

The March elections represented a significant event in Hong Kong's democratic development as more than one candidate stood for election for the first time since the territory came under Chinese rule in 1997. In the election Tsang was opposed by Alan Leong, a lawyer and legislator who represented the newly-formed Civic Party. Leong's participation in the elections was made possible by the pro-democracy camp's ability to secure 130 seats on the 800-member Election Committee whose responsibility it is to elect the CE as direct popular elections are not held in Hong Kong. In spite of this unprecedented development, given that Beijing continues to control the majority of the seats in the Election Committee, Tsang's victory was all but certain and he succeeded in winning 649 of the 795 votes available. More important than the actual election results are the gains made by the pro-democracy movement in fielding a candidate.

In spite of efforts by Beijing to suppress demands for universal suffrage, they continue to come to the fore and the Government of Hong Kong has made some attempts at addressing them. For example, in July 2007 the government released a Green Paper on constitutional development. This document called for public consultations aimed at reaching a consensus to occur over a three-month period and also included recommendations regarding direct elections for the chief executive and for the Legislative Council as early as 2012. The aim of reaching consensus on the issue of democratization will ensure that the consultations do not achieve much.

It is expected that the pro-democracy movement will continue to push for reform; however, Beijing, which ultimately decides on the nature and pace of reform in Hong Kong, will continue to resist these demands and it is unlikely that any significant change will occur in the short-term. Beijing's desire to stifle reform in Hong Kong is driven by its concern over the destabilizing potential that any reform in Hong Kong could have on the mainland as demand for such reform may spread. The Chinese government ultimately sees its continued control over Hong Kong as essential to its continued control on the mainland. Additionally, any political upheaval in Hong Kong could have economic implications for both the SAR and for China – a risk that Beijing is unwilling to take.

Investment Environment:

Hong Kong is regarded as the world's leading proponent of free trade and has no restrictions on investment in any area of the economy. There are no exchange controls and the repatriation of profits, dividends, interest or royalties is freely permitted.

The legal system in Hong Kong is well-established and is considered to be pro-investment. However, there is an underlying uneasiness about the PRC's influence, both over business and the courts.

In 2004, Moody's Investor Services stated that Hong Kong's sovereign credit rating could eventually be linked to that of China because "investors face a significant element of China risk when investing in Hong Kong."

Political Violence:

Political violence is not a problem in Hong Kong. Demonstrations occur regularly but tend to be peaceful but the potential for violent clashes between authorities and pro-democracy protesters could rise as the universal suffrage issue continues to play itself out. In 2005, as many as 250,000 people took to the streets to protest the limited nature of political reforms proposed by Tsang.

Political

Political Structure

Special Autonomous Region of China

Chief Executive

Donald Tsang

National Legislative Body Legislative Council (Legco)

60 seats:

- 30 elected by functional constituencies
- 30 directly elected by proportional representation

Major Parties (seats in assembly)

- Democratic Alliance for the Betterment of Hong Kong (DAB)
- Liberal Party (LP)
- Democratic Party (DP)

Last Elections

- Executive: March 2007
- Legislative: September 2004

Next Elections

- Executive: 2012
- Legislative: 2008

Press Freedom Survey:

- 2006 Score: 29 (Free) (0: Free; 100: Not Free)
- freedomhouse.org

Control of Corruption Index:

- 2006 Score: +1.71 (-2.5: Worst; +2.5: Best)
- worldbank.org

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Political Outlook

Almost nine years after Hong Kong passed from British to Chinese rule, concerns about the SAR's autonomy appear to be well-founded as Beijing has demonstrated both its willingness and ability to directly involve itself in Hong Kong's affairs. Over time, this propensity could erode many of the advantages that have helped make Hong Kong a global commercial and financial centre. Democracy activists will continue to press for universal suffrage in the SAR and Beijing will continue to resist these demands.

Economic

Credit Agencies

Moody's: A1

S&P: AA

Fitch: AA-

Nominal GDP (USD, 2006)

USD187.4bn

Population (2006):

6.9 million

Total Trade / GDP:

349.7%

Currency:

Hong Kong dollar

Exchange regime:

Currency board

Merchandise imports from Canada:

CAD 1,308 mn

Main sources of Foreign Exchange (excl. FDI):

Machinery and trans. (54%)

Largest Merchandise Trading Partner:

China (47%)

United States (15%)

Main imports:

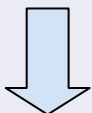
Intermediate goods (43%)

Consumer Goods (29%)

Risks to the Outlook



Continued strength of property markets



Severe US slowdown

Rise in protectionist sentiments against China

March 2007

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Market Spotlight: Real GDP growth continues to decelerate from last year's 6.4%, although it remains above the five year average of 4.3%. This slowdown, however, is anticipated to continue into 2007 in accordance with global economic trends. Nonetheless, growth in domestic demand reached a 5-year high at 5% in 2006 and is envisaged to remain robust this year.

Recent Developments: Economic growth in Hong Kong, after a dip in Q2 to 5.5%, rebounded in Q3 and Q4 to 6.7% y/y and 7% y/y in 2006. On the back of improving business confidence, the marked investment boost in Q3 and Q4 of 10.3% y/y and 9.3% y/y was principally responsible for the upward momentum in the second half of 2006. This pickup in growth was also buoyed by low levels of unemployment and the wealth effect emerging from the considerably large gains in the stock market. Robust export sales and private consumption growth, likewise, made positive contributions of 11% and 5.2%.

Fiscal Policy: According to the recent budget release for fiscal 2007/08 (April 1 – March 31), the Hong Kong government announced a surplus of HK\$55bn (US\$7bn) this year, roughly ten times larger than originally forecasted. Given that the government posted a HK\$14bn surplus in 2005/06 after four years of budget deficits, the current improvement in their fiscal position is admirable. However, the government's tax concessions suggest a cautious stance, as many of the measures have merely a one year time-horizon. The government intends to reduce salaries taxes, with a ceiling of HK\$15,000 (US\$1,920) each, and waive property taxes in the first two quarters of the current year, with a ceiling of HK\$5,000. Such a policy will serve as a strong incentive to lure homebuyers and property investors and thereby a pick up in property demand is expected in the second half of 2007.

Monetary Policy: The Hong Kong Monetary Authority (HKMA) continues to raise the discount window base rate and overnight HIBOR, which are currently at 6.75% and 4.06%. Hong Kong banks in turn are lifting their prime rate. Consumer prices were up by 2% in 2006, an eight year high. This was primarily due to rising house costs as a result of higher rents, which surpassed inflation growth by more than a factor of two. Moreover, a tight labour market with an unemployment rate of 4.8%, the lowest in more than five years, will place upward pressure on nominal wages and consequently consumer prices in 2007. While the HKMA remains committed to its peg against the US dollar by staying within the target band introduced in May 2005, i.e. HK\$7.75-7.85 to the USD, the appreciating Chinese renminbi exceeded the value of the Hong Kong dollar (vis a vis the US dollar) for the first time. With substantial foreign-exchange and fiscal reserves and a sizeable current-account surplus, the government is likely to maintain its peg in 2007.

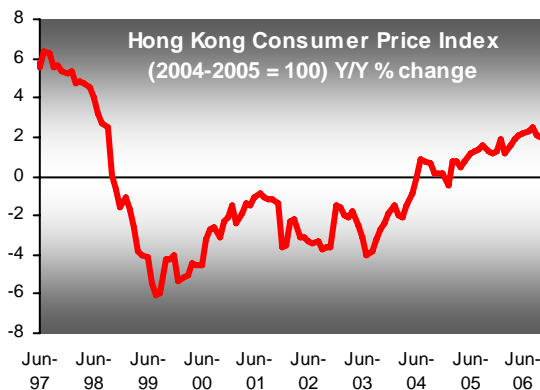
Financial Issues: Behind the auspicious economic conditions, however, loom concerns of a stock market bubble. Recent strength in the Hang Seng Index has primarily been driven by initial public offerings of Chinese companies. In many cases, strong trading has rendered these issuances to become overvalued. A number of these banks had financial and operational problems prior to their nascent arrival on Hong Kong stockmarkets and unless these banks have tended to their inefficiencies, the emergence of a problem will adversely impact investor confidence, leaving ramifications for the rest of the economy.

Outlook: Hong Kong's growth momentum is anticipated to decelerate to 4.9% in 2007, a respectable rate given the strength of expansion in the past few years. Domestic demand and private consumption will remain strong in 2007 supported by continued employment growth. Strong economic growth in China will support Hong Kong's trade this year, offsetting the negative shock from slower US demand and global economic growth. In the longer-term, Hong Kong's economic landscape is expected to remain positive as trade integration with China intensifies.

Economic Indicators

	01-05 avg.	2006	2007(f)	2008(f)
GDP (% growth, real)	4.3	6.4	4.7	4.7
Inflation (% year-end)	-1.3	2.0	2.5	2.6
Fiscal Balance (% of GDP, FY)	-2.1	1.1	1.0	1.6
Exports (% change)	7.4	11.0	10.6	12.9
Imports (% change)	7.1	12.5	10.8	12.6
Current Account (% of GDP)	8.9	9.9	8.8	8.8
Reserves (month of imports)	4.5	3.1	3.3	3.1
External Debt (% of GDP)	35.5	38.9	38.4	37.7
Debt Service Ratio (% of g&s)	2.1	2.3	2.1	2.1
Currency (per USD, year-end)	7.8	7.8	7.8	7.8

Source: EIU, EDC Economics



Source: Bloomberg