INTERNATIONAL MONETARY FUND

Staff Country Reports

April 1996

IMF Staff Country Report No. 96/29

United Kingdom – Hong Kong Recent Economic Developments

This report on recent economic developments in Hong Kong was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation. As such, the views expressed in this document are those of the staff team and do not necessarily reflect the views of the Government of the United Kingdom or the Executive Board of the IMF.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431

Telephone: (202) 623-7430 • Telefax: (202) 623-7201

Telex (RCA): 248331 IMF UR

Internet: publications@imf.org

Price: \$15.00 a copy

**International Monetary Fund
Washington, D.C.**

This page intentionally left blank

INTERNATIONAL MONETARY FUND

UNITED KINGDOM - HONG KONG

Recent Economic Developments

Prepared by B. Chadha, D. Mihaljek, and K. Okamura (all CTA)

Approved by the Central Asia Department

February 22, 1996

	<u>Contents</u>	<u>Page</u>
Basic Data		iv
I.	Introduction	1
II.	Developments in the Real Sector	2
1.	Domestic demand and output	2
a.	Overview	2
b.	Domestic demand	3
c.	External demand	10
d.	Sectoral composition of output	10
2.	Labor market	12
a.	Overview	12
b.	Recent developments	12
c.	Policy responses	15
3.	Property market	15
a.	Overview	15
b.	Residential property market	16
c.	Office property market	19
d.	Land releases	20
4.	Inflation and competitiveness	21
a.	Overview	21
b.	Recent developments and medium-term prospects	23
c.	Trends in competitiveness	24
III.	Fiscal Policy	26
1.	Overview	26
2.	Recent budgetary developments	27
a.	Developments in FY 1992 - FY 1994	27
b.	The FY 1995 Budget	29
c.	Medium-term outlook	30
d.	Fiscal reserves and the Land Fund	30

3.	Revenue developments	32
4.	Expenditure developments	34
a.	Growth and structure of public expenditure	34
b.	Airport Core Program	37
c.	Public housing program	38
5.	Mandatory provident fund scheme	40
IV.	Monetary and Exchange Rate Developments	42
1.	Exchange rate developments	42
2.	Interest rate developments	44
3.	Interest rate deregulation	45
4.	Money and credit developments	46
V.	Equity Market	47
1.	Developments during 1980-95	48
2.	Determinants of equity prices	49
VI.	Banking Sector	51
1.	Structure and characteristics of balance sheets	52
2.	The profitability of Hong Kong's banks	56
3.	Recent changes to the regulatory framework	60
VII.	External Sector Developments	60
1.	Trade developments	61
a.	Merchandise trade	61
b.	Trade in nonfactor services	63
c.	Regional trade flows	65
2.	Medium-term path of the external balance	66
a.	Estimated equation	66
b.	Projections of the external balance	67
VIII.	Trade Policy	69
1.	The World Trade Organization (WTO) activities	69
2.	Hong Kong and China's MFN status	70
3.	Recent developments within APEC	70
IX.	Statistical Issues	70

Text Tables

1.	Gross Domestic Product by Expenditure Component at Constant (1990) Market Prices, 1990-95	4
2.	Labor Force, Employment, and Unemployment, 1989-95	13
3.	Real Estate Prices and Rental Indices, 1990-95	17
4.	Selected Price Indicators, 1990-95	22
5.	Wages, Labor Productivity, and Unit Labor Costs, 1990-95	25

6.	Consolidated Government Accounts, FY 1991/92-FY 1995/96	28
7.	Medium-Range Fiscal Forecasts, 1995/96-1998-99	31
8.	Estimates of Revenue Buoyancy and Marginal Propensity to Tax, 1980-94	33
9.	Estimates of Expenditure Buoyancy and Marginal Propensity to Spend, 1985-94	35
10.	Balance Sheet of All Authorized Institutions, September 1995	54
11.	Loans and Advances by Type, September 1995	55
12.	Share of Property-Related Loans in Total Lending, 1987-95	57
13.	International Comparison to Return on Assets, of the Locally Incorporated Banks, 1988-93	58
14.	Balance of Trade in Goods and Nonfactor Services, 1989-95	62
15.	Merchandise Trade Developments, 1989-95	64
16.	Estimates of External Factor Income Flows by Income Component and by Business Sector for 1993 (At Current Market Prices)	72

Appendix Tables

1.	Gross Domestic Product by Expenditure Component at Current Market Prices, 1990-95	74
2.	Composition of Gross Fixed Capital Formation at Constant (1990) Market Prices, 1989-94	75
3.	Gross Domestic Product by Sector at Current Prices, 1989-93	76
4.	Revenue (General Revenue Account), 1990/91-1995/96	77
5.	Government Expenditure Under the General Revenue Account, 1990/91-1995/96	78
6.	Public Expenditure by Function, 1990/92-1995/96	79
7.	Monetary Indicators, 1990-95	80
8.	Loans for Use in Hong Kong, 1990-95	81
9.	Interest Rate Differential, 1991-95	82
10.	Exchange Fund Balance Sheet, 1990-95	83
11.	Exchange Rate Indices, 1991-95	84
12.	Equity Price Developments, 1988-95	85
13.	Imports, Re-Exports, and Retained Imports, 1989-95	86
14.	Direction of Trade by Area and Major Partners, 1989-95	87
15.	Structure of Trade with China, 1984-95	88

Annex

Consumption Function Estimates for Hong Kong	89
--	----

Charts

1.	Developments in GDP, 1985-95	4a
2.	Labor Market Developments, 1982-95	12a
3.	Inflation and Competitiveness, 1983-95	22a
4.	Fiscal Developments, 1982-95	30a
5.	Public Expenditure in Hong Kong and OECD Countries	36a
6.	Exchange Rate Developments, 1979-95	42a
7.	Interest Rates in Hong Kong and United States, 1989-95	44a
8.	Nominal and Real Interest Rates, 1989-95	44b
9.	Money and Credit Developments, 1989-95	48a

10.	Stock Market Developments, 1980-95	48b
11.	Relative Stock Market Developments, 1980-95	48c
12.	Stock Market and Fundamentals, 1980-95	50a
13.	Actual and Predicted Stock Market Developments, 1980-95	52a
14.	Assets of Licensed Banks by Type, 1985-95	54a
15.	Interest Differentials, 1989-95	56a
16.	Trade Developments, 1980-95	62a
17.	Growth of Trade, 1980-95	64a
18.	Actual Versus Predicted Trade Balance	68a

Box

Government Measures for the Property Market	18
---	----

References	73
------------	----

Hong Kong

Basic Data

Area: 1,092 square kilometers
Population (mid-1995): 6.19 million
GDP per capita (1994): US\$21,250

	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995 1/</u>
GDP (HK\$ billions, current prices)	582.5	668.5	779.3	897.5	1,016.6	1,128.2
<u>Population growth (percent)</u>	0.3	0.9	1.0	1.8	2.4	2.1
<u>Annual percentage changes</u>						
Real GDP	3.4	5.1	6.3	6.1	5.4	5.0
GDP deflator	7.5	9.2	9.7	8.5	7.5	5.7
Hong Kong dollar M3	14.8	15.6	13.7	25.2	18.4	13.5 2/
Budget revenue 3/	8.6	26.9	16.9	25.5	5.0	8.2
Budget expenditure 3/	19.9	7.8	22.9	29.0	10.6	6.5
Exports of goods	9.6	17.3	19.8	13.5	10.4	13.6
Domestic exports	-0.5	0.5	0.2	-4.5	-2.3	3.5
Re-exports	16.0	26.2	28.3	19.6	13.8	16.0
Imports of goods	11.4	19.0	22.2	12.7	14.0	14.9
Real effective exchange rate	3.3	6.9	5.1	8.7	2.4	0.2 2/
<u>Ratios to GDP</u>						
Gross domestic investment	27.4	27.3	29.2	30.7	31.0	31.7
Balance of merchandise trade	-0.9	-2.4	-4.3	-3.3	-8.3	-13.0
Balance of goods and nonfactor service	8.5	6.6	5.3	7.0	1.7	-1.7
Budget revenue 4/	15.4	17.0	17.0	18.5	17.1	16.7
Budget expenditure 4/	14.7	13.8	14.5	16.3	15.8	16.6
Budget balance 4/	0.7	3.2	2.5	2.3	1.3	0.1
<u>Balance of payments (US\$ billions) 5/</u>						
Exports of goods	82.2	98.6	119.5	135.2	151.4	173.7
Domestic exports	29.0	29.7	30.2	28.8	28.7	29.9
Re-exports	53.2	68.8	89.2	106.4	122.7	143.8
Exports of nonfactor services	18.3	20.7	24.9	28.9	31.6	38.7
Imports of goods	82.8	100.6	123.8	139.1	162.3	192.8
Imports of nonfactor services	11.3	13.0	14.8	15.9	18.4	22.1
Balance on goods and nonfactor services	6.3	5.7	5.4	8.2	2.2	-2.4

Sources: Data provided by the Hong Kong authorities; and staff estimates.

1/ Staff estimates.

2/ November 1995 (year-on-year).

3/ Fiscal year begins April 1.

4/ Fiscal year revenue and expenditure divided by calendar year GDP.

5/ National accounts data.

This page intentionally left blank

I. Introduction 1/

This paper reviews economic developments in Hong Kong over the last several years, focusing on the expansion and the subsequent slowing in domestic demand in the 1990s, against the background of the export-driven growth in the second half of the 1980s. Developments in aggregate demand and supply, labor and property markets, and inflation and competitiveness are analyzed in Chapter II. Chapter III reviews recent budgetary developments, discusses issues in the structure of revenue and expenditure, and describes the proposed Mandatory Provident Fund scheme. Monetary and exchange rate developments are analyzed in Chapter IV, the equity market in Chapter V, and developments in the banking sector in Chapter VI. Chapter VII reviews the external sector and discusses medium-term projections of the trade balance. The main issues for trade policy for Hong Kong are described in Chapter VIII, and the main statistical issues in Chapter IX. Finally, the Annex to this paper discusses estimates of a consumption function for Hong Kong.

The last review of recent economic developments for Hong Kong was prepared for the 1992 Article IV consultation discussions, and it covered developments in the late 1980s and early 1990s, when the pressure on inflation from rapid growth in domestic demand was rising. 2/ For the 1993 Article IV consultation discussions, the staff prepared background papers on developments in inflation and asset markets, and discussed alternative medium-term scenarios and implications of the then proposed Old-age Pension Scheme. 3/ Background papers prepared for the 1994 Article IV consultation discussions focussed on institutional developments (including the linked exchange rate system, budgetary performance, and the financial system and regulation), and on economic integration with China (including the impact on business cycles in Hong Kong, real and financial links with China, and the framework for transition in 1997). 4/ These background papers complement to a large extent the review of recent developments presented in this paper.

1/ The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

2/ See SM/93/13 (January 22, 1993).

3/ See SM/94/25 Supplement 1 (February 7, 1994).

4/ See SM/95/23 Supplement 1 (February 13, 1995).

II. Developments in the Real Sector

1. Domestic demand and output

a. Overview

The pattern of growth in Hong Kong in the first half of the 1990s differed from that in the second half of the 1980s. Real GDP expanded by over 5 1/2 percent per annum in 1990-94, compared with 7 percent in 1985-89 (see tabulation below). Growth in the first half of the 1990s was underpinned by domestic demand, which expanded by 7 3/4 percent per annum, compared with 5 1/2 percent in the second half of the 1980s. The role of the external sector changed dramatically: while it contributed about 1 1/2 percent per year to real GDP growth over 1985-89, over 1990-94 the external sector withdrew the stimulus to GDP growth at the average rate of -2 1/2 percent per year, reflecting sharp deterioration in merchandise trade balance. However, growth in the 1990s was much more stable, ranging between a low of 3 1/2 percent in 1990 and a high of 6.3 percent in 1992; by comparison, growth in the second half of the 1980s ranged between a low of 1/2 percent in 1985, and a high of 13 percent in 1987.

	<u>1985-89</u>	<u>1990-94</u>
<u>(Average of annual percentage changes)</u>		
Real GDP	6.9	5.3
Domestic demand	5.5	7.7
External sector contribution to growth	1.4	-2.4

A number of factors contributed to the shift in the growth pattern in the 1990s. Private consumption, boosted by rising real wages and negative real interest rates, surged by over 8 percent per year during 1991-93. Meanwhile, the Government started a massive program of infrastructure development, while the private sector began to invest heavily in machinery and equipment in order to offset the effects of rising labor costs. While export growth remained robust--total exports grew on average by 13 percent per year between 1991 and 1994--growth in imports, which was responding to buoyant domestic demand, was much faster. By end-1995, the balance on goods and nonfactor services trade thus turned to a deficit for the first time since 1982.

Successive increases in U.S. interest rates in 1994 and early 1995 aligned monetary conditions more closely with cyclical developments in Hong Kong. As a result, private consumption and asset markets consolidated during 1994-95. Overall growth remained strong, however, owing to increased expenditure on the new airport, a build-up in inventories in anticipation of

spending on infrastructure projects, and a rebound in exports of goods and services in response to the depreciation of the U.S. dollar during the first half of 1995.

The following sections analyze in detail developments in the components of domestic demand, and provide an overview of external demand and output developments by sector.

b. Domestic demand

Private consumption, which accounts for almost 60 percent of GDP (Appendix Table 1), grew at an average annual rate of close to 8 percent between 1991 and mid-1994, compared with 4 1/4 percent between 1985 and 1989 (Table 1). Spending on durables was particularly buoyant, recording double-digit growth in each year during this period (Chart 1). Consumption growth peaked during the first quarter of 1994 at 11 1/4 percent (annual rate) and, after a gradual deceleration through the rest of 1994, became basically flat during the first three quarters of 1995. Retail sales were hit particularly hard: the overall volume of retail sales dropped by 1 1/4 percent during the first three quarters of 1995, and sales of motor vehicles by 32 percent (see tabulation below).

	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u> Jan-Sept.
	<u>(Annual percentage change)</u>				
Private consumption <u>1/</u>	8.6	7.7	7.8	6.4	1.3
Durables	14.1	21.6	12.4	11.0	...
Nondurables	8.3	7.5	6.8	5.7	...
Services	2.8	5.7	5.8	4.9	...
Retail sales <u>2/</u>	10.3	12.1	12.0	5.8	-1.3
Motor vehicles	14.9	41.2	-6.6	-11.0	-32.4
Durables	15.1	12.2	14.7	6.9	-3.6

Growth in private consumption over the past few years was driven primarily by changes in personal incomes and real interest rates. The labor market was extremely tight in the early 1990s, leading to strong growth in real wages and raising the expectations of future wage increases. At the same time, real interest rates became negative, providing a major boost to

1/ At constant prices.

2/ In volume terms.

Table 1. Hong Kong: Gross Domestic Product by Expenditure Component
at Constant (1990) Market Prices, 1990-95

	1990	1991	1992	1993	1994	1995 Jan.-Sept. 1/
(In millions of Hong Kong dollars)						
Consumption	373,742	405,636	439,308	469,553	497,715	374,708
Private	330,459	359,019	386,519	415,618	441,874	331,032
Government	43,283	46,617	52,789	53,935	55,841	43,676
Gross fixed capital formation	153,776	168,059	183,480	190,259	216,963	169,632
Private	134,006	148,914	163,336	161,893	183,965	...
Government	19,770	19,145	20,144	28,366	32,998	...
Final domestic demand	527,518	573,695	622,788	659,812	714,678	544,340
Private	464,465	507,933	549,855	577,511	625,839	...
Government	63,053	65,762	72,933	82,301	88,839	...
Change in stocks	5,728	4,081	8,453	2,224	24,311	47,569
Total domestic demand	<u>533,246</u>	<u>577,776</u>	<u>631,241</u>	<u>662,036</u>	<u>738,989</u>	<u>591,904</u>
Net exports of goods and nonfactor services	49,303	34,240	19,106	28,187	-11,484	-29,873
Gross domestic product	<u>582,549</u>	<u>612,016</u>	<u>650,347</u>	<u>690,223</u>	<u>727,505</u>	<u>562,036</u>
Consumption	5.7	8.5	8.3	6.9	6.0	1.6
Private	5.7	8.6	7.7	7.5	6.3	1.3
Government	5.5	7.7	13.2	2.2	3.5	4.1
Gross fixed capital formation	8.1	9.3	9.2	3.7	14.0	8.0
Private	8.6	11.1	9.7	-0.9	13.6	...
Government	5.0	-3.2	5.2	40.8	16.3	...
Final domestic demand	6.4	8.8	8.6	5.9	8.3	3.5
Private	6.5	9.4	8.3	5.0	8.4	...
Government	5.3	4.3	10.9	12.8	7.9	...
Total domestic demand	6.8	8.4	9.3	4.9	11.6	8.0
Exports of goods and nonfactor services	8.4	15.0	18.3	12.7	9.8	13.4
Exports of goods	9.6	17.3	19.8	13.5	10.4	13.9
Domestic exports	-0.5	0.5	0.2	-4.5	-2.3	4.7
Re-exports	16.0	26.5	28.3	19.6	13.8	16.1
Exports of nonfactor services	3.6	4.7	10.6	8.0	6.3	10.4
Imports of goods and nonfactor services	11.5	18.1	20.8	12.0	13.4	14.9
Imports of goods	11.4	19.0	22.2	12.7	14.0	15.9
Imports of nonfactor services	12.1	11.3	9.7	5.8	7.6	5.9
Gross domestic product	3.4	5.1	6.3	6.1	5.4	5.1
Memorandum items:						
Contribution to growth:						
From total domestic demand	6.0	7.6	8.7	4.7	11.1	8.2
Of which: From changes in stock	0.4	-0.3	0.7	-1.0	3.2	4.7
From net exports of goods and nonfactor services	-2.6	-2.6	-2.5	1.4	-5.7	-3.1

Sources: Census and Statistics Department, Estimates of Gross Domestic Product, 1961 to 1994; and Quarterly Estimates of Gross Domestic Product, Third Quarter 1995.

1/ Percentage changes calculated over corresponding year-earlier period.

CHART 1

HONG KONG

DEVELOPMENTS IN GDP, 1985-95

Four-quarter percentage change

Annual percentage change

Annual percentage change

Sources: Census and Statistics Department, Quarterly Estimates of GDP, Third Quarter 1995; and Estimates of Gross Domestic Product, 1961-1994; and staff estimates.

consumption, especially of durables. 1/ The empirical estimates of the consumption function for Hong Kong discussed in the Annex suggest that the swing in interest rates between the late 1980s and early 1990s raised the growth rate of private consumption by about 1.3 percentage points. Similarly, the return to positive real interest rates in late 1994 and 1995 slowed the growth rate of real consumption by about 1 percentage point, and the growth rate of durables consumption by close to 3 percentage points. Changes in real income growth, measured in terms of both real GDP and wages, were also pronounced between these periods. Given the high income elasticity of consumption demand, the observed swings in private consumption are not surprising.

Other factors that are widely believed to have had an effect on private consumption are investment income for Hong Kong entrepreneurs from outprocessing operations in China, and the wealth effects of asset price changes. Data on investment income for 1993 indicate a net inflow of investment income of about 1 percent of GDP in 1993; however, no historical comparisons of this figure are possible as yet. 2/ As for the wealth effects of asset price changes, their impact could not be assessed because of lack of household balance sheet data.

Government consumption expenditure, which accounts for about 8 percent of GDP, slowed from 6-8 percent per annum in the early 1990s, to 3-4 percent per annum in recent years. The main reason for this shift was slower growth in compensation of government employees (see tabulation below). The size of the civil service has also declined since the beginning of the decade.

	1990	1991	1992	1993	1994
	<u>(Annual percentage change)</u>				
Government consumption expenditure in constant prices 3/	5.5	7.7	13.2	2.6	3.0
Real expenditure on:					
Wages and salaries	4.9	9.3	14.1	2.5	3.3
Goods and services	8.0	4.5	9.6	4.0	2.6
Civil service employment	1.1	-1.5	-2.5	-0.9	-0.3

1/ Real interest rate, expressed as the Best Lending Rate less the annual rate of CPI(A) inflation, averaged about -2 percent in 1990-93, compared with about 1 1/2 percent in 1986-89. Since late 1994, real interest rates has returned to a positive level of about 1/2 percent. Most consumer and mortgage loans are made at a premium of about 1 3/4 percentage points above the Best Lending Rate.

2/ See Chapter IX.

3/ The expenditure of previously subsidized hospitals was reclassified from private to government consumption as from 1992.

Private investment, which accounts for one quarter of GDP and almost 90 percent of gross fixed capital formation, has been growing by over 8 percent per year since 1991 (Appendix Table 2). Most of this growth came from machinery and equipment investment, which raised the (gross) stock of capital goods in the private sector by more than 75 percent between 1991 and 1995. Retained imports of industrial machinery for manufacturing use, office equipment, and other capital goods (excluding transport equipment) have been particularly strong (see tabulation below). 1/

	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u> Jan.-June
	<u>(Annual percentage change)</u>				
Retained imports of capital goods	20	22	4	11	28
Industrial machinery for:					
Manufacturing use	26	13	15	-2	16
Construction	...	102	33	-16	16
Office equipment	...	...	-7	31	31
Other capital goods	...	...	1	13	31
Employment					
Manufacturing	-10	-13	-12	-14	-12
Construction sites	-14	--	-6	13	11
Services	5	5	5	8	4

Coupled with developments in employment, these data suggest that capital has been increasingly substituted for labor in both manufacturing and the services sectors. These changes have been largely associated with shifts in the relative prices of factors of production. Prices of imported capital goods have generally been growing more slowly than nominal wages since 1991, so that the relative price of capital with respect labor has declined through most of this period (see tabulation below).

1/ Changes in the composition of the capital stock are being inferred from the changes in retained imports of capital goods because the capital stock data are unavailable and most of the capital goods are imported.

	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u> Jan. - June
	<u>(Annual percentage change)</u>				
Price of imported capital goods <u>1/</u>	4.8	3.2	12.5	1.6	13.7
Relative price of capital with respect to labor <u>2/</u>					
Overall economy	-5.7	-6.0	1.6	-7.3	4.2
Manufacturing	-5.6	-5.8	1.7	-6.6	7.0
Services <u>3/</u>	-7.0	-7.1	0.3	-6.5	3.2

Private construction and property investment fluctuated considerably from year to year, but on balance remained flat between 1991 and 1994. What growth there was came mainly from infrastructure development, as residential and non-residential construction both advanced slowly. Other components of property investment--real estate developers' margins and transfer costs of land and buildings--have by and large declined since 1991. Movements in price deflators suggest that construction costs were fairly stable and, on average, grew at half the rate of CPI inflation between 1991 and 1994. On the other hand, price deflators for real estate developers' margins and transfer costs of land and buildings increased much faster than consumer prices, reflecting the strength of excess demand that had led to the property market boom of 1991-94 (discussed below).

Government investment has been the fastest growing component of GDP in the last five years. Public construction has doubled and public investment in machinery and equipment tripled in real terms since 1991. This expansion came entirely from infrastructure development; public investment in residential and nonresidential buildings has actually declined since the beginning of the decade. Most of the infrastructure development was associated with the Airport Core Program (ACP), but there have also been major projects involving river and container port facilities, road and rail transport, environmental projects, and land reclamation. The main impetus for infrastructure development has been the rapid expansion of Hong Kong's external trade since the mid-1980s, which has intensified the demand for transport facilities and stretched Hong Kong's otherwise well-developed infrastructure to the limit.

The Airport Core Program is a massive infrastructure development project which includes a new airport on Chek Lap Kok Island and nine large-

1/ Implicit price deflator for retained imports of capital goods.

2/ Derived from changes in the price of imported capital goods and changes in nominal wages.

3/ Financing, insurance, real estate, and business services.

scale projects providing urban infrastructure services to the airport. ^{1/} Total cost of the ACP is estimated at HK\$158 billion (US\$20.3 billion) in current prices, equivalent to 13 percent of GDP over the construction period of the project. Major work on the ACP started in 1992, and the ACP was 43 percent complete in November 1995; it is expected that the airport will be opened in April 1998. The spending profile of the ACP calls for about 70 percent of spending to be incurred over FY 1994-FY 1996 (see tabulation below). As the ACP projects are contracted out on a "fixed price" basis involving lump-sum payments to contractors, the spending profile differs slightly from actual construction activity, which is expected to reach its peak by mid-1996, when an estimated 20,000 workers will be on the airport island.

Fiscal Year	<u>1991-93</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>Total</u>
<u>(In billions of Hong Kong dollars)</u>						
ACP costs	30.8	31.2	42.1	34.8	18.5	158.2
<u>(In percent)</u>						
Spending profile	19.5	20.2	26.6	22.0	11.7	100.0
Share in GDP	3.7	3.1	3.7	2.8	1.3	13.0

According to official estimates, construction of the new airport is expected to contribute about 0.4 percentage points to growth of GDP in 1995, and about 0.8 percentage points in 1996. The pressure on aggregate demand is being partly offset by the large imported component of the project (most of the required machinery and equipment as well as construction materials are imported), and the crowding-out effect on other capital works projects. The availability of foreign workers under a special labor importation scheme has helped to restrain construction wage increases to about 9 percent per year since the first quarter of 1994. Regarding the long-run impact of the ACP, the Government estimates that the new airport will increase Hong Kong's GDP by at least HK\$420 billion over the period 1997 to 2010. In addition, usable land area is expected increase by 1 1/2 percent as a result of reclamation projects and new land released along the airport railway.

Like government investment, the accumulation of inventories exhibited unusually strong growth in the past two years. After having been reduced to a very low level by the end of 1993, the change in inventories contributed 3 1/4 percent to growth of real GDP in 1994, and as much as 4 3/4 percent during the first three quarters of 1995. The trends in retained imports on the one side, and domestic consumption and investment on the other, suggest that most of the increase in stocks was accounted for by production inputs

^{1/} For a description of the ACP, see Chapter III.

and capital goods. 1/ However, there was also some accumulation of stocks of consumer goods (see tabulation below). 2/

	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u> Jan.-June
	<u>(In percent)</u>			
Share of retained imports in:				
Domestic exports and construction <u>3/</u>	62.1	63.1	70.7	73.1
Investment in machinery and equipment <u>4/</u>	83.0	79.1	75.5	81.3
Domestic consumption <u>5/</u>	21.9	22.3	24.2	26.4

Several factors may have been responsible for this pattern of inventory accumulation. First, large-scale infrastructure projects, which were generally being constructed under very tight schedules, raised substantially the requirement for readily available stocks of imported raw materials, construction machinery, and equipment. Second, increased domestic exports required larger stocks of production inputs and capital goods than in recent years, when domestic exports declined. Finally, there was some unintended accumulation of stocks of consumer goods due to the unexpectedly sharp decline in retail sales in 1995.

While the accumulated inventories will inevitably be run down over the coming year, the net impact of stock decumulation on GDP growth is unlikely to be negative, as most of the stocks will appear in either increased investment or higher export and consumption figures.

1/ As a large proportion of production inputs are imported, an increase in the ratio of retained imports to domestic production or investment indicates an accumulation of inventories, and vice versa.

2/ An increase in the stocks of consumer goods could come from either domestic production or retained imports; however, manufacturing output was flat in 1994, and what increase there was in 1995 was mainly associated with domestic exports, which account for most of the manufacturing output.

3/ Retained imports of raw materials, semi-manufactures, and fuel, divided by the value of domestic exports and construction output. All variables are in constant prices.

4/ Retained imports of capital goods, divided by the value of investment in machinery and equipment (both expressed in constant prices).

5/ Retained imports of consumer goods, divided by the value of private consumption (both in constant prices).

c. External demand

Despite the rapid growth in both merchandise and services exports, the surplus on trade in goods and nonfactor services has declined substantially since the late 1980s, falling from 8 3/4 percent of GDP in 1989 to 1 3/4 percent of GDP in 1994, and further to a (probably small) deficit in 1995. As a result, there has been a substantial withdrawal of external stimulus since the late 1980s, equivalent to about 2 1/4 percent of GDP in each of the five years (see tabulation below).

	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u> Staff Est.
<u>(Contribution to real GDP growth)</u>					
Net exports of goods and nonfactor services	-2.6	-2.5	1.4	-5.7	-1.7
Merchandise trade balance	-2.0	-3.5	0.3	-6.1	-3.5
Net domestic exports <u>1/</u>	-4.7	-7.2	-2.7	-8.4	-6.4
Net re-exports <u>2/</u>	2.7	3.6	3.0	2.3	2.8
Nonfactor services balance	-0.6	1.0	1.1	0.4	1.9

Net re-exports have on average contributed almost 3 percent per annum to real GDP growth since 1991, followed by net exports of nonfactor services, whose contribution averaged about 3/4 percent. Net domestic exports, on the other hand, have been withdrawing the stimulus to GDP growth at the average rate of 6 percent per year since 1991. These developments reflect the rapid increases in real domestic demand during the first half of the decade, and the continuing real appreciation of the Hong Kong dollar. As noted above, retained imports of consumer goods, capital goods, and production inputs were buoyed in the past five years by rising real incomes, accommodative financial conditions, and the ambitious program of public infrastructure development. In addition, the surge in retained imports was attributable in part to the relative strength of the Hong Kong dollar, which appreciated by 30 percent in real effective terms since 1989 as a result of the relatively higher rates of inflation in Hong Kong compared with those registered in trading partner countries.

d. Sectoral composition of output

The shifts in the sectoral composition of output accelerated since the late 1980s (Appendix Table 3). Between 1989 and 1993, the shares of financing, social services, ownership of premises, and transportation

-
- 1/ Domestic exports, less retained imports.
2/ Re-exports, less nonretained imports.

sectors in GDP increased, while those of manufacturing, trade and tourism, and construction sectors declined. In particular, the share of manufacturing declined by 8 percentage points to 11.1 percent of GDP in 1993 (see tabulation below).

	<u>1980-89</u>	<u>1989-93</u>
<u>(Change in the share of output in GDP, in percent)</u>		
Manufacturing	-4.4	-8.2
Utilities	0.9	-0.1
Construction	-1.4	-0.1
Trade and tourism <u>1/</u>	3.6	-2.0
Transportation <u>2/</u>	1.6	0.6
Nonbank financial services <u>3/</u>	-3.5	6.3
Social services <u>4/</u>	2.0	1.6
Property ownership	1.3	0.7
Banking services <u>5/</u>	-0.6	2.1

The decline in the share of the manufacturing sector and the rising importance of the financing, social services, property, and transportation sectors are part of the secular trend of the maturing of the Hong Kong economy. During the past 15 years, this trend has been accelerated by the reforms and opening up of China, which have provided Hong Kong's manufacturers with an opportunity to exploit a large differential in labor and land costs between Hong Kong and the mainland. 6/ At the same time, Hong Kong's services sectors were able to expand their operations on the back of the growing interest in China by foreign and domestic investors. The pace at which this process continues will, of course, depend on developments in China's economy and the global economic environment. The process as a whole will, however, inevitably continue, given the underlying changes in the demographic structure and human capital of Hong Kong's population.

1/ Includes wholesale, retail, and export/import trades, restaurants, and hotels.

2/ Includes transport, storage, and communication.

3/ Includes financing, insurance, real estate services, and business services.

4/ Includes, community, social, and personal services.

5/ An imputed service charge, equal to net interest receipts for the banking sector.

6/ Basic wage costs were up to fifteen times lower and land costs were up to half those in Hong Kong at the start of the integration process.

2. Labor market

a. Overview

Following a long period of tight labor market conditions, Hong Kong's labor market recently showed clear signs of easing, with a sharp rise in the unemployment rate attracting much popular attention. This section, after briefly describing the tight conditions until end-1994, discusses the factors behind the recent rise in the unemployment rate. It shows that the easing in the labor market was driven mainly by a strong surge in labor force growth, primarily reflecting a rise in returning migrants. The section also discusses the Government's policy toward the rise in unemployment. The Government has resisted calls for activist macroeconomic measures to create jobs, and instead, has strengthened the retraining and job-matching program. More recently, a tightening of the labor importation scheme was proposed, but it is unlikely to have a significant influence on overall labor market conditions.

b. Recent developments

Labor market conditions tightened progressively during the 1980s, with the unemployment rate falling from 3-4 percent in the first half of the decade to an average rate of less than 1 1/4 percent in 1989-90 (Chart 2 and Table 2). A number of factors contributed to this tightening. On the demand side, the rapid output growth sustained over the decade added to labor market pressures. On the supply side, the labor force growth rate declined from about 2 1/2 percent in the first half of the 1980s to virtually no growth in 1989-90, owing to a combination of natural demographic trends, a tightening of restrictions on the admission of unskilled workers from China, and a decline in the labor force participation rate. The labor supply situation was also exacerbated by a significant increase in emigration from Hong Kong, especially toward the end of the decade. To cope with the very tight conditions in the labor market, the Government introduced the General Labor Importation Scheme in 1989. Nevertheless, conditions in the labor market remained tight during 1991-94, with the unemployment rate remaining at about 2 percent.

The unemployment rate has risen sharply since early 1995 to 3 3/4 percent in the latter half of the year. Much of the rise in unemployment reflects a surge in labor supply. Between 1981 and 1992, labor force expanded by 1 percent a year. In contrast, labor force grew by as much as 3 1/4 percent in 1993-94, and 4 percent (annual rate) since the second quarter of 1995, the fastest increase in labor force since 1982. As the increase in the labor force participation rate was rather small, higher labor force growth came mainly from a surge in population growth. As shown in the tabulation below, most of the labor force growth was due to a net migration of people into the territory. The net inflow primarily reflected

CHART 2

HONG KONG

LABOR MARKET DEVELOPMENTS, 1982-95

Sources: Census and Statistics Department, *Hong Kong Monthly Digest of Statistics*.

Table 2. Hong Kong: Labor Force, Employment, and Unemployment, 1989-95

	1989	1990	1991	1992	1993	1994	1995			
							I	II	III	IV

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and Financial Services Branch, Third Quarter Economic Report 1995.

1/ Period average.

2/ End of period.

3/ Wholesale, retail, import and export trades, restaurants, and hotels.

the larger number of returning Hong Kong emigrants; 1/ however, increases in the number of immigrants from China and incoming expatriate professionals also played a role. 2/

(Number of Persons)

	<u>Total Population Increase</u>	<u>Natural Increases</u>	<u>Net Migration</u>
1991-92	56,700	41,200	15,500
1992-93	107,500	42,500	65,000
1993-94	104,400	42,400	100,000
1994-95	128,400	41,100	87,300

In addition to the strong growth in labor supply, the recent rise in unemployment partly reflected the labor demand factors. In 1993-94, total employment expanded by over 3 percent per year, keeping up with the growth in labor supply. While employment continued to grow by over 2 1/2 percent (year-on-year) in mid-1995, the growth in labor supply has been much faster. The easing of labor demand was concentrated in the restaurant and retail sectors, that traditionally absorbed much of the labor force released from manufacturing. As discussed above, the tightening of monetary conditions since mid-1994 has led to a considerable cooling off of consumer demand, resulting in slow growth in restaurant businesses and declining retail sales. As a result, there has been less demand for low-skilled manufacturing workers, and there have even been reductions in personnel in shops and restaurants. Meanwhile, the manufacturing sector continued to reduce employment. These sectoral developments have increased skill mismatches between the unemployed and job vacancies, and prolonged the job search process, thus partly contributing to an increase in the unemployment rate. However, the continued strength in overall employment growth suggests that the impact of such demand-side factors was limited.

The easing in labor market conditions alleviated the pressure on wages. After growing by 2 3/4 percent in 1993, real wage growth slowed to 1 1/4 percent in 1994, and further to -1 3/4 percent in 1995, the first drop in real wages since 1991.

1/ Data on the number of returning emigrants are not available because the returnees can enter Hong Kong with their Hong Kong identification cards, issued when they were Hong Kong residents, regardless of their current passport status.

2/ The daily immigration quota from China was raised from 105 to 150 in July 1995. Most immigrants are the elderly, children, and housewives coming to Hong Kong to join their families.

c. Policy responses

The Government has regarded the rise in unemployment largely as a supply-side phenomenon and has rejected calls to take macroeconomic measures for job creation. Instead, it focused on the microeconomic aspects of the problem and strengthened job retraining and job-matching programs. In April 1995, the Government launched a new job matching program that combines conventional retraining with customized job search assistance. The motivation for these actions came from the observation that in the second quarter of 1995 there were 51,700 job vacancies compared with 113,000 unemployed. So far this program has been successful, with over 60 percent of applicants finding new jobs. However, due to its labor intensive design, the program has reached only a small portion of unemployed.

As much of public concern about unemployment has focussed on imported labor, the Government has recently proposed a tightening of the General Labor Importation Scheme. Under the GLIS, a total of 25,000 workers--typically with two-year nonrenewable contracts--were allowed to work in Hong Kong at any one time. The Government proposed replacing the GLIS by a more limited Supplementary Labor Scheme (SLS). Under the proposed SLS, the quota would be reduced to 2,000 workers and allocated directly to individual employers rather than by industry. The downsizing of the labor importation quota is unlikely to have much impact on the labor market. The number of new workers brought into Hong Kong under the GLIS has been very small relative to the overall increase in the size of the labor force. In 1994, the imported labor accounted for less than 5 percent of the increase in total labor force. ^{1/} As the government stopped issuing new quotas for imported workers in August 1994, even the complete elimination of labor importation would not have significantly reduced the strong growth in labor force registered in 1995.

3. Property market

a. Overview

The property market has undergone a prolonged correction since its peak in April 1994. The market downturn was prompted by sharp increases in interest rates in 1994, and also by government measures to dampen speculation in the property market. Although the residential market has been most affected by the downturn, prices of office and retail properties also declined. However, land sales have been little affected and there have been no significant financial repercussions for developers or banks.

^{1/} Specifically, 2,400 workers were admitted under the GLIS and another 2,300 were admitted under the Special Scheme for Airport and Related Projects (SSARP). By contrast, the labor force grew by 100,000.

b. Residential property market

About 52 percent of Hong Kong's population lives in private housing, mostly apartments. 1/ Among private housing units, about 70 percent are owner-occupied. Because of strong demand and relatively tight supply, residential property prices and rents rose continuously between 1984 and 1994. The capital value of apartments doubled, on average, in real terms between 1985 and 1994 (and more than tripled for luxury apartments). The largest gains in prices were realized in 1991-92 (about 40 percent per year), and during the first quarter of 1994, when apartment prices rose by 33 percent (annual rate) on average, and by 60 percent for luxury apartments (Table 3). Such large price increases were widely viewed as excessive. In response, the Government took measures to cool the property market (see the Box). Meanwhile, interest rates firmed as U.S. monetary conditions were tightened: between March 1994 and February 1995, the Best Lending Rate, to which mortgage rates are tied, rose by 2 1/2 percentage points to 9 percent. Following these developments, residential prices began to fall; prices of apartments in new developments declined by 20 percent between the second quarter of 1994 and the third quarter of 1995. 2/

Given the prolonged nature of the decline in the market and the fact that it was the first downturn in more than a decade, consumer confidence and investor sentiment were profoundly affected. On the macroeconomic level, the impact was evident in the slowdown in growth of private residential construction and private consumption, and in the decline in the value-added component of property investment. The financial health of the property sector has been little affected by the downturn, however. Developers have generally followed conservative financial policies and avoided high gearing. These policies have been acknowledged by international rating agencies, which have rated the debt of some major property companies the same as Exchange Fund Notes. The property sector is generally considered to be highly competitive, with a large number of well diversified, listed companies.

As for the banks, although property related loans have accounted for over 40 percent of loans for use in Hong Kong, banks have regarded such lending as relatively safe, as about 60 percent of property lending was to end-users and the mortgage failure rate has traditionally been exceptionally low. Banks had also voluntarily adopted high loan-to-value ratios for mortgage loans (70 percent on average, and 50 percent for luxury apartments), and were not providing fixed-rate loans.

1/ For a discussion of the public housing program, see Chapter III.

2/ The overall decline in apartment prices was smaller, i.e., about 6 percent, year-on-year, in the second quarter of 1995. Rents declined on average by 3 percent between mid-1994 and mid-1995.

Table 3. Hong Kong: Real Estate Price and Rental Indices, 1990-95 ^{1/}

	1990	1991	1992	1993	1994	1994 ^{2/}		
						I	II	III
(1989 = 100)								
Price indices								
Private domestic premises	111	153	215	237	291	283	280	...
Of which:								
40 - 69.9 square meters	111	155	219	244	303	295	288	...
100 square meters and above	105	135	205	250	353	334	328	...
Private retail premises	112	143	200	244	276	262	249	...
Offices	96	97	133	159	219	211	201	...
Flatted factories	106	114	147	177	186	174	166	...
(Percent change)								
Private domestic premises	11.0	37.8	40.5	10.2	22.8	-1.7	-6.0	...
Of which:								
40 - 69.9 sq. meters	11.0	39.6	41.3	11.4	24.2	-3.3	-7.1	...
100 sq. meters and above	5.0	27.6	51.9	22.0	41.2	-0.9	-8.6	...
Private retail premises	12.0	27.7	39.9	22.0	13.1	-5.8	-15.3	...
Offices	-4.0	1.0	37.1	19.5	37.7	1.9	-12.6	...
Flatted factories	6.0	7.5	28.9	20.4	5.1	-9.4	-12.2	...
Rental indices								
(1989 = 100)								
Private domestic premises	110	119	130	140	170	177	174	173
Private retail premises	112	126	149	167	192	194	192	192
Offices	101	95	101	110	134	140	135	131
Flatted factories	105	109	117	129	133	133	133	132
(Percent change)								
Private domestic premises	10.0	8.2	9.2	7.7	21.4	15.7	1.8	-2.8
Private retail premises	12.0	12.5	18.3	12.1	15.0	6.0	0.5	-1.0
Offices	1.0	-5.9	6.3	8.9	21.8	13.8	2.2	-5.1
Flatted factories	5.0	3.8	7.3	10.3	3.1	2.3	0.8	-2.2

Source: Census and Statistics Department, Hong Kong Monthly Digest of Statistics.

^{1/} Data are period averages.

^{2/} Percentage changes are calculated over corresponding year-earlier periods.

Box 1. Government Measures for the Property Market

Following the sharp escalation in property prices and the intensification of property speculation in 1993 and early 1994, the Government took the unusual step of intervening directly in the property market in March and June of 1994. A government task force identified a number of factors underlying the rapid price increases. ^{1/} The demand-side factors included the exceptionally high population growth since 1990 (over 2 percent per year), the decline in household size, a growing number of expatriate professionals working in Hong Kong, the rising affluence of the population, negative real interest rates, and strong inflows of foreign capital. The main supply-side factor was the small net increase in the housing stock (about 3 percent per year between 1990 and 1993). The task force concluded that there was no reason to be concerned about the overall stability of the residential property market. However, measures were needed to address concerns about social stability and Hong Kong's competitiveness. The measures announced by the Government were, therefore, directed at curbing speculation and increasing the supply of land and housing.

Measures announced on March 2, 1994:

1. Change in town planning rules:
 - Re-zoning of land for commercial purposes;
 - Relaxation of limits on office expansion in industrial/office use buildings.
2. Increasing the supply of new sites.
3. Speeding up the processing of new land grants, land exchanges, and lease modifications.
4. Facilitating the redevelopment of existing sites.
5. Involving the private sector in supplying the infrastructure for major private sector projects.

Measures announced on June 8, 1994:

1. Measures to increase housing and land supply:
 - Increasing the overall supply of apartments built on new land by 45,000 units by 2001;
 - Increasing land supply for housing development by 120 hectares before FY 1997;
 - Speeding up the processing of land transactions and building applications;
 - Speeding up the redevelopment of old buildings and underutilized sites.
2. Measures to dampen speculative activities:
 - Lowering the quota for private sales of uncompleted apartments;
 - Restricting forward sales of apartments to not more than 9 months before the date of assignment;
 - Increasing the initial deposit to 10 percent of the purchase price and raising the penalty for default of purchase to 10 percent of the purchase price.

One measure that received a great deal of attention among market analysts was the restriction on forward sales of apartments. Before June 1994, developers were allowed to put their uncompleted apartments on the market for pre-sale up to 18 months before the anticipated date of assignment to buyers. This market innovation had allowed the developers to act as wholesalers, i.e., to unload their stock to speculators (or end-users), who then served as retail distributors for developers. It has been argued that restrictions on forward sales would raise both the risks of property development (by eliminating an important leading indicator for private developers), and the overall costs of property development (by forcing developers to hold on to their stock until final sale), thereby reducing the incentives for developers to acquire developable land. The counterargument has been that, while the speculators may have played a useful market role, their activities had generally amplified price fluctuations. In the event, the measure restricting the pre-sale of uncompleted apartments proved very effective, as the share of speculative sales in total sales stood at about 10 percent in November 1995, compared with over 20 percent in early 1994. ^{2/}

^{1/} See Report of the Task Force on Land Supply and Property Prices (Hong Kong: Planning, Environment and Lands Branch, June 1994).

^{2/} Speculative property transactions are defined as those effected within two years of the last purchase of an apartment.

c. Office property market

The office property market is predominantly a rental market. Price and rent levels vary considerably (as much as five to six times) with the district and the quality of accommodation. Over the past 15 years, cyclical variations in the supply, take-up, and vacancy rates of office space were clearly discernible, with each cycle lasting 4-5 years; net supply has generally responded to demand and rent levels with a lag of 1-2 years.

The latest upswing in prices and rents of office property started in 1991, coinciding with a surge in demand for high quality offices, especially in the Central business district on Hong Kong Island. The demand came from both overseas investors--who were attracted by the prospects of strong growth in trade with China--and Chinese enterprises seeking to establish a presence in Hong Kong. 1/ The supply of office premises, however, turned downward in 1993, with the take-up exceeding supply by 30 percent and the vacancy rate dropping below 5 percent for prime office space. Prices of high quality office accommodation increased by about 34 percent per year between the first quarter of 1991 and the first quarter of 1994, and rents by about 13 percent. At the height of the office market boom in mid-1994, rents for prime office space were among the highest in the world (about US\$120 per square meter per month), raising serious concerns about Hong Kong's competitiveness.

The Government considered intervening in the office market in 1994, but decided against it for a number of reasons. 2/ First, it was concluded that the office market, unlike the residential market, had followed the historical pattern of price/rental movements and was adjusting automatically through processes such as increasing supply in the pipeline and relocation to less expensive areas. Second, the supply of office space was expected to increase significantly from late 1995 through 1997 with redevelopment of sites and land reclamations in the Central district, and development along the airport railway. Third, unlike in the residential market, speculation in the office market was not seen as a problem. Finally, despite concerns about the impact of high rents on Hong Kong's competitiveness, the evidence did not support the fear that companies might be moving their operations out of Hong Kong. 3/ The Government, therefore, saw no need to intervene in

1/ Between 1991 and 1993, the number of overseas companies registered in Hong Kong surged from 2,800 to over 3,500. In 1993, the first Chinese enterprises were listed on the Stock Exchange of Hong Kong.

2/ See *Report on the Review of the Office Market* (Hong Kong: Planning, Environment, and Lands Branch, November 1994).

3/ Factors such as proximity to China, strategic location, good infrastructure, and low taxation were cited as the reasons for staying, notwithstanding the increasing cost of expatriate housing and office rentals.

the office market and encouraged instead the process of office decentralization and relaxed regulations on the conversion of industrial into office space.

In the event, office prices began to decline in mid-1994, and rents in early 1995. Office prices fell on average by 13 percent between mid-1994 and mid-1995, and office rents by about 7 percent since the end of 1994. The forces that brought the market down were rising interest rates, the expected increase in the supply of office space, and the withdrawal of Chinese and overseas capital following the monetary tightening in China and reassessment by overseas investors of the prospects for continued strong expansion in the region. In November of 1995, rents for prime office space were again competitive with office rents in Singapore.

d. Land releases

Virtually all land in Hong Kong is owned by the Hong Kong Government. 1/ Land disposed of by the Government is subject to a lease term. Land for noninstitutional uses is generally leased to the highest bidder at public auctions, with lease terms of 75 years or longer (up to 1,000 years). The reservation price for a given site is based on the market price prevailing one week before the auction. Each lease term requires a large lump-sum premium and a small annual rent. Because the rent serves only as a legal symbol to maintain the lessor and lessee relationship, the premium attached to any given land lease approximates the land value. Most leases are transferable, and the land market is a market for land leases.

Despite the downturn in the property market, prices achieved in auctions in late 1994 and 1995 were generally higher than expected. In particular, better than expected prices were achieved for residential sites in prime urban areas, and for office and commercial sites in well-established commercial and business areas. However, sales of several commercial sites in more remote areas and of industrial-cum-office sites met with little interest and were withdrawn from auction. These developments suggest that the overall cautious sentiment continued to prevail among developers.

Given the special characteristics of the land market in Hong Kong and the steady increase in property prices in recent years, an important issue has been whether the policy of auctioning off land to the highest bidder has negatively affected the supply of property and amplified the secular rise in prices. Several factors suggest that this has generally not been the case:

1/ The Hong Kong Government, acting on behalf of the British Government, has maintained a policy of retaining the freehold of the territories ceded by the Chinese Government in the last century, and a reversionary interest in the leased territories.

- In the residential market, the historical correlation between land supply and net private housing supply is relatively weak, even allowing for a lag of 2-3 years between the land sales and housing completions. However, the negative correlation between land sales and housing prices (with about a year's lag) is relatively strong. 1/

- Since 1984, land releases have been subject to an annual limit of 50 hectares agreed to in the Sino-British Joint Declaration. This limit has been more or less consistently breached, especially with respect to land for housing development, suggesting that the pressure on the Government has been to increase rather than withhold the supply of land.

- The bulk of land for commercial development has traditionally been supplied by developers through redevelopment of old sites. Evidence suggests that the incentive of developers to acquire land for redevelopment (from both the Government and private owners), and the speed of redevelopment, depend primarily on the market response in the forward sales market, which is driven by overall sentiment about the macroeconomic outlook.

- While land sales are a major source of revenue for the Government, the Hong Kong Government share of this revenue is earmarked for capital works projects. 2/

- Finally, recent research indicates that, rather than depressing the supply of property, the restrictive land policy may actually encourage the production of housing units in the short run because the anticipated higher future rents are capitalized into higher current housing prices. 3/ In the long run, the main effect of the current land policy seems to be to promote substitution of capital for land by encouraging the construction of high-rise apartment buildings and raising the density of development.

4. Inflation and competitiveness

a. Overview

Consumer price inflation rose steadily in the late 1980s and early 1990s, reaching 12 percent in 1991 (Chart 3 and Table 4). This trend arose from a combination of excess demand pressures and structural factors. The rapid economic expansion in the second half of the 1980s, coupled with the sharp drop in labor force growth, brought the economy to a very high level

1/ See Peng and Wheaton (1994). Their data cover the period 1965-90.

2/ All proceeds from land sales are shared between the Hong Kong Government and the Land Fund of the Hong Kong Special Administrative Region (HKSAR). The Land Fund will revert to the Government of the HKSAR on July 1, 1997.

3/ See Peng and Wheaton (1995).

Table 4. Hong Kong: Selected Price Indicators, 1990-95

(Percentage change)

	1990	1991	1992	1993	1994	1995	1995 1/			
							QI	QII	Q III	Q IV
CPI (A)	9.7	12.0	9.3	8.5	8.1	8.7	9.5	9.2	8.6	7.7
Food - overall	9.9	11.4	8.8	7.3	6.4	7.2	8.0	7.7	6.8	6.5
- meals away from home	15.5	13.3	10.6	8.7	7.7	7.1	7.3	7.1	7.2	6.8
- excluding meals away from home	4.8	9.4	6.9	5.6	4.8	7.4	8.8	8.3	6.2	6.3
Housing	8.7	12.6	13.0	12.6	11.2	12.2	12.8	12.5	12.4	11.2
Fuel and light	10.9	6.2	5.2	3.8	3.5	7.6	7.7	9.7	7.5	5.6
Alcohol and tobacco	17.3	44.2	9.7	10.5	5.6	6.3	5.3	6.7	7.0	6.0
Clothing and footwear	7.3	7.3	8.5	7.6	8.9	8.7	11.4	10.1	6.0	7.4
Durable goods	3.0	4.4	2.3	2.2	2.8	4.2	4.0	4.3	4.3	4.1
Miscellaneous goods	5.3	7.9	6.8	6.8	6.8	6.7	8.2	8.3	8.9	1.4
Transportation and vehicles	13.4	13.2	7.2	8.3	9.3	7.5	8.5	7.2	7.1	7.0
Services	13.0	14.1	11.8	9.6	11.8	11.4	12.3	11.5	11.1	10.7
Memorandum items:										
Composite CPI	9.7	11.2	9.6	8.8	8.8	9.1	9.8	9.5	9.1	8.2
Residential price index	11.0	37.8	40.5	10.2	22.8	...	-1.7	-6.0	...	...
GDP deflator	7.5	9.2	9.7	8.5	7.5	...	5.5	3.7	4.1	...
Domestic demand deflator	7.7	8.1	8.1	7.8	7.3	...	7.0	7.7	6.1	...
Export prices 2/										
Goods deflator	4.6	2.0	0.8	-0.4	1.3	...	2.1	3.5	2.7	...
Services deflator	8.0	8.2	6.2	5.4	6.5	...	7.8	7.5	7.3	...
Import prices 2/										
Goods deflator	3.6	1.9	0.3	-0.4	2.3	...	4.7	7.0	4.7	...
Services deflator	8.3	3.3	3.3	1.7	7.7	...	10.7	10.3	9.0	...

Sources: Census and Statistics Department, Consumer Price Index Report; Hong Kong Monthly Digest of Statistics; and Quarterly Estimates of GDP, Third Quarter 1995.

1/ Increase over corresponding year-earlier period.

2/ Data are on a national accounting basis.

CHART 3

HONG KONG
INFLATION AND COMPETITIVENESS, 1983-95
(Percentage change)

Sources: Census and Statistics Department, Consumer Price Index Report, and Hong Kong Monthly Digest of Statistics; and staff projections.

of resource utilization. 1/ At the same time, structural shifts associated with the relocation of manufacturing to southern China, as well as Hong Kong's strategic advantages in providing services to support China's external trading and investment relationships, led to large productivity gains in the traded goods and traded services sectors. 2/ Taken together, the high level of resource utilization (reflected in the exceptionally low rate of unemployment) and the large productivity gains exerted strong upward pressure on wages and, hence, prices, especially the prices of labor-intensive goods and services in the nontradable sector. Beyond these two factors, low interest rates in the United States at a time of a cyclical upswing in Hong Kong buoyed private consumption and investment in the early 1990s. Given the high level of capacity utilization at home, these excess demand pressures spilled over into the trade balance in the case of demand for tradables, and into prices in the case of demand for nontradables.

b. Recent developments and medium-term prospects

Despite strong economic activity, consumer price inflation moderated in recent years to about 8-9 percent per year, aided in 1992-93 by falling prices of imported food and energy and, more recently, an easing of labor market pressures. In particular, owing to more abundant labor supply, wage growth decelerated from 11 percent in 1993 to 8 percent in 1995. Consumer price inflation actually picked up in late 1994 and early 1995, but soon resumed a moderating trend, falling to 6 1/2 percent per annum by December 1995. The pick-up in inflation in late 1994 and early 1995 was due to both domestic factors (including the lagged effects of property price inflation from early 1994) and external factors, including the uptrend in world commodity prices, a weaker U.S. dollar, and relatively high inflation in China. As the impact of the depreciation tapered off in mid-1995, and as the labor market slackened and rents eased further, locally generated inflationary pressures began to recede in the second half of the year, providing a relief to the overall inflation rate despite the large concurrent increases in imported prices.

The rate of CPI(A) inflation for 1995 as a whole was 8.7 percent, compared with 8.1 percent in 1994 and a (revised) official forecast of 9 percent. Core inflation, which excludes the volatile prices of (mostly imported) food and energy items, was unchanged from 1994, and about half a percentage point lower than in 1992-93. Among the components of the consumer price index, the subindices for goods with a large import content were generally higher in 1995 than in 1992-93, while the increases in rents and prices of services were generally lower.

1/ For a discussion of developments in actual and potential output, see Chapter II in Supplement 1 to the 1994 Staff Report (SM/95/23 Supplement 1).

2/ Labor productivity in manufacturing increased on average by 12 percent per year between 1986 and 1993.

The GDP deflator rose by just 4 1/2 percent over the first three quarters of 1995, compared with a 7 1/2 percent increase in 1994. The moderate increase partly reflected the sharp decline in the component deflators for real estate developers' margins and for property trading activities, and, more importantly, the deterioration in the terms of trade by 2 1/2 percent during the first three quarters of the year. The growth in both import and export prices doubled from those registered in 1994: import prices rose by 5 1/2 percent, and export prices by 2 3/4 percent over the first three quarters of 1995. Prices of imported and exported services both rose in 1995, albeit at a slower pace than goods prices. Cost saving measures, including job upgrading programs and investment in machinery and equipment, helped to cushion to some extent the adverse effects of higher import prices.

As discussed in Chapter VII, should the current trend of rapid appreciation of the real exchange rate and high growth of domestic demand continue in the medium term, the external balance would decline to an unsustainable level. For the external balance to stabilize, domestic inflation would have to decline to about 4-5 percent per year over the medium term. While this rate of inflation would still exceed that in trading partners' countries, the effect on Hong Kong's external competitiveness would be offset by higher growth in activity in trading partners than in Hong Kong.

c. Trends in competitiveness

During the 1980s, Hong Kong's competitiveness in low-technology light manufacturing industries began to erode as a result of rising wages and the emergence of lower-cost regional competitors. Following the liberalization of foreign investment regulations and the onset of market-oriented reforms in China, Hong Kong firms started to relocate their labor-intensive operations to southern China, where labor and land costs were a fraction of those in Hong Kong. The decline in employment since the mid-1980s and the upgrading of skills in industries that remained in Hong Kong (to supervisory and technical functions, such as product design and marketing), led to strong productivity growth. Labor productivity in manufacturing thus rose at an average annual rate of 12 1/2 percent between 1986 and 1994, while unit labor costs declined by 2 1/2 percent per year over the same period (Charts 2 and 4 and Table 5). Although productivity growth has been maintained at a high level throughout the period, the gains in productivity in recent years seem to have come from different sources than in the mid-1980s. Between 1986 and 1988, real output growth was still strong and large-scale employment reductions had not yet started as wage growth remained tolerable. After 1988, nominal wages started to grow at double-digit rates and layoffs in manufacturing accelerated. However, real output declined by much less than employment, suggesting that there has been a significant increase in the use of labor-saving technology.

In the services sector, the advantages initially enjoyed by Hong Kong firms providing services related to trade and investment in China were.

Table 5. Hong Kong: Wages, Labor Productivity,
and Unit Labor Costs, 1990-95

(Percentage change)

	1990	1991	1992	1993	1994	1995
Nominal wages <u>1/</u>						
Overall economy	12.7	11.1	9.8	10.8	9.9	8.0
Manufacturing	12.2	11.0	9.5	10.7	8.9	5.9
Trade and tourism <u>2/</u>	11.1	9.9	9.6	9.2	10.0	8.6
Financial services <u>3/</u>	16.6	12.6	11.1	12.1	8.7	9.2
Real wages <u>1/</u>						
Overall economy	2.5	-1.1	0.2	2.8	1.3	-1.1
Manufacturing	2.1	-1.1	-0.2	2.8	0.7	-3.0
Trade and tourism <u>2/</u>	1.0	-2.2	--	1.5	1.6	-0.5
Financial services <u>3/</u>	6.3	0.5	1.4	3.2	0.3	--
Labor productivity <u>4/</u>						
Overall economy	4.8	3.9	6.4	3.2	1.8	3.0
Manufacturing	9.7	14.7	13.1	15.9	14.3	16.1
Unit labor costs <u>4/</u>						
Overall economy	7.5	6.9	3.2	7.3	7.7	3.8
Manufacturing	2.3	-3.2	-3.2	-4.6	-4.8	-9.4

Sources: Census and Statistics Department, Hong Kong Annual Digest of Statistics; Hong Kong Monthly Digest of Statistics; Estimates of Gross Domestic Product, 1961 to 1994; Quarterly Estimates of Gross Domestic Product, Third Quarter 1995; and staff estimates.

1/ Based on averages of semiannual data.

2/ Includes wholesale, retail, import and export trades, restaurants, and hotels.

3/ Includes financing, insurance, real estate, and business services.

4/ Based on employment data; data on person-hours are unavailable. Data for 1995 are staff estimates, based on data for the first three quarters.

gradually eroded by stronger regional competition and the cumulative effects of high wage and property price inflation. As relocation options have been more limited in this sector, services firms initially responded to eroding competitiveness by trying to restrain price increases and temporarily absorb higher costs. These actions led to continued growth in business but falling profit margins. Since 1994, many services firms have therefore stepped up investment in labor-saving capital equipment and reduced employment. The macroeconomic implications of these actions have been, among others, the reduced ability of the services sector firms to absorb surplus workers released from the manufacturing sector, higher unemployment among workers with low skills, longer durations of unemployment, and a higher merchandise trade deficit. Because of these implications, the Government has been under pressure to consider policy measures (including tax incentives) to maintain Hong Kong's competitiveness.

Given the Government's noninterventionist approach in economic policy matters, the proposals for policy actions to maintain competitiveness have been highly controversial. Part of the problem is that it is difficult to assess whether the services sector has a competitiveness problem in the first place. Data on value added by sector in constant prices are not available, and attempts to construct such data from various indicators of real activity have to overcome considerable methodological difficulties.

III. Fiscal Policy

1. Overview

Fiscal policy in Hong Kong has traditionally followed a noninterventionist approach, aimed at maintaining a small government and fostering a competitive private sector. To this end, policy has been guided by four broad principles: to maintain a simple tax system with stable and low tax rates; to keep current spending increases in line with nominal GDP growth; to provide funding for key infrastructure projects; and to maintain an adequate level of fiscal reserves for contingencies. Under this prudent approach, budgetary outcomes have generally been stronger than projected in initial budgets. The resulting, sometimes large, surpluses have enabled the authorities to build up substantial fiscal reserves. The macroeconomic impact of the surpluses has been broadly neutral over the past decade. ^{1/}

This chapter reviews recent budgetary developments and the medium-term fiscal outlook (Section 1), growth and structure of the main revenue sources (Section 2), the level of public expenditure and recent shifts in spending priorities, including the Airport Core Program and the public housing program (Section 3), and the proposed Mandatory Provident Fund scheme (Section 4).

^{1/} For an analysis of the budgetary performance in 1984-93, see Chapter III in Supplement 1 to last year's Staff Report (SM/95/23 Supplement 1).

2. Recent budgetary developments

a. Developments in FY 1992 - FY 1994

The main issue for fiscal policy over 1992-94 has been the need for fiscal restraint in the face of strong economic growth and relatively high inflation. The budgets for FY 1992 and FY 1993 provided for substantial declines in the overall surplus. In the event, the projected declines did not materialize; as revenue growth was much stronger than envisaged and capital spending was delayed, large surpluses of 2 1/2 percent of GDP and 2 1/4 percent of GDP were realized in FY 1992 and FY 1993, respectively (Table 6). As a result, fiscal reserves grew by close to 20 percent in both years, reaching 15 1/2 percent of GDP at end-1993. The estimated fiscal impulse was -1/2 percent of GDP in FY 1992, and 1/4 percent of GDP in FY 1993. 1/ By this measure, fiscal policy was contractionary in FY 1992 and slightly expansionary in FY 1993.

The FY 1994 Budget provided for a decline in the overall surplus to about 1 percent of GDP from an average of 2 3/4 percent of GDP in the three preceding fiscal years. This decline was to come about mainly as a result of generous tax cuts granted in the FY 1994 Budget. In particular, the tax rate on corporate profits was reduced by 1 percentage point, and the personal income tax allowances were raised substantially, removing about one fourth of taxpayers from the tax net. 2/ The tax concessions were partly offset by an increase in business registration fees and additional revenue from the property tax. 3/ Total expenditure was projected to rise in line with nominal GDP growth, with somewhat faster growth for social welfare, health, and education.

The budgetary outcome for FY 1994 was again stronger than projected, but by a smaller margin than in the preceding two years. The consolidated surplus for FY 1994 was HK\$13 billion (1.3 percent of GDP). Compared to the original projection, there was a shortfall in total revenue of about

1/ The fiscal impulse measures the size of initial stimulus to aggregate demand arising from discretionary and other changes in fiscal policy after eliminating the cyclical component of the change in budget balance. A positive (negative) sign indicates that policy has become more expansionary (contractionary) relative to the previous year. The estimates of the fiscal impulse presented in this chapter are based on actual budget outcomes adjusted for government equity investments and revenue from land sales.

2/ The concessions included a 28 percent rise in the salaries tax allowance, a reduction in the top marginal tax rate from 25 percent to 20 percent, and an increase in tax allowances for dependent children, parents, and grandparents.

3/ The property tax rates themselves were left unchanged at 5 1/2 percent, but the ratable values increased on average by 33 percent over the previous assessment conducted in 1991.

Table 6. Hong Kong: Consolidated Government Account, FY 1991/92-FY 1995/96 ^{1/}

	1991/92	1992/93	1993/94	1994/95		1995/96	
				Budget	Actual	Budget	Staff proj.
(In billions of Hong Kong dollars)							
General revenue account							
Revenue	101.5	120.8	143.9	147.9	151.1	158.9	162.3
Expenditure	72.9	86.5	98.5	110.0	108.2	126.2	124.5
Current	70.8	81.6	93.2	107.8	106.0	123.5	121.8
Capital	2.1	4.9	5.3	2.3	2.1	2.7	2.7
Surplus before transfers	28.6	34.3	45.4	37.9	42.9	32.8	37.8
Transfers to funds	20.6	15.5	22.5	27.1	39.1	34.0	...
Balance after transfers	8.1	18.8	22.9	10.8	3.8	-1.3	...
Consolidated account funds ^{2/}							
Revenue	12.1	12.0	22.7	28.7	23.9	30.0	27.0
Capital expenditure	19.3	26.8	47.7	56.7	53.6	65.4	63.9
Deficit before transfers	-7.2	-14.8	-25.0	-27.9	-29.6	-35.4	-36.9
Transfers from general revenue account	20.6	15.5	22.5	27.1	39.1	34.0	...
Balance after transfers	13.4	0.7	-2.5	-0.8	9.5	-1.3	...
Total consolidated account							
Revenue	113.6	132.8	166.6	176.6	175.0	188.9	189.3
Expenditure	92.2	113.3	146.2	166.7	161.8	191.6	188.4
Current	70.8	81.6	93.2	107.8	106.0	123.5	121.8
Capital	21.4	31.7	53.0	58.9	55.7	68.0	66.6
Balance	21.4	19.5	20.4	10.0	13.2	-2.6	0.9
Fiscal reserve balance, March 31	99.1	121.0	140.2	143.8	151.0	148.4	151.9
(In percent of GDP)							
Total consolidated account							
Revenue	17.0	17.0	18.5	18.3	17.1	16.5	16.7
Expenditure	13.8	14.5	16.3	17.3	15.8	16.7	16.6
Current	10.6	10.5	10.4	11.2	10.4	10.8	10.7
Capital	3.2	4.1	5.9	6.1	5.4	5.9	5.9
Balance	3.2	2.5	2.3	1.0	1.3	-0.2	0.1
Fiscal reserve balance, March 31	14.8	15.5	15.6	14.9	14.8	13.0	13.4
(Percentage change)							
Total consolidated account							
Revenue	26.9	16.9	25.5	6.0	5.0	8.0	8.2
Expenditure	7.8	22.9	29.0	14.0	10.6	18.4	16.5
Current	17.2	15.3	14.2	15.6	13.8	16.5	14.9
Capital	-14.9	48.2	67.1	11.1	5.1	22.1	19.5
Fiscal reserve balance, March 31	29.4	22.2	15.8	2.6	7.7	-1.7	0.6
(In billions of Hong Kong dollars)							
Memorandum item:							
Net borrowing ^{3/}	1.1	2.5	-1.2	-2.3	-2.4	...	...

Sources: Data provided by the Government Secretariat, Finance Branch; and staff projections.

^{1/} The fiscal year runs from April 1 to March 31.

^{2/} Consists of the Capital Works Reserve Fund; Capital Investment Fund and Loan Fund beginning 1990/91; Disaster Relief Fund beginning 1993/94; and Civil Service Reserve Fund beginning 1994/95.

^{3/} The Government Bond Program was launched in November 1991 in an effort to develop a market in fixed-income securities and facilitate the funding of long-term government infrastructural projects. The bonds are issued before the Government actually requires the funds. The Program limits the size of gross debt outstanding to HK\$5 billion as of June 30, 1997.

0.3 percent of GDP, and an underspending of about 0.6 percent of GDP. The revenue shortfall was due to lower revenue from land sales (reflecting the downturn in the property market); this shortfall was partly offset by higher-than-projected interest earnings on fiscal reserves and additional collections from the salaries tax. As for the underspending, about one third came from lower current expenditure, and two thirds from lower capital expenditure. The main factors contributing to the underspending were lower personnel-related expenses and subsidies, delays in negotiations on the airport financing package, and lower costs of acquiring land for public projects. The estimated fiscal impulse for FY 1994 was $-1/4$ percent of GDP, suggesting that fiscal policy was slightly contractionary, excluding the effects of government equity investments and revenue from land sales.

b. The FY 1995 Budget

The spending profile of the Airport Core Program called for the acceleration of works on the airport project in 1995-96, requiring large capital and equity investment by the Government. The Budget for FY 1995 therefore envisaged a small deficit of $1/4$ percent of GDP. As total revenue was projected to grow more slowly than GDP, and total expenditure faster than GDP, the budget balance was set to swing by $1\frac{1}{2}$ percent of GDP. Reflecting this reduction in the surplus, the fiscal stimulus built into the Budget was estimated at about 1 percent of GDP in FY 1995.

On the revenue side, the FY 1995 Budget provided for a broad-based 10 percent increase in salaries tax allowances and for some modest concessions for the needy, while keeping salaries tax rates and tax bands unchanged. The inheritance tax and excises on tobacco and fuel were also adjusted for inflation. Total revenue was projected to decline by $3/4$ percent of GDP due to delayed effects of tax concessions granted in the FY 1994 Budget, and lower expected profits in the banking and financial sectors. ^{1/}

On the expenditure side, the FY 1995 Budget called for accelerated spending on the airport project and social programs. In particular, real expenditure on education was projected to increase by 6 percent, on health by 8 percent, and on social welfare by as much as 24 percent. Overall, current expenditure was projected to increase by $1/3$ percent of GDP, and capital expenditure by $1/2$ percent of GDP.

Total revenue on the General Revenue Account was slightly lower in the first half of FY 1995 (April-October) than in the same period last year (Appendix Table 4). In particular, receipts from earnings and profits tax, motor vehicle taxes, and stamp duties were lower than in the same period last year, mirroring the slowdown in wage growth and private consumption,

^{1/} The cost of tax concessions was originally estimated at 0.7 percent of GDP in FY 1994 and 0.8 percent in FY 1995. The cost is higher in the second year because of the full-year effect of the concessions.

and the continuing weakness in the property market. Current spending growth was in line with the budget projection, while capital spending was substantially higher than in the first half of FY 1994 because of the huge equity injection of HK\$14 billion into the airport project (Appendix Table 5). As the bulk of revenue normally is collected during the first quarter of the calendar year, the half-yearly results are not entirely indicative of the likely position of the budget at the end of the fiscal year. At this stage, however, it seems that the projected small deficit might indeed materialize at end-March 1996.

c. Medium-term outlook

According to the Medium-Range Fiscal Forecast prepared in conjunction with the FY 1995 Budget, the overall balance would revert to a small surplus in FY 1996, and register a surplus equivalent to about 2 percent of GDP by FY 1997 (Table 7). About two thirds of this surplus would result from the fact that, beginning with July 1997, all revenue from land sales would be credited to the Capital Works Reserve Fund, compared with just one half under the present arrangements. Revenue buoyancy is projected to improve after FY 1996 as the impact of tax concessions granted in the FY 1994 Budget tapers off, while the expenditure/GDP ratio is projected to stabilize at around 15 percent of GDP. Based on this forecast, fiscal policy would be neutral in FY 1996, and would begin to withdraw stimulus from the economy in FY 1997 and FY 1998 as airport spending winds down and revenue buoyancy improves.

d. Fiscal reserves and the Land Fund

While many governments have been saddled with substantial public debt, the Hong Kong Government has over the years built up a reassuring cushion of fiscal reserves by accumulating large budgetary surpluses. Fiscal reserves are deposited with the Exchange Fund, which manages them along with other assets that serve as backing for the Hong Kong currency, and pays the Government interest realized by investing the reserves. The interest is credited to the General Revenue Account, and in recent years it represented 2-3 percent of total government revenue.

Fiscal reserves stood at HK\$151 billion (15 percent of GDP) on March 31, 1995 (Chart 4). Over the past ten years, fiscal reserves grew on average by 22 percent per year, compared with nominal GDP growth of about 18 percent per year. The growth in fiscal reserves slowed in FY 1994 and is expected to remain subdued in the current and next fiscal years because massive investment in the airport project will trim budgetary surpluses. Nevertheless, on March 31, 1997, shortly before the transfer of sovereignty to China, fiscal reserves are projected to stand at an impressive HK\$154 billion (12 percent of GDP). One year later, at the end of FY 1997, there would be an enormous, one-time jump in reserves to HK\$331 billion (22 percent of GDP), representing about 1.4 times total government expenditure projected for FY 1998. This increase is expected to result from

CHART 4

HONG KONG

FISCAL DEVELOPMENTS, 1982-95

In percent of GDP

In percent of GDP

In percent of GDP

Sources: Census and Statistics Department, Annual Digest of Statistics; and data provided by the Government Secretariat, Finance Branch.

Table 7. Hong Kong: Medium-Range Fiscal Forecast, 1995/96-1998/99 ^{1/}

	1994/95	1995/96 Budget	1996/97 Official Proj.	1997/98 Official Proj.	1998/99 Official Proj.
(In billions of Hong Kong dollars)					
Revenue	175.0	188.9	206.5	257.0	292.7
Current	151.1	158.9	177.8	206.6	241.3
Of which: New revenue measures	...	-1.2	-2.5	-2.0	-2.0
Capital	23.9	30.0	28.7	50.4	51.4
Of which: Capital Works Reserve Fund ^{2/}	20.2	25.9	24.7	45.4	46.3
Expenditure	161.8	191.6	200.5	223.7	259.5
Current	106.0	126.2	145.3	166.6	191.0
Capital	55.7	68.0	55.2	57.1	68.5
Of which: Capital Works Reserve Fund ^{3/}	28.2	36.5	42.7	52.7	64.0
Capital Investment Fund ^{4/}	18.6	21.8	12.5	4.4	4.6
Surplus (+)/Deficit (-)	13.2	-2.6	6.0	33.3	33.2
Borrowing ^{5/}	-2.4	...	...	...	...
Fiscal reserves balance, March 31	151.0	148.4	151.3	327.5	360.7
Balance in the Land Fund of the Hong Kong Special Administrative Region ^{6/}	77.8	...	...	142.9	...
(In percent of GDP)					
Revenue	17.1	16.5	15.6	17.1	17.1
Expenditure	15.8	16.7	15.2	14.8	15.1
Current	10.4	10.8	11.0	11.1	11.1
Capital	5.4	5.9	4.2	3.8	4.0
Surplus (+)/Deficit (-)	1.3	-0.2	0.4	2.2	1.9
Reserves at March 31	14.8	13.0	11.4	21.7	21.0

Sources: Government Secretariat, Financial Services Branch; The 1995/96 Budget; and staff estimates.

^{1/} Fiscal year beginning April 1.

^{2/} Includes mainly revenue from land sales.

^{3/} Includes financing of airport-related projects.

^{4/} Includes Government equity injections into the Airport Authority and Mass Transit Railway Corporation.

^{5/} The Government Bond Program was launched in November 1991 in an effort to develop a market in fixed-income securities and facilitate the funding of long-term government infrastructural projects. The bonds are issued before the Government actually requires the funds. The Program limits the size of gross debt outstanding to HK\$5 billion as of June 30, 1997.

^{6/} Balance shown is as of March 31, 1994 and July 1, 1997.

three factors. First, the Land Fund of the Hong Kong Special Administrative Region will revert to the HKSAR Government on July 1, 1997. Second, the HKSAR Government will start receiving full proceeds from land sales as of the same date. Third, the HKSAR Government will collect rents from the extension of leases in New Territories. 1/ After FY 1997, fiscal reserves are projected to resume growth at a more moderate rate.

The Land Fund of the HKSAR was set up in 1986 in order to implement Annex III of the Joint Declaration, which contains provisions on land leases extending beyond the transfer of sovereignty. According to the agreement, revenue from land transactions that confer a benefit that extends beyond June 30, 1997 and are completed on or before May 27, 1985, are shared equally between the Hong Kong Government and the future HKSAR Government, after deducting the cost incurred by the Hong Kong Government in developing the new sites. The Hong Kong Government's share of land revenue is credited to the "Works Account" of the Capital Works Reserve Fund and it can be used only to finance capital works projects. The future HKSAR Government's share is credited to the "Suspense Account" of the Capital Works Reserve Fund and is managed by trustees.

Over the past ten years, assets of the Land Fund have grown quickly to an estimated HK\$78 billion (8 percent of GDP) at end-March 1995 (Chart 4). By July 30, 1997, the Land Fund is projected to grow to HK\$143 billion. The balance of the Land Fund is expected to be consolidated with the general fiscal reserves from April 1, 1998.

3. Revenue developments

The basic approach of the Hong Kong Government with regard to taxation has been to derive revenue from a limited number of sources and to maintain low tax rates with a flat profile. In comparison with OECD countries, Hong Kong has a very simple tax structure: income tax rates are low and generally uniform (15 percent for individuals, 16 1/2 percent for companies); liability to income tax is limited to income derived from sources within Hong Kong; capital gains, dividends, and interest income are not taxed; 2/ while indirect taxes are levied on a few, primarily nonessential items.

1/ Under the Sino-British Joint Declaration and China's Basic Law, land leases extending beyond June 30, 1997 will not be subject to an additional premium, but to an annual rent equivalent to 3 percent of the rateable value of the properties concerned. This provision will apply to most leases in New Territories; one exception will be indigenous villagers holding rural properties, who will continue to pay the previous rent. This provision alone is expected to generate an additional HK\$4-5 billion per year (2 percent of total revenue) for the HKSAR Government.

2/ Except interest income from domestic sources received by licensed banks and corporations carrying on business in Hong Kong.

Despite the small number of taxes and their simple structure, Hong Kong's tax base has, over the years, continued to generate sufficient revenue to meet the budgetary commitments and to maintain healthy growth of fiscal reserves. Data for the period 1980-94 indicate that the overall tax system is quite buoyant: a one percent (one dollar) increase in GDP raises total revenue by 0.96 percent (17 cents) (Table 8). Capital revenue (mostly premia from land sales), stamp duties, and motor vehicle taxes have particularly high buoyancy coefficients. The earnings and profits tax, which is the largest source of revenue, is also highly buoyant, indicating that the income tax base has expanded despite generous allowances that have been periodically granted to taxpayers. One of the main factors responsible for this broadening of the income tax base is an increase in the share of middle-aged population in Hong Kong's labor force, and higher level of education of the workforce.

Table 8. Hong Kong: Estimates of Revenue Buoyancy and Marginal Propensity to Tax, 1980-94

	Buoyancy <u>1/</u>	Marginal Propensity to Tax <u>2/</u>
Tax revenue	1.124	0.121
Earnings and profits tax	1.119	0.074
Property tax	0.951	0.052
Excises	1.044	0.076
Stamp duties	1.268	0.014
Bets and sweeps tax	1.255	0.010
Motor vehicle taxes	1.461	0.051
Nontax revenue	0.461	0.022
Interest on reserves	0.402	0.028
Fees and charges	0.947	0.091
Utilities	0.945	0.082
Capital revenue	1.548	0.028
Total revenue	0.961	0.170

Source: Staff estimates.

1/ Estimated by regressing the logarithm of nominal revenue on the logarithm of nominal GDP.

2/ Estimated by regressing nominal revenue on nominal GDP.

Although historically Hong Kong's revenue system has been buoyant, in recent years there have been concerns that some major revenue sources are vulnerable to cyclical downturns. In particular, it is estimated that about 30 percent of total revenue in recent fiscal years is directly related to land and property. ^{1/} In addition, given its flat rate profile, Hong Kong's income tax system lacks the built-in automatic stabilizer properties of graduated income tax systems.

Judging from the yield of various taxes and the long-run stability of Hong Kong's revenue structure, there seems to be little ground for concerns about stability of the revenue base in Hong Kong. The yield of the earnings and profits tax increased from about 6 percent of GDP in the early 1980s, to about 7 1/2 percent in recent years, despite the fact that profits fluctuated considerably over the course of two business cycles that spanned this period (Chart 4). Excise revenue, stamp duties on property and stock market transactions, and revenue from property and motor vehicle taxes also maintained a stable share in GDP over the years, notwithstanding the volatility of the underlying tax bases.

The structure of revenue has been fairly stable as well: the share of earnings and profits taxes in total revenue has fluctuated in a narrow band around 40 percent; indirect taxes have generally accounted for about 25 percent of total revenue; nontax revenue for about 20 percent; while the share of capital revenue increased in recent years to about 15 percent.

One reason why Hong Kong's revenue base has been relatively stable is, of course, that overall growth has been so strong in the past decade and a half. Despite periodic slumps in the property market, Hong Kong has not experienced a prolonged recession that would put the revenue system under a major strain. However, part of the credit should also go to the simple tax system, with its low administrative and compliance costs, and low and stable tax rates that provide appropriate incentives and a stable environment for workers to work and for domestic and foreign entrepreneurs to invest.

4. Expenditure developments

a. Growth and structure of public expenditure

The basic approach of the Hong Kong Government with regard to public expenditure has been to keep current spending increases in line with the growth rate of nominal GDP, and to provide adequate support for a relatively narrow range of public infrastructure projects for which government supply is deemed efficient.

^{1/} The property revenue includes: property taxes ("rates"); profits tax on property-related businesses; stamp duty on property assignments and leases; and, most importantly, premia from land sales.

Over the past decade, total public expenditure grew on average by 16 percent per year (Table 9), compared with a trend growth rate of nominal GDP of 14.3 percent. Capital expenditure grew slightly faster and was much more buoyant than current expenditure: a 1 percent increase in GDP was associated with a 1.23 percent increase in capital spending over the period 1984-94. Total marginal propensity to spend was about 18 1/2 cents for each dollar of GDP, of which about 13 cents were used for current spending and 6 cents for capital spending. The fastest growing expenditure areas were social services (including health, welfare, and education), and infrastructure. The Government's general stance against tax-based income redistribution thus seems to have been moderated by faster growth in social expenditure. Only expenditure on security grew more slowly than nominal GDP over the past decade.

Table 9. Hong Kong: Estimates of Expenditure Buoyancy and Marginal Propensity to Spend, 1985-94

	Buoyancy <u>1/</u>	Marginal Propensity To Spend <u>3/</u>	Growth Rate 1985-94 <u>2/</u>
Total public expenditure	1.109	0.185	16.0
Security	0.882	0.018	12.7
Social welfare	1.248	0.013	18.0
Health	1.326	0.022	19.1
Education	1.094	0.031	15.8
Infrastructure	1.176	0.030	16.9
Transportation	1.243	0.011	17.9
Housing	1.022	0.021	14.6
Administration	1.087	0.024	15.7
Current expenditure	1.061	0.127	15.3
Capital expenditure	1.233	0.058	17.7

Source: Staff estimates.

1/ Estimated by regressing the logarithm of nominal expenditure on the logarithm of nominal GDP.

2/ Estimated by regressing nominal expenditure on nominal GDP.

3/ Estimated by regressing the logarithm of nominal expenditure on a time variable.

The structure of public expenditure was changing over time, reflecting frequent shifts in spending priorities (Appendix Table 6). However, total public expenditure was relatively stable as a proportion of GDP (about 16 1/2 percent over 1985-94), suggesting that the increases in spending on priority categories were roughly offset by lower growth in spending on other categories (Chart 4). In the mid-1980s, priority areas of spending included security, housing, and community affairs, and in the 1990s health, social welfare and infrastructure. These trends have been largely dictated by demographic factors.

Compared with OECD countries, the structure of public spending in Hong Kong is notable for the absence of large expenditure on defense and social security. While the Hong Kong Government covers a large portion of the cost of defense services provided by the United Kingdom, the amount involved is much smaller than the cost of defense in most other countries. The cost of social security is low because Hong Kong has only private pension funds (discussed below). Public expenditure on education and health is also much lower than in the OECD countries. However, in other categories of public expenditure, such as housing, security, and administration, the level of spending in Hong Kong is comparable to that in the OECD countries (Chart 5).

The coverage of public sector activities in fiscal accounts is fairly comprehensive. Government expenditure financed from the budget accounts for about 80 percent of total public expenditure. The off-budget items that are defined as "public expenditure" in fiscal accounts comprise expenditure by the following institutions: the Housing Authority; the Urban Council and the Regional Council (which roughly correspond to lower-level governments); the trading funds (which include operations such as Sewage Fund); institutions in the private or quasi-private sector, to the extent of their subsidies; and the activities of government departments that are partly financed by charges raised on a commercial basis (e.g., airport, waterworks). Excluded is expenditure by those organizations in which the Government has only an equity position, including statutory organizations such as the Mass Transit Railway Corporation and the Kowloon-Canton Railway Corporation. Also excluded is the value of land granted for public housing projects (discussed below).

The level of provision of public goods in Hong Kong is considered to be higher than indicated in fiscal accounts because, in addition to the Government and nongovernmental organizations, social spending is also supported by private organizations such as the Royal Hong Kong Jockey Club and numerous charities. The Jockey Club, for example, supports the operation of many clinics and welfare organizations, and together with the charities such as the Community Chest often provides capital funding for hospitals, universities, and welfare institutions. The Jockey Club generated about HK\$9 billion (0.9 percent of GDP) in betting revenue, and made contributions exceeding HK\$1 billion (0.1 percent of GDP) between July 1994 and June 1995.

CHART 5

HONG KONG

PUBLIC EXPENDITURE IN HONG KONG AND OECD COUNTRIES 1/

(In percent of GDP)

Sources: National Accounts: Detailed Tables, Volume II, 1981-93 (Paris: OECD, 1995); and data provided by the Government Secretariat (Hong Kong), Finance Branch.

1/ Average shares in GDP for the period covered. Period coverage is as follows: Hong Kong, 1985-95; Austria, 1981-93; Belgium, 1983-87; Denmark, 1980-93; France, 1983-90; Norway, 1980-91.

2/ Data for Austria include only current expenditure.

b. Airport Core Program

The Airport Core Program is the largest public infrastructure program in Hong Kong and currently one of the largest civil engineering undertakings in the world. 1/ The ACP includes a new airport on the Chek Lap Kok Island and nine projects providing urban infrastructure services to the airport. 2/ The capacity of the new airport will be 35 million passengers and 3 million tonnes of cargo per year when the airport is opened in 1998, and 87 million passengers and 9 million tonnes of cargo per year when the second runway is constructed. The ACP is divided into four main components with the following cost structure:

	(In billions)	
	HK\$	US\$
Government ACP Projects	52.5	6.7
Airport Authority	65.2	8.4
Airport Railway	34.0	4.4
Western Harbor Crossing	6.5	0.8
Total ACP	158.2	20.3

Government ACP projects and partly the airport and airport railway are being financed from the Capital Works Reserve Fund of the budget (i.e., from the proceeds of land sales). The Western Harbor Crossing is a privately financed project. Funding for the airport and the railway link to Hong Kong are provided through Government equity injections into the Airport Authority and the Mass Transit Railway Corporation (MTRC), and issuing of debt by the Airport Authority and the MTRC in domestic and international capital markets. In November 1994, China and the United Kingdom agreed to the following split between equity and debt financing:

	(In billions)			
	Equity		Debt	
	HK\$	US\$	HK\$	US\$
Airport Authority	36.6	4.7	11.6	1.5
Airport Railway	23.7	3.0	11.4	1.5
Total	60.3	7.7	23.0	3.0

1/ For a discussion of the short-run macroeconomic implications of the ACP, see Chapter II.

2/ These projects include: railway and highway links between the airport, Kowloon, and the Hong Kong Island; a new town for 20,000 people near the airport; two large suspension bridges; a third harbor tunnel; and two major land reclamation projects.

Both the Airport Authority and the MTRC are planning to retire debt in 2001; the dividend on investments into the airport railway is expected to be payable from 1997, and the dividend on investments into the airport from 2005. 1/ Most of the consortia that are designing and constructing the ACP projects will also operate them under long-term contracts; eventually, the ownership will be transferred to the Government. Although the completion date for the new airport is mid-1997, the opening is scheduled for April 1998, as it will take up to nine months to test equipment and train the personnel involved in the operation of the airport. Once the Chek Lap Kok Airport opens, the Kai Tak Airport will close overnight, clearing the way for redevelopment of the airport site and adjacent areas in Kowloon.

c. Public housing program

The Government of Hong Kong operates an extensive public housing program, which covers about 48 percent of the population (almost 3 million people). The program was started in 1954 in response to an acute housing crisis that developed after World War II. The program received a major boost in 1972, when the Government revealed a long-term plan calling for an acceleration of public housing construction to provide accommodation for 1.8 million people over 10 years. Starting in the early 1980s, public housing policy shifted from massive production to a more quality-oriented program. Housing production in the public sector nevertheless continued to exceed that in the private sector. Total public housing stock at end-1994 was about 870,000 units, compared with about 1 million private housing units (of which about 850,000 were apartments).

The public housing program presently includes public rental housing, subsidized home ownership schemes, financial assistance for homebuyers, and facilitation of private housing production. The current housing production targets, covering FY 1995-2001, are as follows:

- 141,000 public rental units;
- 175,000 subsidized housing units,
 - Of which: 151,000 units under the Home Ownership Scheme, and
 - 24,000 units for "sandwich class" families;
- 195,000 private housing units;
- 16,000 subsidized loans for purchase of private apartments.

The Home Ownership Scheme (HOS) was introduced in 1977 to build new public housing units for sale to qualified applicants at about 50 percent of market price; it has become the largest public housing scheme since. The subsidy comes in the form of land granted by the Government to the Housing Authority and the Housing Society, which arrange for housing production, mostly with private developers. The Sandwich Class Housing Scheme targets families with monthly income of HK\$25,000-50,000. These families have too

1/ The airport railway will start generating revenue earlier because the MTRC will lease commercial property along the railway.

high an income to qualify for public housing, but cannot afford mortgages for private housing. The first batch of sandwich class apartments was sold in 1995. Private housing production has been facilitated by speeding up the formation of land and the development of housing-related infrastructure, increasing the quota for residential development in the land disposal program, and providing projections of housing supply and demand. Financial assistance to homebuyers consists of interest-free loans and low-interest loans to low and middle-income families.

The most important agency involved in the implementation of the public housing program is the Housing Authority (HA), a quasi-autonomous non-governmental organization with 15,000 employees and a high-level representation in the Hong Kong Government. The HA operated over 650,000 rental apartments and over 180,000 HOS units in FY 1994. Total income of the HA in FY 1994 was HK\$18 billion (1 3/4 percent of GDP); the HA realized a surplus (after appropriation) of HK\$5.6 billion in FY 1994, and a deficit of HK\$5 billion in FY 1990; smaller deficits were recorded in FY 1990-FY 1992. 1/ As land for public housing projects is granted at no premium, the full cost of land is not included in HA expenditure. 2/ On April 1, 1994, the cumulative value of land granted for public housing projects was HK\$115 billion (valued at historical cost); the increase over FY 1994/95 was about HK\$19 billion (2 percent of GDP).

In view of the size of the public housing program and the presence of a large subsidy element in the cost of public housing, a number of concerns about the allocative efficiency and equity aspects of the program have been expressed over the years. 3/ In particular, there have been concerns about long waiting periods for public housing (about 7 years on average), and underdeclaring of income and property ownership by the tenants of public housing projects. 4/ As noted above, the practice of granting land outright for public housing projects has also resulted in a large implicit subsidy that was not transparently classified as social spending in fiscal accounts.

1/ The appropriation amounted to HK\$1.9 billion in FY 1994; it includes interest paid on Government permanent and loan capital, and dividend.

2/ The expenditure of the HA includes the cost incurred by the Government in developing the sites for the public housing program. Prior to FY 1994, the expenditure also included the full market value of land for Home Ownership units.

3/ See, for example, Chau (1992) and Fu (1995).

4/ The income test is applied at the time of allocation of apartment. After ten years of tenancy, occupants have to declare income and real estate ownership. Those with earnings exceeding the limit for public housing have to pay double rent; however, earnings from assets are not penalized. The Government estimated that at least 13 percent of families living in public housing owned other property, and many more had sufficient means to live in private housing. In response, the Government has been strengthening income tests for tenants and applicants.

5. Mandatory provident fund scheme

Hong Kong presently has about 14,800 private pension schemes, which cover about 770,000 employees in the private sector (about 26 percent of employed). In addition, the Government operates a retirement scheme for about 140,000 civil servants (about 5 percent of employed). Under the present system, the Government encourages the establishment of voluntary retirement protection schemes and monitors and regulates them under the Occupational Retirement Schemes Ordinance.

The possibility of introducing some form of compulsory retirement benefit scheme has been discussed in Hong Kong for many years. The number of people aged 65 and above has increased from an estimated 390,000 in 1984 (7 percent of total population) to 560,000 in 1994 (9 1/2 percent), and is projected to increase to 1 million by 2016 (13 percent). In December 1993 the Government proposed a comprehensive Old-age Pension Scheme (OPS), under which every eligible resident aged 65 and over would have received a fixed monthly benefit. ^{1/} The key benefit of the OPS, according to the original proposal, was that it would have provided immediate benefits upon implementation to all eligible elderly residents, including low-income employees, homemakers, and retirees. Because of lack of support in the Legislative Council and opposition by China, the OPS proposal was withdrawn in February 1995.

In March 1995, the Government unveiled a new pension proposal--the privately-managed Mandatory Provident Fund (MPF) scheme. The main elements of the MPF proposal are as follows:

- Coverage: All employees and self-employed between the age of 18 and 65 are covered, unless exempt or employed for less than 60 days. The exemptions include civil servants and teachers covered by statutory pension schemes, and domestic employees and their employers.
- Contributions: If the monthly income is between HK\$4,000 and HK\$20,000, both the employee and employer have to contribute 5 percent of the employee's income each. If the monthly income exceeds HK\$20,000, the employee and employer have to contribute up to the first HK\$20,000 of the monthly salary; for the portion of salary above this amount contributions are not mandatory. An employee with monthly below HK\$4,000 is not required, but may elect to contribute; his/her employer must, however, contribute 5 percent of the employee's income.

^{1/} The OPS would have been financed by a levy of 3 percent on assessable income, to be split equally between the employees and employers. For an analysis of OPS, see Chapter IV in Supplement 1 to the 1993 Staff Report (SM/94/25, Supplement 1).

- Vesting and preservation of benefits: All contributions to the MPF must be fully and immediately vested with the employee's account. All benefits derived from the MPF must be preserved until the employee reaches the age of 65, or retires between the ages of 60 and 65.
- Portability of benefits: The accrued benefits of an employee can be transferred to another scheme when an employee changes an employment, or left with the trustee of the scheme maintained by his/her previous employer.
- MPF Schemes Authority (MPFA): The MPFA will administer and regulate the MPF system. The MPFA will also approve trustees, regulate their operations, and make rules and guidelines for administration and regulation of the MPF system.
- Trustees: Trustees are responsible for all aspects of a scheme and must comply with regulations and duties imposed by the MPFA. Trustees may be corporate or individuals; overseas trustees and master trusts can be established if they meet certain requirements.
- Compensation fund: A compensation fund will be established to compensate employees for losses due to fraud or misfeasance. Losses due to poor investment will not be compensated. The Government intends to contribute HK\$300 million as seed money toward the compensation fund.

As the intention of the MPF proposal was not to force employers to adopt a new pension scheme, but rather to protect the employees, it had been agreed that existing private pension schemes could continue to operate if they met some minimum requirements, including providing contributions equivalent to those under the MPF. The Government intended to elaborate various aspects of the MPF with consultants, the financial industry, and employers during the first half of 1996, and draft the MPF legislation and present it to the Legislative Council by the end of 1996. If approved, the MPF would start actual operation in 1997.

The authorities estimated the size of annual contributions to the MPF at about 4 percent of GDP. Assuming a 3 percent real rate of return and a 40-year contribution period, benefits under the MPF are projected at about 50 percent of average wage. The MPF is not expected to affect the gross flow of saving significantly because it would basically re-channel saving from personal to organized funds. The MPF should also have little impact on labor mobility, as the benefits would be portable. The insurance industry and fund managers saw a significant potential in the MPF, as it would accelerate the development of the Hong Kong dollar debt market.

IV. Monetary and Exchange Rate Developments

Since 1983, the objective of monetary policy in Hong Kong has been to maintain a stable exchange rate between the Hong Kong and U.S. dollars within the framework of the linked exchange rate system. Under Hong Kong's linked rate system, while the exchange rate for note issuance is tied to the U.S. dollar--the linked rate of HK\$ 7.8 per U.S. dollar--all other transactions occur at a market-determined rate. The linked exchange rate system has enjoyed a high degree of credibility and consequently interest rate movements in Hong Kong have typically closely mirrored those in the United States, and the market exchange rate has remained close to the linked rate. ^{1/}

This chapter discusses recent developments in exchange rates, interest rates and their deregulation, and movements in money and credit aggregates.

1. Exchange rate developments

Following the second oil price shock in 1979, the Hong Kong dollar suffered a period of rapid and sustained depreciation (Chart 6, first panel). The depreciation accelerated sharply in 1983 with uncertainty created by discussions between the United Kingdom and China regarding the transfer of sovereignty of Hong Kong in 1997, and culminated in the adoption of the linked exchange rate system in October 1983. Since the adoption of the linked rate system the market exchange rate has generally remained close to the linked rate. Since mid-1991, the market exchange rate has persistently been appreciated relative to the linked rate, although the deviation has been relatively small--typically less than 1 percent.

The trade-weighted nominal effective exchange rate of the Hong Kong dollar has fluctuated considerably as the U.S. dollar has moved against other major currencies. As a result, in nominal effective terms, the Hong Kong dollar appreciated markedly from 1983 to early 1985, and subsequently depreciated sharply, falling by nearly 30 percent from its peak in early 1985 to the end of 1987. Since 1987 it has fluctuated within a range of approximately 10 percent width. From early 1994 to mid-1995, following the depreciation of the U.S. dollar versus the currencies of other major countries, it gradually depreciated from the top to the bottom of this range. Following the recovery of the U.S. dollar during the latter half of 1995, the nominal effective value of the Hong Kong dollar has returned to near the middle of this historical range.

^{1/} For descriptions of the operation of the linked exchange rate system--Hong Kong's version of a currency board arrangement--see Chapter I of United Kingdom - Hong Kong - Staff Report for the 1994 Article IV Consultation Discussions, Supplement 1, and Hong Kong Monetary Authority (1994a and 1994b).

CHART 6

HONG KONG

EXCHANGE RATE DEVELOPMENTS, 1979-95

Sources: International Monetary Fund, International Financial Statistics, and Information Notice System.
1/ CPI-based: increase indicates appreciation

Despite the considerable nominal effective depreciation of the Hong Kong dollar between 1979 and 1987, with Hong Kong's relatively high inflation rate, the real effective depreciation was less than half that in nominal terms. Since 1987, as inflation in Hong Kong rose sharply, the real exchange rate appreciated considerably--rising by 45 percent between end-1987 and end-1993. During 1994, as the nominal effective exchange rate depreciated along with the U.S. dollar, the real effective exchange rate fluctuated narrowly, with the level by end-year almost exactly that at the beginning. As the U.S. dollar depreciated sharply during the first half of 1995, the Hong Kong dollar depreciated by 5 percent in real terms, but then more than recovered, ending the year at an all-time high.

Following the Mexican peso crisis, during the second week of January 1995 the Hong Kong dollar came under speculative attack. The Hong Kong dollar depreciated from HK\$7.7375 per U.S. dollar at the beginning of 1995 to a low of HK\$7.7225 per U.S. dollar on January 12 (Chart 6, third panel). In response to selling pressures, the Hong Kong Monetary Authority (HKMA) tightened interbank liquidity and intervened directly in the foreign exchange market. On January 12--with strong selling pressures on the Hong Kong dollar--the HKMA withdrew liquidity from the banking system until the 'Balance'--the net outstanding interbank credit balance--became, for the first time since the institution of the Accounting Arrangements in 1988, negative, falling to HK\$-4.6 billion at mid-day. 1/ Banks, concerned that the HKMA might raise the Liquidity Adjustment Facility (LAF) bid and offer rates--Hong Kong's discount window corridor of interest rates--or even suspend the LAF offer rate, began actively to bid for funds on the interbank market. 2/ The overnight Hong Kong interbank offer rate (HIBOR) surged to an intra-day high of 12 percent--rising by almost 5 percentage points in one day--and closed the day some 2 and a half percentage points higher (Chart 6, third panel). During the following days, as interbank liquidity was kept tight and HIBOR remained at an elevated level, the exchange rate began to recover quickly, rising to HK\$7.734 per U.S. dollar on January 20. The

1/ The 'Balance' refers to the net interbank clearing balance of the banking system with the Hongkong and Shanghai Banking Corporation (HSBC), which serves as the clearing house for the banking system. With the introduction of the Accounting Arrangements in 1988 the Exchange Fund (now operated by the HKMA) became the ultimate provider of liquidity to the banking system and restricted the power of the HSBC to do so.

2/ The LAF assists banks in making late adjustments to their liquidity positions. Under the LAF, overnight funds are provided by the HKMA--typically on a secured basis through a sale and repurchase agreement of a bank's holdings of Exchange Fund bills--at the LAF offer rate. Banks can deposit surplus funds with the LAF at the bid rate. In setting the bid and offer rates for the LAF, the HKMA takes into account a variety of factors including the level of the exchange rate, interest differentials vis-a-vis the U.S. dollar, and local money market conditions. In practice the corridor between the bid and offer rates has typically been 2 percentage points.

prompt squeeze of interbank credit by the HKMA successfully fended off the attack. Since the speculative attack in January, there have been few pressures on the Hong Kong dollar and the nominal exchange has been relatively stable.

2. Interest rate developments

Following their U.S. dollar counterparts, Hong Kong dollar interest rates fell persistently from 1989 until mid-1992, then remained relatively flat through 1993 (Chart 7). In early 1994, interest rates started to rise. While the first rise in the U.S. federal funds rate in February 1994 was not followed immediately by an adjustment of the LAF bid and offer rates, there were strong expectations of imminent increases, and the three-month Hong Kong interbank offered rates (HIBOR) rose in line with the corresponding Eurodollar rate (LIBOR) (Chart 7, first panel). HIBOR continued to remain above LIBOR in the early part of the year, but the gap between the two narrowed until the situation was briefly reversed in mid-year, with the two rates then staying close together. In January 1995, as discussed above, there was a sharp increase in HIBOR engineered by the HKMA to ward off the speculative attack against the Hong Kong dollar. Subsequently, however, HIBOR eased quickly, falling below the (declining) LIBOR rate, and has since fluctuated around it.

Changes in interbank rates have been transmitted fully, albeit not always immediately, to deposit and lending rates. Caps on deposit rates administered by the Hong Kong Association of Banks (HKAB) and the best lending rate (BLR), both of which had been fixed since June 1992, were increased four times during 1994--in March, May, August, and November--and again in February 1995. The first phase of deregulation of interest rate caps on Hong Kong dollar time deposits was initiated in October 1994. (The deregulation of interest rates is discussed separately below.) As a result of this deregulation, time deposit rates, which have traditionally been well below their U.S. counterparts--except for brief periods in 1991-92--rose faster than their U.S. counterparts, and by December 1994 exceeded them (Chart 7, second panel). They then followed the spike in HIBOR in January, but fell below their U.S. counterparts by March 1995 and have remained below since.

Another notable feature of recent interest rate developments has been the fact that the best lending rate in Hong Kong, which has persistently remained above--and sometimes substantially above--the U.S. prime rate since January 1991, fell below it in May 1994. Subsequently, from mid-1994 to mid-1995 the BLR moved very closely in line with the U.S. prime rate, but has once again, since mid-1995, persistently exceeded it.

With nominal interest rates determined effectively by those in the United States, but with substantially higher rates of inflation in Hong Kong, real lending and deposit rates have been negative for several

CHART 7

HONG KONG
INTEREST RATES IN HONG KONG AND THE UNITED STATES,
1989-95

Sources: Hong Kong Monthly Digest of Statistics, and International Monetary Fund, International Financial Statistics.

CHART 8

HONG KONG
NOMINAL AND REAL INTEREST RATES, 1989-95

Sources: Hong Kong Monthly Digest of Statistics, and staff estimates.

1/ Calculated by subtracting realized inflation over the previous 12 months from the nominal interest rate.

years. ^{1/} Since late 1990 the best lending rate, the 3-month interbank rate, and the 3-month deposit rate have all been negative (Chart 8, second panel). Only in mid-1995, as inflation slowed, has the BLR become slightly positive in real terms.

3. Interest rate deregulation

Following a period of intense competition among banks in the early 1960s, which on occasion included "interest rate wars", the former Exchange Banks Association (EBA) reached an Interest Rate Agreement (IRA) in 1964. The IRA stipulated deposit charges and maximum rates of interest that could be offered on Hong Kong dollar deposits by member banks. In 1981 the HKAB replaced the EBA. Under its Interest Rate Rules (IRR), the Committee of the HKAB was authorized to determine--after consultations with the HKMA under delegated authority from the Financial Secretary--maximum interest rates paid by licensed banks on Hong Kong dollar deposits. ^{2/} The IRR applied to interest rates paid on all deposits of less than HK\$500,000 that had a maturity of less than 15 months. In practice, the IRR affected the rates on several types of deposits: current accounts; savings accounts; 24-hour call or notice deposits; 7-day call or notice deposits; call deposits of longer than 7 days; and time deposits of various maturities--from 7 days to 15 months. The IRR prohibit the payment of interest on current or checking accounts. Interest rates on all other types of deposits were changed periodically by the HKAB Committee. In April 1994, the total amounts of current, savings, and time deposits affected by the IRR were HK\$106 billion, HK\$281 billion, and HK\$37 billion, respectively, representing 11.8 percent, 31.2 percent, and 4.1 percent of total deposits. In total, the IRR affected interest rates on almost half of all deposits.

The IRR were defended on the grounds that they induced stability in the banking system in Hong Kong's potentially volatile financial environment, enabling banks to build substantial reserves against internal and external shocks. The IRR were criticized by domestic consumer groups and competing foreign banks. Consumer groups argued that the IRR agreement enabled major local banks to earn monopoly rents by virtue of their extensive branch networks. Foreign banks complained that the IRR was simply a device for maximizing profits of the large local banks. Foreign banks, particularly U.S. ones that did not enjoy the extensive branch networks of the local banks, were forced to borrow funds at a premium from local banks in the Hong Kong money market or to engage in currency swaps. ^{3/}

^{1/} Real interest rates are calculated by subtracting the realized inflation rate over the previous twelve months.

^{2/} The IRR are discussed in detail in Hong Kong Monetary Authority (1994c).

^{3/} The contribution of interest margins to the profitability of Hong Kong banks is discussed and compared to that in other countries in Chapter V of this paper.

The development of foreign currency swap deposits for retail customers in recent years reduced the extent to which the IRR could segment the deposit market. 1/ Authorized institutions in Hong Kong began to accept swap deposits with an amount as low as HK\$30,000 for maturities as short as seven days. Interest rates on swap deposits are based on interbank rates. Consequently, and in response to increasing pressures from domestic consumer groups and international banks, the Legislative Council voted in 1994 in favor of a plan to deregulate the payment of interest on time deposits. As noted earlier, time deposits affected by the IRR comprised only 4 percent of total deposits in April 1994. Demand and savings deposits affected by the IRR (that is the 'retail' component comprising deposits of denominations less than HK\$500,000)--which together represented a substantial proportion of total deposits (over 40 percent)--were not planned to be deregulated.

Deregulation under the plan was to proceed in stages. In the first phase, which was implemented on October 1, 1994, restrictions on all time deposits of more than one-month maturity were removed. On January 3, 1995, this was extended to deposits of maturity over seven days. The third phase of deregulation was to have been implemented on April 1, 1995. It was to have entailed the deregulation of all deposits fixed for more than 24-hour call. This was to be followed by a final phase of deregulation where 24-hour call deposits were to be liberalized during the remainder of the year. The deposit cap on such deposits was to be cut from HK\$500,000 to zero in stages, conditional on the HKAB and the HKMA concluding prior to each reduction that there was not likely to be any resultant instability in the monetary and banking systems.

In the event, there was a notable migration of funds from regulated to deregulated categories of deposits. In March 1995, the HKMA, arguing that it needed more time to assess the impact of the first two phases of deregulation and citing concerns about the impact of increased deregulation on the stability of the banking system, postponed the planned further deregulation of time deposits from April to September. In October 1995, the HKMA announced that the program of deregulation would end with a lifting of the ceilings on time deposits of exactly 7 days. The planned liberalization of deposits of shorter maturity was canceled.

4. Money and credit developments

With monetary policy tied to maintaining the nominal exchange rate, the monetary aggregates have effectively been demand-determined.

1/ Foreign currency swap deposits are fixed time deposits where the depositor purchases foreign currency on the spot market placing it on deposit and at the same time enters into an agreement with the bank to sell the foreign currency forward at the time of maturity. Such deposits are, therefore, a close substitute for Hong Kong dollar time deposits.

As interest rates declined from 1989-92, the growth of M1 steadily accelerated, reaching a four-quarter growth peak of 35 percent in the second quarter of 1992 (Chart 9, first panel). As interest rates stabilized, the growth of M1 began to decelerate. With the sustained increase in interest rates during 1994, the liberalization of interest rates on time deposits in October 1994, and the decline in the stock and property markets during the year, there was a sharp fall-off in the demand for transactions balances. M1 growth decelerated sharply in the second quarter of 1994, and has continued to decline. Over the course of 1994, M1 fell slightly even as nominal GDP grew by over 13 percent, so that the velocity of circulation increased considerably (Appendix Table 7). The level of M1 changed little during the first two quarters of 1995 and then fell slightly in the third quarter, and the velocity of circulation continued to increase.

While the growth of M1 accelerated during 1989-91, the growth of the broader monetary aggregates, M2 and M3, decelerated. Since 1991 the broader monetary aggregates have continued to grow at about the same pace.

While the growth of total credit extended by all authorized institutions increased moderately in 1994 and then accelerated during the first ten months of 1995, the growth of loans for use in Hong Kong moderated slightly in 1994, and then decelerated considerably in the first ten months of 1995 (Chart 9, second panel and Appendix Table 8). 1/ Following the rapid run-up in stock prices in 1993 and their subsequent sharp reversal in 1994, the growth of loans to financial concerns and stockbrokers decelerated sharply from over 20 percent in 1993 to around 5 percent in 1994. This deceleration continued in 1995 with total credit to the sector contracting in spite of the robust recovery in the stock market. Loans to the property sector, which grew during 1993 at a rate comparable to those made to financial concerns and the stock market, decelerated much more slowly in 1994, despite the announcement and subsequent adoption of the Government's measures to curb speculative activity in the property market. While the growth of loans to the property sector decelerated further in 1995, again they did so at a relatively modest pace.

V. Equity Market

Equity prices in Hong Kong increased substantially during 1980-94, rising twelve-fold over the period. While a number of factors suggest that this rapid increase was driven primarily by economic fundamentals, there have been concerns it may have been driven instead by one (or possibly more)

1/ The high degree of internationalization of the banking system--involving the booking of a large variety and volume of transactions unrelated to local economic activity--complicates the analysis of credit developments. In assessing the impact of credit developments on the Hong Kong economy, it is therefore probably more appropriate to examine the behavior of loans for use in Hong Kong.

"speculative bubble"--as is commonly argued to have been the case in many industrial countries during the 1980s. If the increase was driven by speculative forces and equity prices are significantly overvalued, then there is the possibility that a subsequent correction could lead, through wealth effects and weaker consumer and investor confidence, to adverse macroeconomic consequences, as occurred in Japan in the early 1990s with the "bursting" of the asset price bubble. ^{1/} The discussion below first examines recent equity price developments, and then analyzes the role of a number of fundamentals--interest rates, earnings growth, and political developments--in affecting them. The evidence suggests that equity price movements have generally been closely tied to changes in fundamentals.

1. Developments during 1980-95

Equity prices in Hong Kong have been on a steep upward trend since the early 1980s, increasing twelve-fold between 1980 and early 1994, albeit with some abrupt reversals in recent years (Chart 10, first panel). Since the sharp decline in mid-1989 following events in China, when the Hang Seng index fell to an average level of about 2,350 in June, equity prices rose rapidly, and by December of 1992 the index had more than doubled, reaching an average level of about 5,500. During 1993, equity prices rose even more rapidly, doubling during the year, and by early January of 1994 the Hang Seng index reached almost 12,600. Starting later in the month, triggered by increases in U.S. interest rates, equity prices began to decline precipitously and the Hang Seng index fell to an average level of about 7,500 by January of 1995--losing more than 40 percent of its value. Since February of 1995 stock prices have recovered robustly with the Hang Seng index almost regaining the 10,000 mark by end-December--an increase of over 33 percent from the low at the beginning of the year.

The tremendous increase in the Hang Seng index since the early 1980s reflects in part the high inflation rate in Hong Kong. In real terms, the Hang Seng index increased much less rapidly (Chart 10, second panel). The steep rise in equity prices in Hong Kong over the period has been in line with the increase in equity prices of other major emerging markets in the region (Chart 11, first panel). The sharp increase in equity prices over the period was accompanied by sharp increases in market capitalization, which rose 16-fold from HK\$184.6 billion at the end of 1984 to a peak of HK\$2,975.4 billion by the end of 1993. Following the decline in equity prices in 1994, this declined to HK\$2,085.2 by the end of 1994.

^{1/} For an examination of movements in asset prices in Japan, and the extent to which they were determined by changes in underlying fundamentals, see Kahkonen (1995).

CHART 9

HONG KONG
MONEY AND CREDIT DEVELOPMENTS, 1989-95

Source: Hong Kong Monetary Authority, Monthly Statistical Bulletin.

1/ Four-quarter percentage change.

2/ Annual percentage change. Figures for 1995 refers to September growth relative to December 1994.

CHART 10

HONG KONG
STOCK MARKET DEVELOPMENTS, 1980-95

Source: Hong Kong Monthly Digest of Statistics and staff estimates.

CHART 11

HONG KONG
RELATIVE STOCK MARKET DEVELOPMENTS, 1980-95

Source: Hong Kong Monthly Digest of Statistics, WEFA/INTLINE and Morgan Stanley Capital International.

2. Determinants of equity prices

Since the price of an asset should equal the present discounted value of the expected earnings on that asset, equity price movements can be expected to depend on changes in expected earnings growth, market interest rates, and market perceptions of risk affecting economic prospects. ^{1/} The potential role of these and other factors in affecting equity prices in Hong Kong is discussed in turn.

First, Hong Kong's stock market has traditionally been highly sensitive to external political developments likely to effect Hong Kong's post-1997 prospects--those between China and the United Kingdom; and those in China itself. In 1982-83, uncertainty created by the Sino-British discussions over the transfer of sovereignty of Hong Kong to China exerted a depressing effect on the stock market for a sustained period of time (Chart 10). Similarly, the events in China in June 1989 had a sharp negative impact.

Second, movements in interest rates on financial instruments, which represent a relatively risk-free alternative to equity investments, would be expected to play an important role in affecting equity prices. The data reveal a clear negative association between real interest rates and the real value of equity prices (Chart 12, first panel).

Third, expectations of future earnings growth appear to have played an important role. This is, however, somewhat harder to establish, as long time series for corporate earnings are not available. When GDP growth is used as a proxy for corporate earnings growth, there is in fact little positive association, except perhaps in the 1985-87 and 1990-92 periods (Chart 12, second panel). It is worth emphasizing, however, that it is expectations of future output growth that are relevant for determining share prices, and ex post the lack of a positive association may simply represent the fact that expectations of future output growth did not materialize. In recent years, as the Hong Kong and Chinese economies have become increasingly integrated, expectations of Hong Kong's future economic prospects have become increasingly tied to those of China. The large increase in stock prices during 1993 has been attributed by various observers to optimistic investor expectations of prospects for the booming Chinese economy, with shares of Hong Kong companies heavily involved in business related with China being bid up most actively.

Finally, it should be noted that developments in the Hang Seng index reflect to a notable extent developments in the property market, as shares of property companies represent almost 20 percent of the index. During 1994, for example, the sharp correction in the property market following the Government's announcement early in the year of its intention to introduce measures to reduce speculative activity, resulted in a decline in the

^{1/} For a discussion of the determinants of equity price movements see French and Poterba (1991).

Hang Seng property index during 1994 of almost 40 percent, contributing substantially to the decline in the overall index.

To quantify the relative historical roles of the above factors in affecting equity prices, an error-correction equation relating the real value of equity prices to real interest rates, output growth as a proxy for real corporate earnings growth, and a dummy variable to capture several events--political uncertainty in 1983, the global stock market crash in 1987, and the events in China in mid 1989--was estimated using quarterly data for the period 1980-95. The following estimates were obtained:

$$\Delta(H_t - P_t)$$

$$\begin{aligned} = & - 0.01610 \cdot \Delta R_t + 0.00248 \cdot \Delta (\Delta Y_t) \\ & (1.91742) \quad (0.49210) \\ & - 0.09174 \cdot (H_{t-1} - P_{t-1}) - 0.01239 \cdot R_{t-1} - 0.00054 \cdot (\Delta Y_{t-1}) \\ & (2.29124) \quad (2.60443) \quad (0.13931) \\ & - 0.10160 \cdot DUM_t + 0.05044 \\ & (2.49263) \quad (1.44353) \end{aligned}$$

$$\begin{aligned} R^2 &= 0.2242; & \bar{R}^2 &= 0.1396; & F_{6, 55} &= 2.6495 \\ \text{Durbin Watson(1)} &= 1.9485 & & & \text{Durbin Watson(4)} &= 2.0293 \end{aligned}$$

where

- H: Logarithm of the Hang Seng stock price index
- P: Logarithm of the GDP deflator
- Y: Logarithm of real GDP
- R: Real 3-month time-deposit interest rate, defined as the nominal interest rate less inflation over the previous 12 months
- DUM: Dummy variable set to 1 to capture political risk factors in 1983 and 1989, and shock to world stock markets in October 1987
- Δ: First difference operator

and the numbers in parentheses are t statistics.

The estimates reveal that movements in real interest rates in Hong Kong had a significant negative effect on real equity prices both in the short and long runs. The dummy variable used to capture changes in the perception of political risk is also estimated to have had a significant negative impact. While the coefficient capturing the short-run effect of changes in output growth on equity prices is positive, it is insignificant. The coefficient on output growth capturing the long-run effect is negative, though it too is close to zero and insignificant. This does not imply that expected output growth has not been an important determinant of equity prices. In fact one would expect equity prices in the long run to be determined by the long-run rate of growth of output, that is potential

CHART 12

HONG KONG
STOCK MARKET AND FUNDAMENTALS, 1980-95

Sources: Hong Kong Monthly Digest of Statistics, and staff estimates.

1/ Calculated by subtracting realized inflation over the previous 12 months from the nominal interest rate.

output. To the extent that potential output has grown at a relatively stable rate, its expected growth rate is captured by the constant term in the equation.

The estimated equation was used to construct a dynamic forecast of share prices starting in 1980. Chart 13 compares this dynamic forecast with actual share prices during 1980-95. It shows that, in general, actual share prices were close to their fitted values. A sustained deviation occurred during the period from late 1993 through 1995, though, when share prices consistently exceeded what would have been predicted by movements in the fundamentals. By the first quarter of 1995, however, the decline in stock prices brought them to levels suggested by actual movements in output and interest rates.

While the exercise suggests that the run-up in share prices in late 1993 and early 1994 was "excessive", it does not necessarily imply that the ascent of the stock market during this period represented a pure "bubble". Share prices during the period would have been consistent with expectations of future output growth that exceeded the actual rates, or lower interest rates than subsequently materialized. A subsequent downward revision in expectations of future earnings growth--as appeared to have occurred in terms of prospects for the Chinese economy in late 1994--or increases in expected interest rates could then explain the subsequent decline in the stock market. Since the second quarter of 1995 actual share prices began to rise while their predicted values continued to decline. This probably reflected to a considerable extent the expectation cuts in the U.S. interest rates. By end-1995, the two had once again begun to move together.

Another criterion for judging whether equity prices are overvalued is provided by examining the behavior of price-earnings (PE) ratios of equities in Hong Kong, and comparing them to those in other countries (Chart 11, second panel). Compared to the major industrial countries, in the early 1980s, the PE ratio of Hong Kong equities briefly exceeded that in the three major industrial countries. Subsequently it followed developments in the PE ratios of equity prices in the United States and Germany. Since 1987 it has consistently remained below that in the major industrial countries. Thus, relative to earnings, equities in Hong Kong have--on average--been a better value than in the major industrial countries, perhaps reflecting a risk premium as compensation for the higher volatility of returns in Hong Kong.

VI. Banking Sector

While Hong Kong has long been an important international financial center, the banking sector has historically been subject to episodes of instability, as prudential regulations were generally weak and bank failures

common. 1/ Over the last decade, prudential regulations were significantly tightened and Hong Kong now meets--and in many case exceeds--all international prudential criteria. In recent years, Hong Kong's banks have become some of the most profitable in the world.

The first section of this chapter examines the structure and various characteristics of Hong Kong's banking system. The international nature of the system has led to external and foreign currency denominated assets significantly outweighing domestic and Hong Kong dollar denominated assets in bank portfolios. The importance of the property sector in Hong Kong's economy has led domestic lending to be concentrated in the sector. The second section compares the profitability of Hong Kong's banks to that in other countries. The comparison reveals that the relatively high return on assets of Hong Kong's banks is attributable to their ability to maintain low cost-to-income ratios, and high asset quality which has required low rates of loan write-off provisions. The final section discusses recent regulatory changes in the banking system.

1. Structure and characteristics of balance sheets

There are three types of banks--known as Authorized Institutions--in Hong Kong. Licensed banks (LBs) take all types of deposits and dominate the sector, accounting for almost 95 percent of total bank assets. Restricted license banks (RLBs) and deposit-taking companies (DTCs) perform specialized functions such as merchant banking, consumer finance, and investment services. Except for deposit taking, banking regulation in Hong Kong does not restrict the types of activities in which the three different types of institutions can engage. Representative offices of foreign banks are required to confine their customer business to liaison activities. As of September 1995, there were 185 licensed banks (31 of which are incorporated in Hong Kong), 63 restricted license banks, 132 deposit-taking companies, and 162 representative offices of foreign banks.

Domestic banking has historically been dominated by a small number of large foreign-owned banks. Foremost among them has been the Hongkong and Shanghai Banking Corporation (HSBC) group. Besides being the preeminent commercial bank (estimated to currently account for over half of all local deposits and assets), for many decades the HSBC also performed several of the functions of a traditional central bank, bestowing upon it an unusual degree of political and financial power for a commercial bank. The other major bank historically has been the Standard Chartered Bank. The relative position of the HSBC and Standard Chartered has declined in recent years, however, as the economic influence of the Bank of China (BOC) has grown. It is estimated that the BOC and its 12 "sister" banks and their many branches

1/ The last major crisis was triggered by the collapse of the Bank of Credit and Commerce Hong Kong Limited in 1991, which led to runs on some of the other local banks. There was a series of crises during 1982-86 involving smaller local banks as they pursued aggressive lending policies.

CHART 13
HONG KONG
ACTUAL AND PREDICTED STOCK MARKET DEVELOPMENTS, 1980-95

Source: Staff Estimates.

now account for about a third of local deposits. In 1994 the BOC joined the HSBC and Standard Chartered as the third note-issuing bank. ^{1/} The market share of local banks that are not affiliated with foreign institutions (the so-called private Chinese banks) has shrunk substantially over the years.

The banking industry in Hong Kong has grown rapidly over the last decade, with total assets of the licensed banks growing from HK\$1.1 trillion in 1985 (400 percent of GDP) to HK\$7.5 trillion (650 percent of GDP) by September 1995 (Chart 14, first panel). ^{2/} While both domestic and external assets grew rapidly during the period, the ten-fold growth of external assets outpaced the six-fold increase in domestic assets. As a result, external assets accounted for almost 2/3 of total assets in 1995 compared with only about 1/2 in 1985. As a consequence of the importance of foreign assets in bank portfolios, another notable characteristic of bank assets is that the greater proportion of them is denominated in foreign currencies (Chart 14, second panel).

The aggregated balance sheet for Hong Kong's banking system (i.e., LBs, RLBs, and DTCs) as of September 1995 shows that about two thirds of banks' liabilities are comprised of interbank liabilities, while about one fourth is represented by customer deposits (Table 10). Some 85 percent of total interbank liabilities are owed to overseas banks. Negotiable certificates of deposit (NCDs) and other debt instruments account for just 2 percent of total liabilities, while reserve capital and other liabilities account for the remaining 6 percent.

On the assets side, about 43 percent of total bank assets are comprised of interbank claims, again primarily on overseas institutions. Loans constitute 47 percent of total assets, of which almost 60 percent are for use outside Hong Kong (Table 10). NCDs and other securities account for most of the remaining assets.

An important characteristic of Hong Kong's banking system is the dominance of foreign currency denomination for many categories of bank liabilities and assets. Interbank liabilities and assets abroad are almost entirely denominated in foreign currencies (Table 10), while loans and advances denominated in foreign currency exceed their Hong Kong dollar counterparts 2 to 1 (Table 11). Of total customer deposits, about half are denominated in foreign currency (of which about half are in U.S. dollars).

^{1/} Under Hong Kong's linked exchange rate system--Hong Kong's version of a currency board arrangement--all currency notes are issued by the note-issuing commercial banks. For a description of the operation of the linked exchange rate system, see Chapter 1 of United Kingdom - Hong Kong - Staff Report for the 1994 Article IV Consultation Discussions, Supplement 1, SM/95/23.

^{2/} External assets of domestic banks are defined as interbank claims on banks abroad plus loans extended which are not for use in Hong Kong.

Table 10. Hong Kong: Balance Sheet of All Authorized Institutions,
September 1995

	Hong Kong Dollar (In billions of Hong Kong dollars)	Foreign Currency (In billions of Hong Kong dollars)	Total (In billions of Hong Kong dollars)	Share in Total Assets/ Liabilities (In percent)	Share of Hong Kong Dollar Assets/ Liabilities (In percent)
Liabilities					
Amount due to authorized institutions in Hong Kong	454	321	774	9.7	58.7
Amount due to banks abroad	198	4,244	4,442	55.6	4.5
Deposits from customers ^{1/}	1091	1072	2,164	27.1	50.4
Negotiable certificates of deposit (NCDs) outstanding	86	48	134	1.7	64.2
Other debt instruments outstanding	1	31	33	0.4	3.0
Capital, reserves and other liabilities	244	191	436	5.5	56.0
Total liabilities	2,075	5,908	7,983	100.0	26.0
Assets					
Notes and coins	9	2	11	0.1	81.8
Amount due from authorized institutions in Hong Kong	454	321	775	9.7	58.6
Amount due from banks abroad	112	2,548	2,660	33.3	4.2
Loans and advances to customers	1,215	2,513	3,728	46.7	32.6
NCDs held	53	34	87	0.1	60.9
Negotiable debt instrument held, other than NCDs	86	386	472	5.9	18.2
Investments in shareholdings	16	3	19	0.2	84.2
Interest in land and buildings	39	1	40	0.5	97.5
Other	67	123	190	2.4	35.3
Total assets	2,050	5,933	7,983	100.0	25.7
Memorandum items:					
Number of reporting institutions	375				
Number of branches	1,543				

Source: Hong Kong Monetary Authority, Monthly Statistical Bulletin.

^{1/} Unadjusted for foreign currency swap deposits.

CHART 14

HONG KONG

ASSETS OF LICENSED BANKS BY TYPE, 1985-95

Billions of Hong Kong dollars

Billions of Hong Kong dollars

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics, and Hong Kong Annual Digest of Statistics; and Hong Kong Monetary Authority, Monthly Statistical Bulletin.

Table 11. Hong Kong: Loans and Advances by Type, September 1995

	Hong Kong Dollar (In billions of Hong Kong dollars)	Foreign Currency (In billions of Hong Kong dollars)	Total (In billions of Hong Kong dollars)	Share of HK\$ Loans in Total Loans (In percent)	Share of Loan Type in Total Loans (In percent)
Loans for use in Hong Kong	1,186	331	1,519	78.1	40.8
Trade-related	75	79	155	48.4	4.2
Other	1,111	252	1,364	81.5	36.6
Loans for use outside Hong Kong	24	2,148	2,172	1.1	58.3
Trade-related	4	14	18	22.2	0.5
Other	20	2,134	2,154	0.9	57.8
Loans for which the place of use is not known	4	35	39	10.3	1.0
Total loans	1,215	2,513	3,728	32.6	100.0

Source: Hong Kong Monetary Authority, Monthly Statistical Bulletin.

Another important characteristic of the banking system is the concentration of lending to the property sector. As of September 1995, residential mortgages represented 24 percent of loans for use in Hong Kong. When loans for building, construction, and property development and investment are included, the share of property-related lending in total loans for use in Hong Kong rises to 44 percent (Table 12). The share of property-related lending in total loans is, however, much lower at 16 percent.

2. The profitability of Hong Kong's banks

In recent years, Hong Kong's banks have been some of the most profitable in the world, with after-tax rates of return on assets well in excess of those for banks in the major industrial countries (Table 13). The HSBC has for some time been judged to be one of the most profitable banks in the world, and its affiliate the Hang Seng Bank was rated the most profitable bank in the world for the 1994-95 financial year by IBCA, a bank credit rating agency.

The reasons underlying the high profitability of Hong Kong's banks has in recent years been a subject of some controversy. In particular, the setting of interest rates by cartel under the Hong Kong Association of Bank's (HKAB) Interest Rate Rules (IRR) agreement on retail deposits was criticized by domestic consumer groups and competing foreign banks as enabling the major local banks to earn monopoly rents by virtue of their extensive branch networks. Partly in response to these criticisms, the Hong Kong Monetary Authority (HKMA) undertook a study of the desirability of the liberalization of the IRR, and subsequently partially liberalized time-deposit rates. ^{1/} An important question is whether the high profitability of Hong Kong's banks in recent years can be attributed to the existence of the IRR. If so, then the eventual abolition of the IRR would likely adversely impact their profitability.

The IRR has indeed been associated with banks in Hong Kong enjoying a lending-deposit spread on time deposits that has persistently exceeded that in many other countries--such as the United States (Chart 15). During 1994-95, with the deregulation of interest rates on time deposits, the spread on such deposits fluctuated widely. The initial decline in the spread on time deposits for Hong Kong banks that accompanied the general increase in interest rates in February 1994 was similar to that for U.S. banks. Subsequently, however, while the spread recovered for U.S. banks during February-August, the spread for Hong Kong banks continued to deteriorate, as time deposit rates in Hong Kong rising faster than lending rates. In

^{1/} The IRR and their subsequent partial deregulation is described in Chapter IV of this paper.

CHART 15
HONG KONG
INTEREST DIFFERENTIALS, 1989-95

Sources: Hong Kong Monthly Digest of Statistics and International Monetary Fund, International Financial Statistics.

Table 12. Hong Kong: Share of Property-Related Loans in Total Lending, 1987-95

(In percent)

	1987	1988	1989	1990	1991	1992	1993	1994	1995 ^{1/}
Loans for building, construction, property development and investment									
As a share of loans for use in Hong Kong	11.2	12.9	16.5	15.7	15.4	15.6	16.9	19.8	19.0
As a share of total loans and advances	5.1	6.1	7.6	6.0	5.6	5.8	6.4	7.6	7.0
Residential mortgages									
As a share of loans for use in Hong Kong	18.5	18.8	18.8	21.2	24.2	24.6	25.2	23.7	24.5
As a share of total loans and advances	8.4	8.9	8.7	8.2	8.8	9.1	9.5	9.1	9.0
Total real property-related loans ^{2/}									
As a share of loans for use in Hong Kong	29.7	31.7	35.3	36.8	39.6	40.3	42.1	43.5	43.5
As a share of total loans and advances	13.5	15.1	16.2	14.2	14.4	14.8	15.8	16.7	16.0

Sources: Census and Statistics Department, Hong Kong Annual Digest of Statistics 1994; Hong Kong Monetary Authority, Monthly Statistical Bulletin; and staff estimates.

^{1/} As of end-September 1995.

^{2/} Total property-related loans are the sum of loans for building, construction, property development and investment, and loans for residential mortgages.

Table 13. Hong Kong: International Comparison of Return on Assets, of the Locally Incorporated Banks, 1988-93 ^{1/}

(In percent of average total assets)

	1988	1989	1990	1991	1992	1993
1. Net Interest Income						
Hong Kong	1.63	1.72	1.65	1.92	2.02	2.06
United States	3.50	3.49	3.45	3.57	3.85	3.87
Japan	1.17	1.00	0.90	1.11	1.26	1.25
Germany	2.19	2.04	2.04	2.16	2.21	2.18
2. Non-Interest Income						
Hong Kong	1.22	1.08	1.08	1.01	1.51	1.27
United States	1.50	1.62	1.68	1.86	2.03	2.23
Japan	0.41	0.31	0.29	0.14	0.05	0.04
Germany	0.98	1.15	1.14	0.95	0.99	1.00
3. Gross Income (1 + 2)						
Hong Kong	2.85	2.80	2.73	2.93	3.53	3.33
United States	5.00	5.11	5.13	5.43	5.88	6.10
Japan	1.58	1.31	1.19	1.25	1.31	1.29
Germany	3.17	3.19	3.18	3.11	3.20	3.18
4. Operating Expenses						
Hong Kong	1.25	1.28	1.26	1.22	1.30	1.24
United States	3.30	3.36	3.46	3.66	3.78	3.88
Japan	0.88	0.81	0.80	0.86	0.92	0.96
Germany	2.18	2.07	2.03	2.06	2.04	1.95
5. Provisions						
Hong Kong	0.27	0.29	0.34	0.27	0.20	0.14
United States	0.56	0.97	0.95	1.01	0.75	0.46
Japan	0.05	0.04	0.03	0.07	0.13	0.14
Germany	0.25	0.42	0.53	0.47	0.69	0.69
6. Profit Before Tax (3 - 4 - 5)						
Hong Kong	1.33	1.23	1.13	1.44	2.03	1.95
United States	1.14	0.78	0.73	0.77	1.34	1.76
Japan	0.64	0.46	0.36	0.32	0.26	0.18
Germany	0.73	0.70	0.63	0.58	0.47	0.55
7. Taxes						
Hong Kong	0.21	0.21	0.13	0.22	0.28	0.29
United States	0.33	0.30	0.23	0.24	0.42	0.55
Japan	0.34	0.22	0.17	0.17	0.15	0.09
Germany	0.40	0.37	0.29	0.29	0.26	0.22
8. Profit after tax (6 - 7)						
Hong Kong	1.12	1.02	1.00	1.22	1.75	1.66
United States	0.81	0.48	0.49	0.52	0.92	1.21
Japan	0.30	0.24	0.19	0.15	0.11	0.10
Germany	0.33	0.32	0.34	0.30	0.22	0.33

Sources: Hong Kong Monetary Authority (1994), and Organisation for Economic Cooperation and Development (1995).

^{1/} For Hong Kong the data refer to the 31 locally incorporated Licensed Banks. For the United States, Japan, and Germany, the data refer to all commercial banks.

December 1994, for the first time, the spread fell below that for U.S. banks. With a further deterioration in January 1995, the spread for Hong Kong banks fell almost 3/4 percentage point below that for U.S. banks. Starting in February 1995, the spread for Hong Kong banks began to recover quickly and by March had again overtaken that for U.S. banks. From the low in January of 1.6 percentage points, the lending-deposit spread increased continuously--rising by about 2 percentage points by the end of 1995.

The spread on savings deposits, interest rates on which continue to be set by the HKAB, declined by a relatively small amount--a quarter of a percentage point--early in 1994 and have been maintained at a constant level since. Since the payment of interest on checking deposits is prohibited under the HKAB's IRR, the general increase in interest rates in 1994 increased the lending margins on such deposits.

While banks in Hong Kong may enjoy a high and relatively more stable spread between deposit and lending rates as a result of the IRR, Table 13 shows that, in fact, the net interest income of banks in Hong Kong as a proportion of assets is not high by international standards. ^{1/} While the net interest income of Hong Kong's banks has in recent years been above that of banks in Japan, it has been somewhat below that of German banks and well below that of banks in the United States. Therefore, while the IRR may have helped maintain profitability, the level of net interest income cannot be ascribed a primary role in explaining the high profitability of Hong Kong's banking sector relative to other countries.

How then have Hong Kong's banks achieved their relatively high profitability? Table 13 reveals that, compared with the United States and Germany, operating expenses and provisions for bad loans and other losses are substantially lower for Hong Kong's banks, yielding the relatively higher return on assets. The low operating expenses reflect the fact that banks in Hong Kong have been--and remain--relatively efficient despite increases in the costs of doing business in recent years. While the level of provisioning for bad debts is discretionary, banks in Hong Kong have in fact displayed high asset quality with a relatively low proportion of bad debts on their loan books. Besides prudent credit management, this reflects also the favorable economic environment in Hong Kong in recent years. By contrast, banks in many industrial countries have had to contend with the effects of recession and collapses in property prices that substantially increased the number of nonperforming loans.

^{1/} International differences in net interest income as a proportion of total assets, of course, reflect not only differences in interest rate spreads but also differences in the maturity structure of banks' assets. Banks in Hong Kong appear to have lower loan-deposit ratios, that is they tend to hold more liquid assets. For a given interest rate spread, net interest income as a proportion of their assets would, therefore, be expected to be lower.

During 1994 bank profits were maintained at high levels, with a modest decline in the rate of return on assets attributable almost entirely to a decline in noninterest income, while all other components of income and expenses as a proportion of total assets remained steady. Net interest income was roughly constant as the negative impacts of the deregulation of interest rates on time deposits, and the decline in the spreads on these deposits, were offset by increases in the spread on noninterest bearing deposits as a result of the increase in the general level of interest rates. During the first three quarters of 1995, banking activity continued to be buoyant and bank profitability was maintained.

3. Recent changes to the regulatory framework ^{1/}

Besides the freeing of interest rates on time deposits (as discussed in detail in Chapter IV), there were two other important changes in the regulatory framework facing banks.

First, the new Banking Amendment Bill was passed in February 1995. The bill amended the existing Banking Ordinance in a number of ways to improve the legal framework within which the authorization and prudential supervision of authorized institutions is conducted. The bill had two main objectives. One was to make the HKMA responsible for the authorization, revocation and suspension of all three types of institutions (LBs, RLBs and DTCs). The other objective was to define more clearly the scope, objectives and powers of an adviser or manager appointed under the Banking Ordinance to take control of an authorized institution that was experiencing difficulties.

Second, there were continuing increases in the disclosure of banks' balance sheet items. In 1994 for the first time, banks published transfers to their inner reserves, and for 1995 they will begin to publish the levels of such reserves. Since the banks have for some time been in a relatively strong position, the increased disclosure of their balance sheet items appeared to have no negative effect on market perceptions of the banks. There are plans to start to publish more off-balance sheet items, and more information on derivatives trading. Banks also plan to begin publishing their capital and liquidity ratios. Hong Kong banks disclosure requirements are now broadly in line with international standards.

VII. External Sector Developments

The importance of trade to Hong Kong's economy is highlighted by the very high proportion of exports and imports to GDP, each of which reached

^{1/} For a complete listing of Hong Kong's banking regulations and an international comparison of the regulatory framework see Attachments I and II to Chapter IV of United Kingdom - Hong Kong - Staff Report for the 1994 Article IV Consultation Discussions, Supplement 1, SM/95/23.

some 140 percent in 1994, up from levels of 90 percent in the early 1980s (Chart 16). Despite considerable year-to-year fluctuations in growth, the overall rise in trade has been dramatic, with total merchandise exports and imports expanding by annual average rates of about 20 percent in the period 1980-95. Growth of exports and imports of nonfactor services has averaged about 16 percent at an annual rate over this period. The external balance has declined substantially over time from a peak of over 10 percent in 1989 to a projected small deficit in 1995.

This chapter discusses external developments in Hong Kong. Section 1 reviews trade developments with a focus on the recent deterioration in the external balance. The decline in the external balance has been due to a deterioration of the merchandise trade balance, mainly reflecting a surge in imports, which were buoyed by the rapid increase in domestic demand and the real appreciation of the Hong Kong dollar over the past several years. Section 2 assesses alternative medium-term paths for the external balance by analyzing the longer-term relationship between the external balance, the real exchange rate, and foreign and domestic activity. It finds that a continuation of Hong Kong's relatively high inflation rate and the consequent appreciation of the real exchange rate would lead to an unsustainable decline in the external balance. It suggests that, for the external position to stabilize, inflation needs to slow from the current level of 8-9 percent to a 4-5 percent range.

1. Trade developments

The overall balance of merchandise trade and nonfactor services has declined substantially, from the recent peak of 11 1/2 percent of GDP in 1989 to 2 1/4 percent of GDP in 1994 (Table 14). The decline in the overall balance has reflected a deterioration of the merchandise trade balance, which swung from a surplus of 1 percent of GDP in 1989 to a deficit of 8 1/4 percent of GDP in 1994, while the surplus on nonfactor services has been fairly stable at around 10 percent of GDP. In 1995, the merchandise trade deficit reached a record high of US\$ 19 billion (13 percent of GDP). As a result, the overall balance is projected to have recorded a small deficit.

a. Merchandise trade

The deterioration of the merchandise trade balance reflects, primarily a surge in imports, which have been buoyed by the rapid increase in domestic demand and the real appreciation of the Hong Kong dollar over the past several years. During 1989-92, while both exports and imports grew rapidly, import growth exceeded export growth, resulting in a deterioration in the trade balance of about 5 1/4 percent GDP. The growth of both exports and imports slowed in late 1993 and early 1994, owing mainly to the implementation of an economic stabilization program in China since mid-1993. Subsequently, export growth picked up moderately, as re-export trade with China rose and domestic exports to industrial countries recovered. However,

Table 14. Hong Kong: Balance of Trade in Goods and Nonfactor Services, 1989-95 1/

	1989	1990	1991	1992	1993	1994	1995
(In billions of Hong Kong dollars)							
Trade balance	5.3	-5.3	-16.2	-33.5	-29.5	-84.4	-147.0
Exports of goods	570.5	639.9	765.9	925.0	1,046.3	1,170.0	1,344.2
Domestic exports of goods	224.1	225.9	231.0	234.1	223.0	222.1	231.7
Re-exports	346.4	414.0	534.8	690.8	823.2	947.9	1,112.6
Imports of goods	565.2	645.2	782.0	958.5	1,075.7	1,254.4	1,491.2
Of which: Retained imports	254.2	289.9	329.4	383.3	400.0	460.0	561.2
Net balance on nonfactor services	55.0	54.6	60.3	75.1	92.6	101.4	128.2 2/
Exports of nonfactor services	127.1	142.3	161.1	189.4	218.1	253.0	299.0 2/
Of which: Transportation	46.7	54.5	64.7	73.5	80.0	...	...
Travel	38.7	41.5	42.7	53.2	61.6	...	...
Imports of nonfactor services	72.2	87.7	100.8	114.2	126.6	146.6	170.8 2/
Of which: Transportation	22.4	25.8	28.0	32.3	33.8	...	...
Travel	29.4	37.1	43.7	47.5	54.9	...	...
Net balance of trade on goods and nonfactor services	60.3	49.3	44.1	41.6	62.1	22.0	-5.5 2/
(In percent of GDP)							
Trade balance	1.0	-0.9	-2.4	-4.3	-3.3	-8.3	-13.0 2/
Exports of goods	108.9	109.8	114.6	118.7	117.9	114.4	119.1 2/
Domestic exports of goods	42.8	38.8	34.6	30.1	25.1	21.7	20.5 2/
Re-exports	66.1	71.1	80.0	88.7	92.7	92.7	98.6 2/
Imports of goods	107.9	110.8	117.0	123.1	121.2	122.7	132.2 2/
Of which: Retained imports	48.5	49.8	49.3	49.2	45.1	45.0	49.7 2/
Net balance on nonfactor services	10.5	9.4	9.0	9.6	10.2	10.4	11.4 2/
Exports of nonfactor services	24.3	24.4	24.1	24.3	24.2	24.7	26.5 2/
Imports of nonfactor services	13.8	15.1	15.1	14.7	14.1	14.3	15.1 2/
Net balance of trade on goods and nonfactor services	11.5	8.5	6.6	5.3	6.9	2.2	-1.7 2/
(Percentage change)							
Exports of goods	15.7	12.2	19.7	20.8	13.1	11.8	14.9
Domestic exports of goods	3.0	0.8	2.3	1.3	-4.7	-0.4	4.3
Re-exports	25.8	19.5	29.2	29.2	19.2	15.1	17.4
Imports	12.8	14.2	21.2	22.6	12.2	16.6	19.3
Of which: Retained imports	--	14.1	13.6	16.4	4.4	15.0	22.0
Exports of nonfactor services	14.6	11.9	13.2	17.5	15.2	16.0	18.2 2/
Imports of nonfactor services	14.9	21.5	15.0	13.3	10.8	15.8	16.5 2/

Sources: Census and Statistics Department, Hong Kong Annual Digest of Statistics; Estimates of Gross Domestic Product, 1961 to 1994; and Quarterly Estimates of Gross Domestic Product, Second Quarter, 1995; and staff estimates and projections.

1/ National accounts basis, except for 1995. Figures for trade of goods for 1995 are based on trade statistics because of the lags in availability of national accounts data. The two data series differ only in the inclusion of gold import for production purpose, resulting in a small difference in imports figures.

2/ Staff estimates based on data for January-September 1995.

CHART 16

HONG KONG

TRADE DEVELOPMENTS, 1980-95

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and staff estimates.

in relation to GDP, exports recorded a continued decline in 1994 and early 1995. As imports rebounded more strongly than exports, partly due to massive import requirements for buoyant construction activity, the trade balance declined sharply in 1994 and 1995.

Re-exports have provided the key impetus to overall export growth, reflecting the shift of manufacturing and processing activities from Hong Kong into China. Following a slowdown from an average annual growth rate of 50 percent in 1987-88 to 20 percent in 1990, growth in re-exports accelerated to an annual rate of about 30 percent in 1991-92, supported by the buoyant Chinese economy (Chart 17 and Table 15). Following a moderation to 15 percent in 1994, re-export growth accelerated in the first half of 1995, owing to sustained strong demand in the major markets as well as the weakening of the Hong Kong dollar along with the U.S. dollar. For 1995 as a whole, re-exports recorded robust growth of 17 1/2 percent.

Reflecting the structural transformation of the Hong Kong economy, the ratio of domestic exports to GDP has continuously declined from the peak of 45 percent in 1987 to 22 percent in 1994. After a 27 percent rise in 1987, growth tapered off rapidly to less than 1 percent in 1990. Following a slight recovery in 1991-92 mainly driven by strong demand in China, domestic exports recorded negative growth in 1993-94. Domestic exports rebounded to positive growth in the latter half of 1994 and recorded relatively strong 4 3/4 percent growth in 1995, reflecting a pickup in overseas demand and the depreciation of the U.S. dollar in early 1995.

Imports grew at an average annual rate of nearly 20 percent over the last decade, with notable slowdowns during periods of cyclical weakness. During 1989-92, total import growth accelerated from an annual growth rate of 12 3/4 percent to 22 1/2 percent. In line with rapid re-export growth over the same period, nonretained imports grew at an annual average rate of 28 percent and led much of the pickup of overall imports. Although the pace was more moderate, retained imports also expanded over the same period, reflecting robust consumer and investment demand and the real appreciation of the Hong Kong dollar.

Following a slowdown in 1993, total imports grew by 17 percent in 1994 and continued to be strong with 19 1/4 percent growth in 1995. A notable aspect of this growth is the rapid increase in retained imports, which surged by 15 percent in 1994 and 22 percent in 1995, compared with only 4 percent growth in 1993 (Appendix Table 13). The recent surge in imports reflects some special factors, including a transitory surge in import volumes as buoyant construction activity required the build-up of stocks of inputs, and higher import prices due to the rise in world commodity prices and the appreciation of the yen during the first half of 1995.

b. Trade in nonfactor services

Hong Kong has maintained substantial surpluses on its nonfactor services account over the past decade, which have been sufficient to offset

Table 15. Hong Kong: Merchandise Trade Developments, 1989-95

(Percentage change)

	1989	1990	1991	1992	1993	1994	1995
Total exports							
Value	15.7	12.2	19.7	20.8	13.1	11.8	14.9
Unit value	5.1	2.7	2.6	0.9	-0.4	1.5	3.4 <u>1/</u>
Quantity	10.7	9.6	17.3	19.8	13.5	10.4	13.1 <u>1/</u>
Domestic exports							
Value	3.0	0.8	2.3	1.3	-4.7	-0.4	4.3
Unit value	2.8	1.3	1.9	1.0	0.3	1.6	2.4 <u>1/</u>
Quantity	0.1	-0.5	0.5	0.2	-4.5	-2.3	3.6 <u>1/</u>
Re-exports							
Value	25.8	19.5	29.2	29.2	19.2	15.1	17.4
Unit value	6.1	3.0	2.2	0.8	-0.6	1.5	3.7 <u>1/</u>
Quantity	18.6	16.0	26.5	28.3	19.6	13.8	15.3 <u>1/</u>
Imports							
Value	12.8	14.2	21.2	22.6	12.2	16.6	19.2
Unit value	3.6	2.5	1.9	0.2	-0.6	2.8	5.4 <u>1/</u>
Quantity	8.9	11.4	19.0	22.2	12.7	14.0	15.1 <u>1/</u>
Terms of trade	1.3	0.3	0.7	0.7	0.2	-1.3	-1.9 <u>1/</u>

Sources: Census and Statistics Department, Estimates of Gross Domestic Product 1961 to 1994 and Quarterly Estimates of Gross Domestic Product, Second Quarter 1995; and Financial Services Branch, Third Quarter Economic Report 1995.

1/ January-October, percentage change from year-earlier period.

GROWTH OF TRADE, 1980-95

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and staff estimates.

its merchandise trade deficits until recently. These surpluses reflect Hong Kong's role as a major international center for tourism, transportation, insurance and financial services. They also reflect Hong Kong's increasingly important role in providing southern China with trade-related and financial services.

During 1989-91, the surplus on nonfactor services gradually declined from 10 1/2 percent to 9 percent of GDP, reflecting rapid growth in imports of services. Subsequently, the surplus has expanded to 10 1/2 percent of GDP in 1994 and 11 3/4 percent of GDP in the first three quarters of 1995, mainly owing to rapid growth in exports of trade-related and professional services.

A shift from re-exports to transshipments has played an important role in services trade developments. ^{1/} As auxiliary services and product processing in China have become more developed, a growing portion of the final packaging can be fully performed in China and shipped directly to markets via Hong Kong. This shift involves a loss in earnings from re-export margins, and thus a decline in the merchandise trade balance. A good part of the loss is, however, shown as an offsetting increase in either the services trade surplus or net investment earnings. Following the moderate growth of 7 percent in 1993, seaborne outward transshipments expanded rapidly by 41 percent in 1994, and continued to grow in 1995 with a year-on-year rise of 39 percent in the first three quarters.

c. Regional trade flows

China, the United States and Japan have been the most important trading partners of Hong Kong for many years, together accounting for about 60 percent of exports as well as imports (Appendix Table 14). Among them, China is the largest partner for both exports and imports. The United States is a major market for Hong Kong's exports, but supplies a relatively minor share of Hong Kong's imports. Similarly, Japan is more important for Hong Kong as a source of imports than as an export market.

Regarding re-exports by origin, China's share is dominant at (about 60 percent). This reflects Hong Kong's role as a conduit for Chinese exports to the rest of the world, as well as the relocation of outprocessing activities to southern China. By destination, China and the United States are by far the largest two markets for Hong Kong's re-exports, accounting for over half of the total in recent years. While the U.S. share has been stable at slightly above 20 percent, China's share has increased rapidly, surpassing one third of total re-exports in the first three quarters of 1995. For domestic exports, China and the United States are again by far

^{1/} Transshipment of goods is defined as transport of goods to their final destination via Hong Kong under a single bill of lading. In contrast, re-exports enter Hong Kong under one bill of lading and leave with another one, identifying Hong Kong as a transfer point.

the two largest markets. It is particularly noticeable that the U.S. share is on steady decline, while the share of domestic exports destined for China rapidly increased until 1993, and remained stable since.

Most of Hong Kong's imports traditionally come from Asian countries, with China and Japan accounting for over half of the total. While the share of imports from Japan has declined over time, partly reflecting the appreciation of the yen, the share of imports from China has increased steadily.

2. Medium-term path of the external balance

This section analyzes the determinants of Hong Kong's external balance and assesses medium-term prospects of the external balance under alternative scenarios. A single equation model is used, focusing on the link between the external balance, the real exchange rate, domestic demand, and foreign activity. The reference scenario assumes continued rapid real exchange rate appreciation and high growth in domestic demand, while foreign activity follows a path given by exogenous projections. Two alternative cases are explored: a case with continued rapid real exchange rate appreciation, a moderation in domestic demand growth, and higher foreign activity than the reference scenario; and a case with a slowdown in real exchange rate appreciation, a moderation in domestic demand growth, and the same foreign activity path as the reference scenario.

The results indicate that a continuation of strong domestic demand and rapid appreciation of the real exchange rate would result in an unsustainable decline in the external balance. A moderation in domestic demand growth and robust foreign activity help improve the external position, but the medium-term decline remains unsustainable as long as the current pace of real exchange rate appreciation continues. For the external position to stabilize under the assumption of domestic demand converging to the growth rate of potential output, the results suggest that real exchange rate appreciation would need to slow to around 1-2 percent per year over time. Given the linked exchange rate system, this result implies that inflation must decline from the current level of 8-9 percent to 4-5 percent, compared with currently projected inflation in trading partners of 3 percent.

a. Estimated equation

To assess the link between the external balance and real exchange rates, foreign activity and domestic demand, regressions were performed using ordinary least squares on annual data for 1969-1995. ^{1/} The estimated equation is as follows (t-ratios in parentheses):

^{1/} Data used for 1995 are staff estimates based on the observations in the first three quarters.

$$TB_t = 0.48 TB_{t-1} - 0.19 \log(RER_{t-1}) + 0.09 \log(IMW_t) - 0.09 \log(DD_t) \\ (2.70) \quad (2.40) \quad (1.56) \quad (1.49) \\ + 0.03 \quad \frac{1}{(2.30)}$$

R Bar squared = 0.54

Standard error of the regression = 0.03

Durbin-Watson = 1.34

where TB is net exports of goods and nonfactor services expressed as a ratio to GDP, RER is the CPI-based real effective exchange rate of the Hong Kong dollar, IMW is a weighted average of partner countries' import volumes using Hong Kong's export weights, and DD is total real domestic demand.

The estimated equation shows that the real exchange rate, foreign activity and domestic demand have strong effects on the external balance. Specifically, the estimated parameters indicate that a 1 percent appreciation in the real effective exchange rate of the Hong Kong dollar leads to a fall in the external balance of about 0.2 percent of GDP in the short run (with a 1 year lag), and about 0.4 percent of GDP in the long run. The estimated impact of foreign and domestic demand on the external balance is almost equal in size: in the short run, a 1 percent rise in the import volumes of trading partners raises the external balance by 0.1 percent of GDP, whereas a 1 percent rise in domestic demand lowers the external balance by 0.1 percent of GDP. Chart 18 compares the predicted external balance using the estimated equation with the actual balance during 1969-95. The equation correctly predicts the recent decline in the external balance.

b. Projections of the external balance

In order to use the equation for medium-term projections of the external balance, one needs to specify assumptions for real exchange rate, domestic demand and foreign activity. The reference scenario is based on the assumption that the real effective exchange rate continues to appreciate rapidly at an annual rate of 6 percent, while growth in domestic demand remains strong at the recent level of 7 percent per year over the medium term. In the reference scenario, foreign demand is assumed to follow a path based on the spring 1996 round of World Economic Outlook (WEO) projections for Hong Kong's trading partners. This implies that growth in imports of partner countries is projected to slow gradually from about 10 percent per year in 1995 to about 8 percent by 2000. For the period beyond 2000, growth

1/ A regression using the ratio of foreign and domestic activity-- $\log(IMW_t/DD_t)$ --was also carried out. It yielded a coefficient of 0.10 and a t-value of 1.61.

in foreign activity is assumed to continue at 8 percent per year, reflecting continuing fast growth in partner countries (especially China) and trade flows in the region.

The Case A scenario assumes the same appreciation of the real effective exchange rate as the reference scenario, but a moderation in domestic demand growth to a level comparable with that of potential output, that is, about 5 percent per year. ^{1/} Foreign activity is assumed to continue to grow at the current pace of 10 percent per year, as opposed to the gradual slowdown to 8 percent assumed in the reference scenario.

The Case B scenario assumes a gradual slowdown in the appreciation of the real exchange rate from the current 6 percent to 1 1/2 percent per year over time. Domestic demand is assumed to grow by 5 percent per year, in line with potential output, and foreign activity is assumed to follow the same path as in the reference scenario.

Under Hong Kong's linked exchange rate system, the assumption for the real exchange rate is linked to the future course of inflation, as changes in the CPI-based real exchange rate indicate changes in consumer prices, given the constant nominal exchange rate. Assuming that the real exchange rate continues to appreciate at an annual rate of 6 percent and domestic demand growth moderates to 5 percent per year (Case A), implies that the inflation differential between Hong Kong and trading partners would remain at about 6 percent in the medium term. In contrast, the assumptions of the Case B scenario imply a gradual narrowing of the inflation differential to about 1-2 percent.

The paths of the external balance for the three scenarios are shown in Chart 18. Under the reference scenario, a continuation of the rapid appreciation of the real exchange rate and high growth in domestic demand leads to an unsustainable decline in the external balance over the medium term. Under the Case A scenario, a moderation of growth in domestic demand and a higher foreign activity improve the external position slightly, compared with the reference scenario. However, even with these assumptions, the continued rapid real exchange rate appreciation leads the external balance to a path of unsustainable decline.

Under the Case B scenario, the slowdown in the annual rate of appreciation of the Hong Kong dollar to about 1 1/2 percent would stabilize the external balance over time at about 1/2 percent of GDP. Assuming the trading partners' inflation rate of 3 percent, this implies that, for the external balance to stabilize in the medium term, the inflation rate in Hong Kong would have to slow to 4-5 percent over time from the 8-9 percent rates observed recently. The remaining difference in inflation, and thus

^{1/} Growth in Hong Kong's potential output is assumed to remain at the 5 percent pace estimated for recent years.

CHART 10
HONG KONG
ACTUAL VERSUS PREDICTED TRADE BALANCE
(In percent of GDP)

Sources: Census and Statistics Department, Estimates of GDP, 1961 to 1994; and staff estimates.

the appreciation of Hong Kong's real exchange rate, would be accounted for by faster growth of activity in trading partners.

VIII. Trade Policy

As a fully open economy with no tariff barriers or other restrictions on trade, Hong Kong is an ardent supporter of free trade and the multilateral trading system. At the same time, in view of the close economic linkages with China, trade policy issues related to China have important implications for Hong Kong.

1. The World Trade Organization (WTO) activities

Hong Kong attaches particular importance to its independent membership in the WTO as a symbol of autonomy in customs and trade policy. Hong Kong has been actively involved in the activities of the WTO as a member of various committees established to implement the Uruguay Round (UR), and has also contributed to bringing negotiations on financial services and movement of natural persons to a conclusion.

The focus of Hong Kong's multilateral trade policy is currently on preparations for the WTO ministerial meeting in Singapore in December 1996. The meeting is scheduled to discuss the implementation of the UR agreements, unfinished business such as access policies for telecommunications and maritime transport, and some new issues, including the links between trade and labor standards, the environment, investment, and competition. The views on trade and labor standards are sharply divided between developed and developing countries. Hong Kong is of the view that trade measures should not be used to enforce labor standards.

The implementation of the UR agreements is generally expected to improve market access for Hong Kong exports. However, the authorities continued to argue in the WTO that the rules on launching anti-dumping proceedings should be tightened, so as to ensure that anti-dumping measures are not abused.

Hong Kong worked closely with other exporters of textiles and clothing to press for a phase-out of Multifiber Arrangement (MFA) restrictions and integration of the textiles sector into the GATT framework. The WTO Agreement on Textiles and Clothing provides for a phasing out of the MFA over a ten-year period. The resulting gradual liberalization of the textiles sector is expected to accelerate the pace of relocation of manufacturing facilities of the textiles sector, and enhance the on-going change in industrial structure.

Hong Kong has supported China's accession to the WTO, which is expected to improve market access in China both for Hong Kong's exports and

trade through Hong Kong. China's accession to the WTO would also increase investment into China and opportunities for growth of supporting services, which would benefit Hong Kong.

2. Hong Kong and China's MFN Status

Under the WTO framework, while all members are granted MFN status--treatment on an equal and nondiscriminatory basis as far as trade and tariffs are concerned--nonmembers may also be granted this status at the discretion of a trading partner. China's MFN status is reviewed by the United States on an annual basis, with the current status being valid through mid-1996. The Government estimated that the withdrawal of China's MFN status would reduce Hong Kong's re-exports to the United States by some 40 percent, which would slow GDP growth by 2-3 percentage points a year. There would be further losses to Hong Kong if China were to retaliate by curtailing its imports from the United States, and if there were a consequent weakening of investment in China.

3. Recent developments within APEC

Hong Kong has actively participated in the Asia Pacific Economic Forum (APEC). Following the leaders' declaration in Osaka in November 1995, the Government is currently preparing a comprehensive action agenda that would cover trade, competition, services and human resource developments. Hong Kong's guiding principle in participating in regional economic arrangements continues to be the promotion of free trade and the reinforcement of the multilateral trading system. Hong Kong firmly believes that all the APEC initiatives should be consistent with the WTO principles of global, open trade.

While there is broad agreement within APEC that it should be an open regional arrangement to facilitate trade between parties and not to raise barriers to trade with outsiders, opinions differ at the practical level. Currently, at issue is how comprehensive the action agenda should be, and whether members should be granted MFN treatment. It is still premature to tell the concrete impact of the APEC on Hong Kong's trade.

IX. Statistical Issues

The Hong Kong authorities produce a large number of high-quality data for the real, external, monetary, and fiscal sectors of the economy. The data are generally provided in high frequencies, suitable breakdown, with a minimum delay and are publicly available and widely disseminated. The main data deficiencies include: data on the capital account of the balance of payments and data on unilateral transfers, which are currently not compiled; factor income data, which are presently available for one year (1993) only; foreign reserves data, which are presently not reported at a frequency higher than quarterly; and production-based GDP estimates at constant

prices, which are not compiled. This section discusses preliminary estimates of Hong Kong's external factor income flows, released in November 1995.

The project to compile data on factor income flows started in 1994, when the first round of an annual survey of external factor income flows was launched. The survey covered about 21,000 businesses in Hong Kong, including financial institutions, trading companies, and manufacturing firms. The preliminary estimates of the survey indicate that the GNP for 1993 was HK\$910 billion, compared with HK\$900 billion for the GDP. The ratio of GNP to GDP of 1.011 is comparable to that of Japan (1.009), Singapore (1.014), and Taiwan Province of China (1.016). Total factor income flow to Hong Kong amounted to HK\$318 billion (35 percent of GDP) in 1993, and total factor income outflow to HK\$309 billion (34 percent of GDP) (Table 16). The massive amounts of factor income inflows and outflows reinforce the belief that Hong Kong is a major international center for trade and finance. Direct investment income accounted for 25 percent of total inflow, and 50 percent of total outflow of factor income. The amount of direct investment income outflow--HK\$154 billion (US\$20 billion)--indicates that external investors have accumulated a huge stock of investment in Hong Kong in the past. At the same time, Hong Kong investors have made substantial investments abroad in recent years, yielding over US\$10 billion (9 percent of GDP) in 1993.

The total value of inflow of portfolio investment (US\$9 billion) was six times larger than that of outflow of portfolio investment in 1993, suggesting that Hong Kong residents invested in overseas securities much more than the nonresidents invested in Hong Kong securities. The banking sector was the dominant contributor to other investment income, which accounted for 53 percent of total inflow and 46 percent of total outflow of factor income. Banks' external assets and liabilities, which mainly consist of interbank placement of funds, generated total inflow of US\$21 billion in interest income, and US\$18 billion in outflow of interest income. The banking sector was also the largest contributor to total external factor income flows.

The data on external factor flows for 1994 are expected to be released in the third quarter of 1996; and the data for 1995 in the first quarter of 1997.

Table 16. Hong Kong: Estimates of External Factor Income Flows by Income Component and by Business Sector for 1993 (At Current Market Prices)

	<u>Inflow</u>		<u>Outflow</u>		<u>Net Flow</u>
	<u>HK\$ million</u>	<u>Percent</u>	<u>HK\$ million</u>	<u>Percent</u>	<u>HK\$ million</u>
Total external factors					
income flows	318,397	100.0	308,458	100.0	9,939
By income component					
Direct investment income	81,011	25.4	153,984	49.9	-72,973
Portfolio investment income	68,796	21.6	11,209	3.6	57,587
Other investment income	168,490	52.9	143,165	46.4	25,325
Compensation of employees	100	--	100	--	--
By business sector					
Financial					
Banking	204,190	64.1	201,420	65.3	2,770
Other than banking	55,208	17.3	36,539	11.8	18,669
Nonfinancial					
Investment holding (nonfinancial)	38,391	12.1	28,716	9.3	9,675
Other than investment holding	20,608	6.5	41,783	13.5	-21,175

Source: Data provided by the Hong Kong authorities.

References

- Chau, L.C., "Public Housing," in The Economic System of Hong Kong, ed. by H.C.Y. Ho and L.C. Chau (Hong Kong: Asian Research Service, 1988), pp. 243-56.
- French, Kenneth R. and James M. Poterba, "Were Japanese stock prices too high?", Journal of Financial Economics, Volume 29, No. 2, October 1991, pp. 337-364.
- Fu, Yuming, "Housing Market and Housing Policies," in The Other Hong Kong Report, 1995, ed. by Stephen Y.L. Cheung and Stephen M.H. Sze (Hong Kong: Chinese University Press, 1995), pp. 261-86.
- Hong Kong Monetary Authority, Monetary Management in Hong Kong, Proceedings of the Seminar on Monetary Management organized by the Hong Kong Monetary Authority on 18-19 October 1993, Hong Kong: Hong Kong Monetary Authority, (1994a).
- Hong Kong Monetary Authority, The Practice of Central Banking in Hong Kong, Hong Kong: Hong Kong Monetary Authority, (1994b).
- Hong Kong Monetary Authority, Study on the Consumer Council Report "Are Hong Kong Depositors Fairly Treated?", Hong Kong: Hong Kong Monetary Authority, July 1994, (1994c).
- Kahkonen, Juha, "Movements in asset prices since the mid-1980s", in Savings Behavior and the Asset Price "Bubble" in Japan: Analytical Studies, Edited by Ulrich Baumgartner and Guy Meredith, International Monetary Fund, Occasional Paper Series, No. 124, 1995.
- OECD, Bank Profitability: Financial Statements of Banks [1979-1993], Organization of Economic Cooperation and Development, Paris, France, 1995.
- Peng, Ruijie, and William C. Wheaton, "Effects of Restrictive Land Supply on Housing in Hong Kong: An Econometric Analysis," Journal of Housing Research, Vol. 5, No. 2/1994, 263-92.
- Planning, Environment and Lands Branch, Report of the Task Force on Land Supply and Property Prices (Hong Kong: Planning, Environment and Lands Branch, June 1994).
- Planning, Environment and Lands Branch, Report on the Review of the Office Market (Hong Kong: Planning, Environment, and lands Branch, November 1994).

Table 1. Hong Kong: Gross Domestic Product by Expenditure Component
at Current Market Prices, 1990-95

	1990	1991	1992	1993	1994	1995 Jan.-Sept. 1/
(In millions of Hong Kong dollars)						
Consumption	373,742	442,568	515,740	586,859	674,307	548,906
Private	330,459	391,098	451,670	514,239	590,991	478,184
Government	43,283	51,470	64,070	72,620	83,316	70,722
Gross fixed capital formation	153,776	177,729	213,808	245,182	297,238	238,080
Private	134,006	157,189	191,493	212,118	257,340	...
Government	19,770	20,540	22,315	33,064	39,898	...
Final domestic demand	527,518	620,297	729,548	832,041	971,545	786,986
Private	464,465	548,287	643,163	726,357	848,331	...
Government	63,053	72,010	86,385	105,684	123,214	...
Change in stocks	5,728	4,098	8,187	2,299	28,004	59,236
Total domestic demand	<u>533,246</u>	<u>624,395</u>	<u>737,735</u>	<u>834,340</u>	<u>999,549</u>	<u>846,222</u>
Net exports of goods and nonfactor services	<u>49,303</u>	<u>44,117</u>	<u>41,600</u>	<u>63,123</u>	<u>17,018</u>	<u>-29,846</u>
Exports of goods and nonfactor services	782,195	926,973	1,114,304	1,261,827	1,413,920	1,204,799
Exports of goods	639,874	765,886	924,952	1,046,250	1,170,013	993,251
Domestic exports	225,875	231,045	234,124	223,027	222,092	171,875
Re-exports	413,999	534,841	690,829	823,223	947,921	821,376
Exports of nonfactor services	142,321	161,087	189,352	215,577	243,907	211,548
Imports of goods and nonfactor services	732,892	882,856	1,072,704	1,198,704	1,396,902	1,234,645
Imports of goods	645,200	782,042	958,462	1,075,710	1,254,427	1,110,715
Imports of nonfactor services	87,692	100,814	114,242	122,994	142,475	123,930
Gross domestic product	<u>582,549</u>	<u>668,512</u>	<u>779,335</u>	<u>897,463</u>	<u>1,016,567</u>	<u>816,376</u>
(In percent of GDP)						
Memorandum items:						
Consumption	64.2	66.2	66.2	65.4	66.3	67.2
Gross fixed capital formation	26.4	26.6	27.4	27.3	29.2	29.2
Final domestic demand	90.6	92.8	93.6	92.7	95.6	96.4
Change in stocks	1.0	0.6	1.1	0.3	2.8	7.3
Total domestic demand	91.5	93.4	94.7	93.0	98.3	103.7
Net exports of goods and nonfactor services	8.5	6.6	5.3	7.0	1.7	-3.7

Sources: Census and Statistics Department, Estimates of Gross Domestic Product, 1961 to 1994; and Quarterly Estimates of Gross Domestic Product, Third Quarter 1995.

1/ Percentage changes calculated over corresponding year-earlier period.

Table 2. Hong Kong: Composition of Gross Fixed Capital Formation
at Constant (1990) Market Prices, 1989-94

	1989	1990	1991	1992	1993	1994
(In millions of Hong Kong dollars)						
Gross domestic fixed capital formation ^{1/}	142,204	153,776	168,059	183,480	191,498	217,243
Private	123,381	134,006	148,914	163,336	163,132	184,245
Public	18,823	19,770	19,145	20,148	28,366	32,998
Transfer costs of land and buildings	7,766	8,296	11,481	13,126	12,481	11,198
Private	7,766	8,296	11,481	13,126	12,481	11,198
Public	--	--	--	--	--	--
Construction	53,088	57,314	57,658	57,650	65,058	75,030
Private	35,946	39,172	40,468	39,335	39,209	45,271
Public	17,142	18,142	17,190	18,315	25,849	29,759
Residential buildings	21,519	23,475	22,576	23,024	24,071	25,423
Private	16,065	18,375	17,963	17,770	19,069	20,566
Public	5,454	5,100	4,613	5,254	5,002	4,857
Non-residential buildings	18,005	20,311	22,034	20,502	20,339	21,024
Private	14,287	16,158	18,032	17,084	15,853	18,480
Public	3,718	4,153	4,002	3,418	4,486	2,544
Other construction	13,564	13,528	13,048	14,124	20,648	28,583
Private	5,594	4,639	4,473	4,481	4,287	6,225
Public	7,970	8,889	8,575	9,643	16,361	22,358
Real estate developers' margin	24,830	28,355	29,034	27,865	26,512	30,034
Private	24,830	28,355	29,034	27,865	26,512	30,034
Public	--	--	--	--	--	--
Machinery and equipment	56,520	59,811	69,886	84,839	87,447	100,981
Private	54,839	58,183	67,931	83,010	84,930	97,742
Public	1,681	1,628	1,955	1,829	2,517	3,239
Transportation equipment	8,212	8,468	10,129	12,618	13,179	14,027
Private	7,352	8,043	9,676	11,936	12,684	13,813
Public	860	425	453	682	493	214
Machinery and other equipment	48,308	51,343	59,757	72,221	74,268	86,954
Private	47,487	50,140	58,255	71,074	72,244	83,929
Public	821	1,203	1,502	1,147	2,024	3,025
(Percentage change)						
Memorandum items:						
Total gross domestic fixed capital formation	3.5	8.1	9.3	9.2	4.6	13.4
Private	2.0	8.6	11.1	9.7	0.8	12.9
Public	14.2	5.0	-3.2	5.2	40.8	16.3
Private investment in residential construction	-2.8	14.4	-2.2	-1.1	-0.3	7.9
Private investment in plant, machinery, and equipment	2.1	5.8	16.8	22.0	1.6	16.2

Source: Census and Statistics Department, Annual Digest of Statistics, 1995 Edition.

^{1/} Totals for 1993 and 1994 differ slightly from the latest estimates in (text) Table 1, as the disaggregated series has not yet been revised.

Table 3. Hong Kong: Gross Domestic Product by Sector at Current Prices, 1989-93

	1989	1990	1991	1992	1993
<u>(In millions of Hong Kong dollars)</u>					
Agriculture and fishing	1,386	1,432	1,441	1,468	1,612
Mining and quarrying	224	210	222	205	197
Manufacturing	96,170	98,352	97,223	99,764	92,584
Electricity, gas, and water	10,860	12,612	13,521	15,637	17,591
Construction	25,738	30,220	34,659	37,337	43,089
Wholesale, retail and export/import trades, restaurants and hotels	124,749	140,722	163,284	190,760	224,443
Transportation, storage, and communications	44,654	52,927	60,604	71,227	78,975
Financing, insurance, real estate, and business services	97,297	113,127	143,296	178,923	214,417
Community, social, and personal services	70,124	81,328	94,293	110,703	130,226
Ownership of premises	51,534	59,257	68,873	80,941	91,473
Adjustment for financial intermediation services ^{1/}	-23,800	-30,741	-45,902	-54,846	-63,176
Gross domestic product at factor cost (production-based estimates)	<u>498,935</u>	<u>559,446</u>	<u>631,514</u>	<u>732,120</u>	<u>831,429</u>
Indirect taxes less subsidies	25,390	29,614	36,323	48,777	53,278
Gross domestic product at market prices (production-based estimates) ^{2/}	<u>524,326</u>	<u>589,060</u>	<u>667,837</u>	<u>780,897</u>	<u>884,707</u>
<u>(In percent of GDP)</u>					
Memorandum items: ^{3/}					
Manufacturing	19.3	17.6	15.4	13.7	11.1
Wholesale, retail and export/import trades, restaurants and hotels	25.0	25.2	25.9	26.1	27.0
Financing, insurance, real estate, and business services	19.5	20.2	22.7	24.4	25.8
Transportation, storage, and communications	8.9	9.5	9.6	9.7	9.5
Ownership of premises	10.3	10.6	10.9	11.1	11.0

Source: Census and Statistics Department, Annual Digest of Statistics, 1995 Edition.

^{1/} An imputed service charge, equal to net interest receipts for the banking sector.

^{2/} Difference between production-based estimates and expenditure-based estimates reflects statistical discrepancy.

^{3/} Measured relative to production-based GDP at factor cost.

Table 4. Hong Kong: Revenue (General Revenue Account), 1990/91-1995/96 1/

(In millions of Hong Kong dollars)

	1990/91	1991/92	1992/93	1993/94	1994/95		1995	1994	1995
					Budget	Actual	Budget	April-September	
Taxes	61,914	78,922	96,813	113,790	116,677	118,643	124,380	29,985	28,063
Direct taxes	36,997	45,553	56,086	66,625	73,785	75,754	80,445	9,765	9,313
Earnings and profits tax	36,341	44,870	55,061	65,439	72,820	74,295	79,360	9,015	8,694
Estate duty	656	683	1,025	1,186	965	1,459	1,085	750	619
Indirect taxes	24,917	33,369	40,727	47,165	42,892	42,889	43,935	20,220	18,750
Duties	5,729	6,844	7,216	7,113	7,485	7,583	8,555	3,500	3,576
General rates	3,039	3,494	4,423	4,461	5,050	5,156	6,025	2,545	2,959
Internal revenue	13,143	18,406	23,012	30,020	24,196	23,202	22,394	11,144	9,816
Bets and sweeps tax	5,884	7,110	7,818	10,082	9,900	9,352	10,856	3,088	3,943
Entertainment tax	136	141	15	1	--	...	...	--	...
Hotel accommodation tax	269	266	314	375	400	445	495	208	230
Stamp duties	5,939	9,569	13,409	17,976	13,190	12,714	10,340	7,502	5,284
Air passengers' departure tax	718	1,120	1,255	1,383	503	488	498	244	257
Cross Harbor Tunnel passage tax	197	200	201	203	203	203	205	102	102
Motor vehicles taxes	2,054	3,437	4,940	4,192	4,121	4,662	4,422	2,248	1,491
Royalties and concessions	816	886	1,136	1,379	1,676	1,653	2,080	783	908
Taxi concessions	136	302	--	--	364	633	459	--	...
Nontax revenue	20,761	22,535	23,968	30,110	31,212	32,409	34,569	14,803	16,036
Fines and penalties	652	886	892	1,123	1,329	1,520	1,590	678	798
Properties, investments, and interest	5,846	4,554	3,588	5,652	7,200	8,376	8,031	3,341	4,173
Of which: Interest	4,505	2,982	1,767	3,387	3,690	4,942	5,290	2,333	2,886
Reimbursements and contributions	2,413	2,863	4,032	6,447	4,067	4,166	4,574	1,984	2,150
Utilities	5,617	6,650	7,174	7,997	8,403	8,392	9,322	4,062	4,139
Fees and charges	5,992	7,170	8,015	8,627	9,765	9,562	10,657	4,601	4,623
Land transactions 2/	241	412	267	264	358	393	395	137	153
Other	--	--	--	--	--	...	...	--	...
Total revenue	82,675	101,457	120,781	143,900	147,889	151,052	158,949	44,788	44,099

Source: Data provided by the Government Secretariat, Finance Branch.

1/ The fiscal year runs from April 1 to March 31.

2/ Includes only land transactions completed before the coming into force of the Sino-British Joint Declaration (5/27/85), or land transactions conferring a benefit that expires before June 30, 1997. Revenue from other land transactions is credited to the Suspense Account of the Capital Works Reserve Fund.

Table 5. Hong Kong: Government Expenditure Under the General Revenue Account, 1990/91-1995/96 1/

(In millions of Hong Kong dollars)

	1989/90	1991/92	1992/93	1993/94	1994/95 Budget	1994/95	1995/96 Budget	1994 April-September	1995
Current expenditure	<u>60,378</u>	<u>70,773</u>	<u>81,593</u>	<u>93,191</u>	<u>107,750</u>	<u>106,022</u>	<u>123,515</u>	<u>52,579</u>	<u>59,675</u>
Personal emoluments	23,443	25,286	25,852	28,702	32,856	32,077	36,637	15,909	17,502
Personnel-related expenses	4,937	6,584	7,711	8,695	10,854	9,835	12,061	5,413	6,249
Departmental expenses	4,552	4,782	4,438	4,910	5,657	5,568	6,534	2,336	2,651
Other charges	9,712	10,939	11,770	13,904	15,122	15,633	18,336	7,495	8,720
Subventions	17,734	23,182	31,822	36,980	43,261	42,909	49,947	21,426	24,553
Capital expenditure 2/	<u>22,459</u>	<u>22,628</u>	<u>20,432</u>	<u>27,849</u>	<u>29,353</u>	<u>41,239</u>	<u>36,707</u>	<u>15,081</u>	<u>22,333</u>
Plant, equipment, and works	776	758	641	466	698	546	767	147	152
Other nonrecurrent	1,091	904	3,431	3,767	859	598	1,023	279	617
Subventions	382	416	822	1,116	696	995	882	256	281
Transfers to funds	20,210	20,550	15,538	22,500	27,100	39,100	34,035	14,399	21,283
Capital Works Reserve Fund/Public Works	15,200	15,000	12,198	13,650	15,500	15,500	13,000	7,809	6,498
Capital Investment Fund	4,100	3,900	3,340	8,500	9,500	7,500	19,500	4,740	14,000
Loan Fund	910	1,650	--	300	2,100	9,100	1,500	1,850	750
Disaster Relief Fund	--	--	--	50	--	--	--	--	35
Civil Service Pension Reserve Fund	--	--	--	--	--	7,000	--	--	--
Total expenditure	<u>82,837</u>	<u>93,401</u>	<u>102,025</u>	<u>121,040</u>	<u>137,103</u>	<u>147,261</u>	<u>160,222</u>	<u>67,660</u>	<u>82,008</u>

Source: Data provided by the Government Secretariat, Finance Branch.

1/ The fiscal year runs from April 1 to March 31.

2/ Includes capital expenditure financed directly from the General Revenue Account (GRA) and transfers from the GRA to Consolidated Account Funds.

Table 6. Hong Kong: Public Expenditure by Function, 1991/92-1995/96 1/, 2/

(In millions of Hong Kong dollars)

	1991/92		1992/93		1993/94		1994/95 Revised Budget		1995/96 Budget	
	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital
Economic	4,667	1,127	5,318	2,159	5,959	6,488	6,650	1,395	7,666	2,884
Security	13,177	1,400	15,173	1,113	16,643	679	18,130	995	19,719	1,639
Internal security	10,990	1,294	12,451	1,037	13,597	612	14,640	893	15,690	1,421
Immigration	1,049	84	1,165	42	1,310	49	1,465	76	1,659	93
Other	1,138	22	1,557	34	1,736	18	2,025	26	2,370	126
Social services	15,905	1,614	19,371	1,565	23,307	4,320	27,509	2,438	32,749	4,255
Social welfare	6,136	219	7,301	268	8,787	383	10,537	489	12,955	1,943
Health	9,769	1,395	12,340	1,297	14,520	3,937	16,972	1,949	19,794	2,312
Education	16,590	2,863	19,407	2,751	22,572	2,838	26,235	2,984	30,332	3,614
Environment	635	2,042	789	2,339	1,266	1,868	1,778	2,837	2,242	3,960
Community and external affairs	5,319	1,431	5,866	1,107	6,626	1,699	7,695	1,893	8,984	2,769
Recreation, culture, and amenities	4,346	1,395	4,858	1,071	5,540	1,664	6,462	1,861	7,602	2,732
District and community relations	696	16	717	16	734	17	836	20	949	18
Other	277	20	291	20	352	18	397	12	433	19
Infrastructure	5,458	8,787	6,030	11,454	6,240	16,811	6,974	20,611	8,028	23,671
Transportation	1,245	2,503	1,413	4,514	1,549	7,464	1,588	9,185	1,824	9,414
Land and buildings	1,884	5,203	2,106	5,827	1,865	7,873	2,237	9,545	2,592	12,079
Water supply	2,329	1,081	2,511	1,113	2,826	1,474	3,149	1,881	3,612	2,178
Civil service support services	13,039	1,716	14,140	1,894	15,562	5,722	18,167	3,794	21,340	5,087
Housing	5,123	7,454	5,082	7,850	7,079	9,528	8,965	11,802	10,172	14,817
Total public expenditure	79,913	28,434	91,176	32,232	105,254	49,953	122,103	48,749	141,232	62,696

Source: Data provided by the Government Secretariat, Finance Branch.

1/ Public expenditure comprises expenditure by the Housing Authority, the Urban Council, the Regional Council, expenditure financed by the Government's statutory funds, and all expenditure charged to the General Revenue Account. Expenditure by institutions in the private or quasi-private sector is included to the extent of their subventions. The activities of government departments that are partly financed by charges raised on a commercial basis are also included (e.g., airport, waterworks). Excluded is expenditure by those organizations in which the Government has only an equity position, including statutory organizations such as the Mass Transit Railway Corporation and the Kowloon-Canton Railway Corporation. Similarly, debt repayments and equity payments are excluded, as they represent financing items.

2/ Owing to the reclassification of public expenditure by function, figures for 1990/91-1992/93 have been revised accordingly and expenditure by the Monetary Authority has been excluded.

Table 7. Hong Kong: Monetary Indicators, 1990-95 1/

	1990	1991	1992	1993	1994	1995 2/			
						March	June	Sept.	Nov.
<u>(Percentage change)</u>									
M1	13.3	19.5	21.1	20.6	-1.2	-0.7	0.4	-1.2	2.1
M2	22.4	13.3	10.8	16.0	13.2	17.0	17.6	15.6	13.0
M3	21.5	11.6	9.5	15.6	13.9	17.7	18.1	15.4	12.7
Hong Kong dollars 3/	14.8	15.6	13.7	25.2	18.4	10.1	18.2	16.5	13.5
Foreign currency 4/	27.4	8.4	6.0	6.9	9.1	16.0	17.9	14.0	11.7
Total credit	36.4	26.3	9.7	15.4	15.6	17.6	20.7	15.5	14.4
Hong Kong dollars	16.9	18.9	12.7	20.4	20.5	14.1	8.7	7.6	6.7
Foreign currency	48.5	30.0	8.4	13.0	13.2	19.3	26.8	19.5	18.4
Of which:									
Total loans	40.6	25.4	10.1	15.7	14.2	16.3	21.0	16.2	15.0
Hong Kong dollars	15.6	19.2	12.2	17.9	16.8	13.3	12.1	11.3	10.7
Foreign currency	58.3	28.6	9.0	14.6	12.9	17.9	25.5	18.7	17.3
<u>(Percent of total)</u>									
Currency composition									
M1									
Hong Kong dollars 3/	85.4	87.0	89.7	89.8	90.6	91.6	90.7	90.5	90.5
Foreign currency 4/	14.6	13.0	10.3	10.2	9.4	8.4	9.3	9.5	9.5
M3									
Hong Kong dollars 3/	44.3	45.9	47.7	51.6	53.6	53.1	53.6	54.3	53.8
Foreign currency 4/	55.7	54.1	52.3	48.4	46.4	46.9	46.4	45.7	46.2
Velocity									
M2	0.48	0.49	0.51	0.50	0.62	0.50	0.49	0.49	...
M3	0.45	0.47	0.49	0.49	0.60	0.48	0.48	0.47	...
Memorandum items:									
Nominal GDP (HK\$ billions)	582.5	668.5	779.3	897.5	1,016.6	1,044.2	1,066.4	1,088.9	...
Nominal growth of GDP (percent)	11.2	14.8	16.6	15.2	13.3	11.9	9.1	8.4	...

Sources: Hong Kong Monetary Authority, Monthly Statistical Bulletin; Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and staff estimates.

- 1/ Twelve-month change in monetary stocks at end of period; unadjusted for valuation changes in foreign currency-denominated deposits.
- 2/ Percentage changes calculated over corresponding year-earlier periods.
- 3/ Adjusted to include foreign currency swap deposits.
- 4/ Adjusted to exclude foreign currency swap deposits.
- 5/ Nominal GDP for four preceding quarters.

Table 8. Hong Kong: Loans for Use in Hong Kong, 1990-95 ^{1/}
(Twelve-month percentage change)

	1990	1991	1992	1993	1994	1995		
						March	June	Sept.
Loans for use in Hong Kong	17.9	18.5	11.4	18.2	17.1	13.5	11.4	11.5
Of which:								
Manufacturing	6.6	10.6	16.9	15.7	16.4	14.8	11.2	12.8
Transportation and equipment	10.9	24.3	13.3	7.2	15.3	10.4	3.3	0.6
Building, construction, and property development	12.3	16.3	13.1	27.9	36.9	31.7	26.2	19.6
Wholesale and retail trade	19.1	7.8	9.5	12.6	38.5	33.0	38.9	33.8
Miscellaneous	20.9	21.5	10.8	17.8	7.7	5.5	3.7	6.4
Of which:								
To purchase flats in the Home Ownership Scheme and Private Sector Participation Scheme	28.8	39.6	13.4	60.6	15.0	12.9	5.9	8.7
To purchase other residential property	32.8	34.9	13.6	16.6	9.5	7.9	9.8	12.4
To financial concerns	23.0	8.6	10.1	24.7	3.0	10.0	0.1	0.4
To stockbrokers	-19.2	38.6	0.7	59.2	41.2	18.4	-15.1	16.5

Sources: Hong Kong Monetary Authority, Monthly Statistical Bulletin; and Census and Statistics Department, Hong Kong Monthly Digest of Statistics.

^{1/} Based on outstanding loans at end of period.

Table 9. Hong Kong: Interest Rate Differentials, 1991-95

	Interbank Rates 1/			Deposit Rates 1/			Lending Rates 2/ 3/		
	HIBOR 4/	LIBOR 5/	Differential	Hong Kong dollars	U.S. dollars	Differential	HSBC's BLR	U.S. Prime Rate	Differential
1991									
January	6.9	7.3	-0.4	6.7	7.2	-0.5	9.9	9.5	0.4
February	7.1	6.7	0.4	6.2	6.5	-0.3	9.5	9.0	0.5
March	7.2	6.6	0.6	6.2	6.4	-0.2	9.5	9.0	0.5
April	6.7	6.2	0.5	6.2	6.1	0.2	9.5	9.0	0.5
May	8.4	6.1	2.3	6.5	5.9	0.6	9.6	8.5	1.1
June	7.7	6.2	1.5	7.2	6.1	1.2	10.5	8.5	2.0
July	6.5	6.1	0.4	6.2	6.0	0.3	9.5	8.5	1.0
August	6.1	5.8	0.3	5.9	5.6	0.3	9.5	8.5	1.0
September	5.4	5.6	-0.2	5.5	5.5	0.0	9.2	8.2	1.1
October	5.3	5.5	-0.2	5.2	5.3	-0.1	9.0	8.0	1.0
November	4.4	5.1	-0.7	4.8	4.9	-0.2	8.6	7.6	1.0
December	4.1	4.6	-0.5	4.8	4.5	0.3	8.5	7.2	1.3
1992									
January	4.6	4.2	0.4	4.8	4.0	0.7	8.5	6.5	2.0
February	4.7	4.2	0.5	4.8	4.1	0.7	8.5	6.5	2.0
March	4.9	4.4	0.5	4.8	4.2	0.5	8.5	6.5	2.0
April	4.4	4.3	0.1	4.8	4.0	0.8	7.8	6.5	1.3
May	3.8	4.0	-0.2	4.0	3.8	0.2	7.0	6.5	0.5
June	3.9	4.0	-0.1	3.2	3.9	-0.6	6.6	6.5	0.1
July	3.4	3.7	-0.3	2.8	3.4	-0.6	6.5	6.0	0.5
August	3.3	3.4	-0.1	2.8	3.3	-0.6	6.5	6.0	0.5
September	3.1	3.3	-0.2	2.8	3.1	-0.4	6.5	6.0	0.5
October	3.9	3.4	0.5	2.8	3.3	-0.5	6.5	6.0	0.5
November	4.9	3.8	1.1	2.8	3.6	-0.8	6.5	6.0	0.5
December	4.3	3.6	0.7	2.8	3.5	-0.7	6.5	6.0	0.5
1993									
January	3.7	3.3	0.4	2.8	3.2	-0.4	6.5	6.0	0.5
February	3.4	3.2	0.2	2.8	3.1	-0.4	6.5	6.0	0.5
March	3.4	3.2	0.1	2.8	3.1	-0.4	6.5	6.0	0.5
April	3.2	3.1	0.2	2.8	3.1	-0.3	6.5	6.0	0.5
May	3.4	3.2	0.2	2.8	3.1	-0.3	6.5	6.0	0.5
June	4.0	3.3	0.7	2.8	3.2	-0.5	6.5	6.0	0.5
July	3.6	3.3	0.3	2.8	3.2	-0.4	6.5	6.0	0.5
August	3.4	3.3	0.1	2.8	3.1	-0.4	6.5	6.0	0.5
September	3.3	3.2	0.1	2.8	3.1	-0.4	6.5	6.0	0.5
October	3.2	3.4	-0.1	2.8	3.2	-0.5	6.5	6.0	0.5
November	3.6	3.5	0.1	2.8	3.3	-0.6	6.5	6.0	0.5
December	3.6	3.4	0.2	2.8	3.3	-0.5	6.5	6.0	0.5
1994									
January	3.5	3.3	0.2	2.8	3.1	-0.4	6.5	6.0	0.5
February	4.1	3.5	0.5	2.8	3.4	-0.7	6.5	6.0	0.5
March	4.2	3.9	0.4	2.8	3.8	-0.9	6.5	6.1	0.5
April	4.4	4.1	0.3	3.5	4.0	-0.5	6.8	6.4	0.3
May	4.6	4.6	-0.0	3.7	4.5	-0.8	6.9	7.0	-0.1
June	4.9	4.6	0.3	4.2	4.5	-0.3	7.2	7.2	--
July	4.8	4.9	-0.0	4.2	4.7	-0.5	7.2	7.2	--
August	4.9	4.9	-0.0	4.4	4.8	-0.4	7.4	7.5	-0.1
September	5.2	5.1	0.1	4.8	5.0	-0.3	7.8	7.8	--
October	5.4	5.6	-0.2	5.4	5.5	-0.2	7.8	7.8	--
November	6.1	5.9	0.2	5.6	5.8	-0.2	8.0	8.1	-0.1
December	6.3	6.4	-0.1	6.1	6.3	-0.2	8.5	8.5	--
1995									
January	7.4	6.3	1.1	6.8	6.2	0.6	8.5	8.5	--
February	6.5	6.3	0.2	6.6	6.2	0.4	8.9	9.0	-0.1
March	6.2	6.3	-0.1	6.1	6.1	-0.1	9.0	9.0	--
April	6.8	6.2	0.5	5.9	6.1	-0.2	9.0	9.0	--
May	6.1	6.1	-0.0	6.0	6.0	-0.1	9.0	9.0	--
June	5.9	6.0	-0.1	5.6	5.9	-0.3	9.0	9.0	--
July	5.8	5.9	-0.1	5.4	5.8	-0.3	9.0	8.8	0.2
August	6.2	5.9	0.3	5.5	5.8	-0.2	9.0	8.8	0.2
September	6.2	5.9	0.3	5.7	5.7	-0.1	9.0	8.8	0.2
October	5.9	5.9	0.0	5.4	5.8	-0.3	9.0	8.8	0.2
November	6.0	5.9	0.1	5.3	5.7	-0.4	9.0	8.8	0.2
December	6.0	5.8	0.2	5.3	5.6	-0.3	9.0	8.6	0.3

Sources: Hong Kong Monetary Authority, Monthly Statistical Bulletin; and IMF, International Financial Statistics.

1/ Three-month period average rates.

2/ Monthly period average.

3/ United States prime lending rates and Hongkong and Shanghai Banking Corporation's quoted Best Lending Rates.

4/ Hong Kong interbank offered rate.

5/ London interbank offered rate.

Table 10. Hong Kong: Exchange Fund Balance Sheet, 1990-95

(In millions of Hong Kong dollars: end of year)

	1990	1991	1992	1993	1994	1995 June 30
Assets						
Foreign currency	192,323	225,333	274,948	335,499	408,485	449,788
Hong Kong dollar	3,874	10,788	12,546	12,987	24,126	31,454
Total	196,197	236,121	287,494	348,486	384,359	418,334
Liabilities						
Certificates of indebtedness ^{1/}	40,791	46,410	58,130	68,801	74,301	74,630
Transfers of fiscal reserves ^{2/}	63,226	69,802	96,145	115,683	131,240	143,908
Coins in circulation	2,003	2,299	2,559	2,604	3,372	3,332
Exchange Fund bills	6,671	13,624	19,324	25,157	46,140	50,840
Other ^{3/}	391	4,834	3,220	1,385	2,208	2,247
Balance of banking system ^{4/}	480	500	1,480	7,314	22,614	22,056
Total	113,562	137,469	180,858	220,944	279,875	297,013
Accumulated earnings	82,635	98,652	106,636	127,542	128,610	152,775

Source: Hong Kong Monetary Authority, Monthly Statistical Bulletin.

^{1/} As backing for their bank note issues, the three note-issuing banks are required to hold non-interest-bearing certificates of indebtedness issued by the Exchange Fund. Since October 17, 1983 these certificates have been issued to or redeemed from the note-issuing banks against payment in U.S. dollars at a fixed rate of HK\$7.80 per US\$1.00.

^{2/} Fiscal reserves that have been transferred from the General Revenue Account, Capital Investment Fund, Loan Fund, and Capital Works Reserve Fund to the Exchange Fund on an interest-bearing basis.

^{3/} Other liabilities comprise expenses accrued at the year's end, primarily interest due on fiscal reserve transfers, contingency reserves for bank rescue operations, and any other borrowings.

^{4/} In accordance with the Accounting Arrangements introduced in July 1988, the Hongkong and Shanghai Banking Corporation Ltd., as the Management Bank of the Clearing House of the Hong Kong Association of Banks, is required to maintain a Clearing Account with the Exchange Fund. The balance in the Account, which represents the level of liquidity in the interbank market, can only be altered by the Exchange Fund.

APPENDIX

Table 11. Hong Kong: Exchange Rate Indices, 1991-95 ^{1/}

	Real Effective Exchange Rate	Nominal Effective Exchange Rate	Exchange Rate (US\$ per HK\$1)
1991			
January	96.5	66.2	63.8
February	96.1	65.5	63.8
March	100.4	67.8	63.9
April	103.0	68.8	63.9
May	103.8	69.3	64.0
June	105.9	70.7	64.3
July	105.8	70.3	64.1
August	105.5	69.6	64.1
September	104.7	69.0	64.2
October	104.2	68.4	64.2
November	103.1	67.5	64.1
December	102.3	66.6	64.0
1992			
January	102.8	66.4	64.1
February	104.9	67.2	64.1
March	107.6	68.6	64.2
April	108.2	68.9	64.3
May	107.3	68.2	64.3
June	106.8	67.3	64.3
July	106.8	66.9	64.3
August	106.4	66.3	64.4
September	107.5	66.5	64.4
October	109.3	67.5	64.4
November	113.3	69.7	64.3
December	113.9	69.7	64.3
1993			
January	116.8	70.8	64.3
February	117.9	71.7	64.3
March	116.4	70.9	64.3
April	114.3	69.3	64.4
May	114.3	69.0	64.4
June	117.4	70.7	64.3
July	116.5	70.0	64.2
August	116.9	70.0	64.2
September	116.9	69.5	64.3
October	118.9	70.2	64.4
November	120.2	70.9	64.4
December	120.8	71.1	64.4
1994			
January	121.8	72.0	64.4
February	120.8	71.1	64.4
March	120.3	70.7	64.4
April	120.6	70.5	64.4
May	120.9	70.2	64.4
June	120.1	69.7	64.4
July	118.6	68.4	64.4
August	119.3	68.5	64.4
September	118.7	68.0	64.4
October	118.4	67.5	64.4
November	119.5	67.6	64.4
December	121.5	68.3	64.3
1995			
January	121.1	67.8	64.2
February	120.7	67.5	64.4
March	117.9	65.5	64.4
April	115.3	63.8	64.3
May	116.3	64.2	64.3
June	116.3	64.0	64.3
July	118.1	64.6	64.3
August	122.0	66.2	64.3
September	124.4	67.4	64.3
October	124.2	67.0	64.4
November	124.9	67.2	64.3
December	...	...	64.3

Source: IMF, Information Notice System.

^{1/} Base year 1980=100. Increase indicates appreciation.

Table 12. Hong Kong: Equity Price Developments, 1988-95

	1988	1989	1990	1991	1992	1993	1994	1995
<u>(Index of share prices)</u>								
Hang Seng Index								
End of year	2,687.4	2,836.6	3,024.5	4,297.3	5,512.4	11,888.4	8,191.0	10,073.4
Average of end of month	2,556.7	2,781.0	3,027.5	3,471.5	5,546.0	7,696.0	9,453.5	9,098.5
Sector indices								
(Average of end of month)								
Finance	1,625.7	1,808.1	1,906.9	2,304.4	4,643.6	6,282.8	7,988.8	8,381.4
Utilities	3,486.6	3,198.7	3,840.6	4,448.9	6,698.1	8,993.7	10,708.0	10,323.0
Property	3,847.9	4,535.2	4,874.5	5,843.3	9,215.7	12,362.5	16,556.6	15,550.8
Commerce and industry	2,318.0	2,687.0	2,797.0	2,981.1	4,379.3	5,733.2	7,331.1	6,719.8
<u>(Percentage change)</u>								
Hang Seng Index								
End of year	16.7	5.6	6.6	42.1	28.3	115.7	-31.1	23.0
Average of end of month	-11.4	8.8	8.9	14.7	59.8	38.8	22.8	-3.8
Sector indices								
Finance	-16.0	11.2	5.5	20.8	101.5	53.9	27.2	4.9
Utilities	-3.0	-8.3	20.1	15.8	50.4	35.3	19.1	-3.6
Property	-9.6	17.9	7.5	19.9	57.7	34.1	33.9	-6.1
Commerce and industry	-8.6	15.9	4.1	6.6	46.9	30.9	27.9	-8.3

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and the Asien Wall Street Journal.

Table 13. Hong Kong: Imports, Re-Exports, and Retained Imports, 1989-95

	1989	1990	1991	1992	1993	1994	1995 Staff Est. 2/
(In billions of Hong Kong dollars)							
Raw materials and semimanufactures							
Imports	230.5	248.7	293.1	329.9	355.1	431.8	539.2
Re-exports	119.5	127.2	155.3	187.3	214.9	264.3	332.1
Retained imports	121.3	133.0	150.7	157.4	153.3	170.2	226.0
Consumer goods							
Imports	201.5	247.7	306.4	394.5	454.8	514.2	557.7
Re-exports	166.1	219.3	290.7	376.8	447.4	498.4	539.9
Retained imports	55.4	69.2	77.5	104.0	117.4	135.0	151.0
Capital goods							
Imports	84.4	94.6	122.7	167.8	199.4	228.9	293.8
Re-exports	46.6	53.5	72.1	108.1	140.9	161.6	194.7
Retained imports	43.9	48.8	59.5	76.1	83.8	93.0	125.0
Foodstuffs							
Imports	34.0	37.0	41.4	45.4	45.0	53.4	59.3
Re-exports	11.4	11.4	13.2	14.4	13.8	17.1	19.0
Retained imports	23.5	26.6	29.6	32.5	32.8	37.7	41.6
Fuels							
Imports	12.5	14.5	15.3	17.7	18.3	22.5	26.6
Re-exports	2.8	2.5	3.5	4.3	6.1	6.5	9.5
Retained imports	10.0	12.3	12.1	13.7	12.6	18.9	13.6
Total imports 1/	565.2	645.2	782.0	958.5	1,075.7	1,254.4	1,491.2
Total re-exports 1/	346.4	414.0	534.8	690.8	823.2	947.9	1,112.5
Total retained imports 1/	254.2	289.9	329.4	383.3	400.0	460.0	564.4
(In percent of GDP)							
Raw materials and semimanufactures							
Imports	44.0	42.7	43.8	42.3	39.5	42.2	47.5
Re-exports	22.8	21.8	23.2	24.0	23.9	25.8	29.3
Retained imports	23.2	22.8	22.5	20.2	17.0	16.6	19.9
Consumer goods							
Imports	38.5	42.5	45.8	50.6	50.5	50.3	49.1
Re-exports	31.7	37.6	43.5	48.4	49.7	48.7	47.6
Retained imports	10.6	11.9	11.6	13.4	13.0	13.2	13.3
Capital goods							
Imports	16.1	16.2	18.4	21.5	22.2	22.4	25.9
Re-exports	8.9	9.2	10.8	13.9	15.7	15.8	17.2
Retained imports	8.4	8.4	8.9	9.8	9.3	9.1	11.0
Foodstuffs							
Imports	6.5	6.3	6.2	5.8	5.0	5.2	5.2
Re-exports	2.2	2.0	2.0	1.8	1.5	1.7	1.7
Retained imports	4.5	4.6	4.4	4.2	3.6	3.7	3.7
Fuels							
Imports	2.4	2.5	2.3	2.3	2.0	2.2	2.3
Re-exports	0.5	0.4	0.5	0.5	0.7	0.6	0.8
Retained imports	1.9	2.1	1.8	1.8	1.4	1.8	1.2
Total imports 1/	107.9	110.8	117.0	123.0	119.5	122.7	131.4
Total re-exports 1/	66.1	71.1	80.0	88.6	91.5	92.7	98.0
Total retained imports 1/	48.5	49.8	49.3	49.2	44.4	45.0	49.7

Sources: Census and Statistics Department, Trade Analysis Section; and staff estimates.

1/ Components do not necessarily add up to totals, as the disaggregated series have not yet been revised.

2/ Annualized, based on data for January-September for imports and re-exports, and for January-June for retained imports.

Table 14. Hong Kong: Direction of Trade by Area and Major Partners, 1989-95

(Percent of total)

	1989	1990	1991	1992	1993	1994	1995 Jan.-Sept.
Imports	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
China	34.9	36.8	37.7	37.1	37.5	37.5	36.1
Japan	16.6	16.1	16.4	17.4	16.6	15.5	15.1
Taiwan Province of China	9.2	9.0	9.6	9.1	8.8	8.6	8.6
United States	8.2	8.1	7.6	7.4	7.4	7.1	7.7
Korea	4.5	4.4	4.5	4.6	4.5	4.6	5.0
Other	26.6	25.6	20.9	24.4	25.2	26.7	27.5
Domestic exports	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
China	19.3	21.0	23.5	26.5	28.4	27.5	27.9
United States	32.2	29.4	27.2	27.6	27.0	27.7	26.1
Germany ^{1/}	7.0	8.0	8.4	6.8	6.3	5.8	5.2
Japan	5.8	5.3	5.0	4.7	4.3	4.7	5.2
United Kingdom	6.5	6.0	5.9	5.4	4.8	4.6	4.7
Other	29.2	30.3	30.0	29.0	29.2	29.3	30.9
Re-exports (destination)	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
China	29.9	26.8	28.7	30.7	33.4	34.1	34.5
United States	20.8	21.2	20.7	21.5	21.9	22.2	21.3
Japan	6.4	5.9	5.5	5.4	5.4	5.8	6.1
Germany ^{1/}	3.9	5.7	6.0	4.8	5.0	4.4	4.0
United Kingdom	2.6	2.9	2.7	3.0	3.0	2.9	2.8
Other	36.4	37.5	36.4	34.6	31.5	30.6	31.3
Memorandum items:							
Re-exports (origin)	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
China	54.3	58.1	59.0	58.4	57.6	57.6	57.2
Japan	11.3	10.2	10.7	12.3	13.4	12.9	11.8
Taiwan Province of China	7.8	7.3	7.8	7.9	7.9	7.6	7.6
United States	6.4	5.9	5.0	4.6	4.5	4.6	5.0
Korea	3.3	2.8	2.8	2.8	2.6	2.9	3.4
Other	16.9	15.7	14.7	14.0	14.0	14.4	14.5

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and staff estimates.^{1/} Data prior to October 1990 have been adjusted to include trade figures from the former German Democratic Republic, so as to ensure comparability of these trade figures with those after German reunification.

Table 15. Hong Kong: Structure of Trade with China, 1984-95

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995 Jan.-Sept.
(In billions of Hong Kong dollars)												
Trade with China												
Balance	-16.4	2.2	-22.7	-29.3	-22.7	-49.9	-77.8	-85.6	-80.3	-64.2	-87.1	-70.8
Total exports	39.3	61.2	58.9	88.0	132.9	146.8	158.4	207.7	274.1	337.9	383.8	329.4
Domestic exports	11.3	15.2	18.0	27.9	38.0	43.3	47.5	54.4	62.0	63.4	61.0	47.6
Re-exports (to China)	28.1	46.0	40.9	60.2	94.9	103.5	110.9	153.3	212.1	274.6	322.8	281.8
Total imports	55.8	59.0	81.6	117.4	155.6	196.7	236.1	293.4	354.3	402.2	470.9	400.2
Of which: Re-exports (from China)	28.1	34.6	51.6	84.3	131.5	188.3	240.4	315.7	403.8	474.0	545.8	470.1
(Percent of GDP)												
Trade with China												
Balance	-6.6	0.8	-7.3	-7.6	-5.0	-9.5	-13.3	-12.8	-10.3	-7.1	-8.5	-8.7
Total exports	15.9	22.5	18.8	22.9	29.2	28.0	27.2	31.1	35.2	37.5	37.5	40.3
Domestic exports	4.6	5.6	5.8	7.2	8.4	8.3	8.1	8.1	8.0	7.0	6.0	5.8
Re-exports (to China)	11.3	16.9	13.1	15.6	20.9	19.8	19.0	22.9	27.2	30.5	31.6	34.5
Total imports	22.5	21.7	26.1	30.5	34.2	37.5	40.5	43.9	45.5	44.7	46.0	49.0
Of which: Re-exports (from China)	11.3	12.7	16.5	21.9	28.9	35.9	41.3	47.2	51.8	52.7	53.4	57.6

Sources: Census and Statistics Department, Monthly Digest of Statistics; Revised Estimates of Gross Domestic Product, 1961 to First Quarter, 1994; Quarterly Estimates of Gross Domestic Product, Third Quarter, 1995; and staff estimates.

ANNEX

Consumption Function Estimates for Hong Kong

The consumption equations are based on the rational expectations forward-looking model of consumption as discussed in Hall and Taylor (1993). Forward-looking behavior is captured empirically by constructing a measure of permanent income that depends on expectations of actual future income. The consumption equations also include the real interest rate, which depends on the expected rate of inflation.

Consumption was broken down into durables, nondurables, and services. This disaggregation was chosen because durables are more volatile than services and more sensitive to interest rates. Nondurables tend to lie in between in terms of their volatility and sensitivity.

The general form for the equations is given by

$$CX = a + bCX(-1) + dYP + eRRL,$$

where CX becomes consumer durables CD, consumer nondurables CN, and consumer services CS, and where CX(-1) denotes consumption lagged by one period, YP is permanent income, and RRL is the real interest rate.

The permanent-income variable is defined as

$$YP = Y + 0.9Y(+1).$$

where Y and Y(+1) denote current and next-period real income, respectively. Real GDP is used as a proxy for real income.

The real interest rate variable is defined as the difference between the Best Lending Rate, BLR, and the expected rate of inflation, LP:

$$RRL = BLR - LP.$$

The expected rate of inflation was obtained by fitting the following price equation:

$$\begin{aligned} LP &= f + gLP(-1) + hLW + iLIMP + jT + U, \\ U &= rU(-1) + V, \end{aligned}$$

where LP is the log of the GDP deflator, LW is the log of the real wage index for overall economy, LIMP is the log of the unit value index for

imports, T is a time trend, and U is the first-order autoregressive term. The estimated price equation for the period 1967-94 is shown below: 1/

$$LP = 0.114 + 0.381LP(-1) + 0.216LW + 0.177LIMP + 0.038T, \\ (0.148) \quad (1.385) \quad (1.699) \quad (1.899) \quad (1.723)$$

$$\text{Adj. } R^2 = 0.999, \quad DW = 1.777, \quad F = 837.7$$

The estimated coefficients of the price equation have the expected signs and are statistically significant at the 5 percent test level, except for the coefficient on lagged inflation (which is significant at the 10 percent level) and the constant term. The estimates suggest that changes in the GDP deflator are most sensitive to real wage and import price changes. Compared with similar estimates for the G-7 countries (Taylor (1993)), the wage elasticity and especially the import price elasticity of the aggregate price level are both very high in Hong Kong.

The consumption equations are linear in the levels of the variables and were estimated using the generalized method of moments (GMM) estimator for the period 1969-94. 2/ The details of the estimated consumption equations are presented in Table A-1, and the elasticities associated with the estimated coefficients in Table A-2 below. The elasticities of consumption with respect to lagged consumption and permanent income, and the semi-elasticities of consumption with respect to the interest rate (i.e., the percentage changes in consumption associated with a percentage point change in the real interest rate) were calculated for the 1993 sample points.

All estimated coefficients on real income and real interest rate, and all but one on lagged consumption (in the equation for services), are statistically highly significant. In particular, the real interest rate enters significantly in all equations, confirming the view that consumption in Hong Kong is highly sensitive to real interest rate changes.

1/ Values of t-statistics are shown in parentheses. The estimate for the autocorrelation coefficient r was 0.599 ($t=1.856$). The estimates were obtained by the Cochrane-Orcutt iterative method. The Durbin-Watson statistic of 1.77 indicates the absence of auto-correlation.

2/ The GMM estimator gives consistent estimates of the parameters as well as consistent estimates of the standard errors of the estimates. The instruments used were: $CD(-1)$, $CN(-1)$, or $CS(-1)$, as appropriate; lagged real GDP; lagged interest rate; lagged inflation; and a time trend.

Table A-1. Hong Kong: Estimates of Consumption Equations, 1969-94

Dependent Variable	Constant	Lagged Consumption	Real Income	Real Interest Rate	R ²	DW
Durables	-3,944.81 (-3.86)	0.928 (17.41)	0.013 (4.00)	-470.97 (-2.76)	0.99	1.78
Nondurables	3,640.58 (1.40)	0.782 (5.11)	0.029 (1.81)	-463.10 (-1.87)	0.99	1.55
Services	-3,206.05 (-2.18)	0.142 (0.63)	0.121 (4.01)	572.38 (2.56)	0.99	1.92
Domestic consumption by residents	-1,701.86 (-0.88)	0.743 (6.30)	0.096 (2.78)	-927.11 (-2.31)	0.99	1.45

Source: Staff estimates.

Table A-2. Hong Kong: Consumption Demand Elasticities and Semi-Elasticities, 1969-94

Dependent Variable	Lagged Consumption Elasticity	Real Income Elasticity		Real Interest Rate Semi-Elasticity	
		Short Run	Long Run	Short Run	Long Run
Durables	0.452	0.188	0.343	-0.612	-1.117
Nondurables	0.423	0.189	0.328	-0.275	-0.477
Services	0.118	0.472	0.535	0.317	0.359
Domestic consumption by residents	0.409	0.233	0.394	-0.217	-0.367

Source: Staff estimates.

The interest rate semi-elasticity is highest for durables. The impact is about one-half as large for nondurables, and about a third as large for overall consumption by domestic residents. The long-run semi-elasticity of durables consumption is very high: an increase in real interest rate of 1 percentage point lowers consumption of durables by 1.12 percent after adjustment lags. The positive sign of the interest rate semi-elasticity for services suggests that the substitution effect of interest rate changes is stronger than the income effect. ^{1/} Services also have the highest elasticity with respect to income: a 1 percent increase in real income raises consumption of services by about 1/2 percent.

Compared with the estimates of consumption equations for the G-7 countries presented in Taylor (1993), these results suggest that consumption in Hong Kong is highly sensitive to both real income and real interest rate changes. For example, the highest long-run semi-elasticity of interest rate in the sample studied by Taylor was -0.96 (for France and Japan), compared with -1.12 for Hong Kong. This result probably reflects the fact that, compared with the G-7 countries, in Hong Kong there are few possibilities for smoothing consumption outside the family budget.

References

- Census and Statistics Department, *Estimates of Gross Domestic Product, 1961 to 1964* (Hong Kong: Census and Statistics Department, March 1995).
- Hall, Robert E., and John B. Taylor, *Macroeconomics: Theory, Performance, and Policy*, 4th edition. (New York: Norton, 1993).
- Taylor, John B., *Macroeconomic Policy in a World Economy: From Econometric Design to Practical Operation* (New York: Norton, 1993).

^{1/} In theory, the impact of interest rate changes on consumption is ambiguous, as it depends on the relative strength of the substitution vs. the income effect.