

April 1998

IMF Staff Country Report No. 98/41

People's Republic of China—Hong Kong Special Administrative Region: Recent Economic Developments

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INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA
HONG KONG SPECIAL ADMINISTRATIVE REGION

Recent Economic Developments

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Approved by Asia and Pacific Department

April 13, 1998

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Hong Kong SAR
Basic Data

Area: 1,095 square kilometers
Population (mid-1997): 6.5 million
GDP per capita (1996): US\$24,500

	1992	1993	1994	1995	1996	1997 1/
GDP (HK\$ billions, current prices)	779.3	897.5	1,010.9	1,078.2	1,193.9	1,338.9
Population growth (percent)	1.2	1.9	2.0	2.5	2.4	3.0 2/
Annual percentage changes						
Real GDP	6.3	6.1	5.4	3.9	4.9	5.3
GDP deflator	9.7	8.5	6.9	2.6	5.5	6.5
Hong Kong dollar M3	13.7	25.2	18.4	14.9	18.9	14.0 3/
Budget revenue 4/	16.9	25.5	5.0	2.9	15.8	26.8
Budget expenditure 4/	22.9	29.0	10.6	13.2	-0.2	16.7
Exports of goods	19.8	13.5	10.4	12.0	4.8	5.0
Domestic exports	0.2	-4.5	-2.3	2.0	-8.4	2.0
Re-exports	28.3	19.6	13.8	14.3	7.5	5.6
Imports of goods	22.2	12.7	14.0	13.8	4.3	6.3
Real effective exchange rate	6.3	10.2	1.4	-1.1	6.0	8.5 5/
Ratios to GDP						
Gross domestic investment 6/	28.5	27.6	31.9	34.8	32.3	33.6
Balance of merchandise trade	-4.3	-3.3	-8.4	-14.1	-11.9	-11.8
Balance of goods and nonfactor services	5.3	7.0	1.2	-4.3	-1.7	-2.5
Budget revenue 4/ 7/	17.0	18.6	17.3	16.7	17.5	19.7
Budget expenditure 4/ 7/	14.5	16.3	16.0	17.0	15.3	15.9
Budget balance 4/ 7/	2.5	2.3	1.3	-0.3	2.2	3.8
Balance of payments (US\$ billions) 8/						
Exports of goods	119.5	135.2	151.4	173.7	180.7	186.6
Domestic exports	30.2	28.8	28.7	29.9	27.4	27.4
Re-exports	89.2	106.4	122.7	143.8	153.3	159.2
Exports of nonfactor services	24.9	27.9	31.1	34.3	37.3	38.6
Imports of goods	123.8	139.1	162.3	193.3	199.1	207.1
Imports of nonfactor services	14.8	15.9	18.6	20.8	21.6	22.5
Balance on goods and nonfactor services	5.4	8.2	1.6	-6.0	-2.6	-4.3

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

1/ Staff projections.

2/ Mid-1997 over mid-1996.

3/ October 1997 (year-on-year).

4/ Fiscal year begins April 1.

5/ January-October 1997 (average of 12-month changes).

6/ Gross domestic fixed capital formation and change in stocks.

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

8/ National accounts basis.

I. INTRODUCTION¹

1. The principal political event of 1997 in Hong Kong was the historic transfer of sovereignty from the United Kingdom to China and the establishment of the Hong Kong Special Administrative Region on July 1. The transition was remarkably smooth, and the economy performed strongly both in the run up to and after July 1. However, beginning in mid-1997, the regional crisis began to erode confidence in Hong Kong's exchange rate and prompted a series of speculative attacks. Pressures on the exchange rate have led to sharply higher interest rates, weakened domestic demand, and clouded growth prospects for 1998. Against this background, this review of recent economic developments focuses on the revival in economic activity since mid-1996, the expansion in the first half of 1997, and the sharp swings in financial markets during the summer and autumn of 1997. While the recent events will likely slow growth in 1998, Hong Kong's medium-term outlook remains promising. With its economy based on efficient producer service industries and high value-added manufacturing, flexible factor markets, and a stable and transparent policy framework, Hong Kong is uniquely positioned to benefit from the vast growth potential of mainland China, and to continue to play a leading role in facilitating economic and financial integration in the region.

2. Chapter II provides an update on the transition issues since the transfer of sovereignty on July 1, 1997. Cyclical developments and trends in domestic and external demand, the labor market, and the property market are analyzed in Chapter III. Chapter IV reviews the recent budgetary trends and social policy initiatives, and analyzes the longer-term fiscal implications of an aging society. Monetary and exchange rate developments, bank performance, and institutional developments in the financial sector are reviewed in Chapter V. Chapter VI concludes with an analysis of competitiveness, economic integration with China, and industrial policies. *Data reported in this paper are based on the information that was available as of the end of December 1997.*

¹The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood in 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.

II. TRANSFER OF SOVEREIGNTY²

3. On July 1, 1997, Hong Kong became a Special Administrative Region (SAR) of the People's Republic of China after 155 years of British colonial rule. The transfer of sovereignty, which had been prepared by British and Chinese diplomats since 1982, was accomplished smoothly and successfully. The new government of the Hong Kong SAR continues to pursue free-market policies and administers Hong Kong with a high degree of autonomy (Box 1). The first Chief Executive of the Hong Kong SAR reappointed all 23 principal officials of the previous government to serve in the first government of the Hong Kong SAR.

4. Continuity in the civil service and the judiciary, which has been critical for achieving a smooth transition, has also been maintained. As provided for in the Basic Law, the existing legal and judicial system will also be maintained. The first election of the Hong Kong SAR Legislative Council will be held on May 24, 1998, under arrangements outlined in the Basic Law and elaborated in the Legislative Council Ordinance enacted in October 1997.³

5. The constitutional arrangements laid out in the Basic Law provide for a high degree of autonomy of the Hong Kong SAR in conducting its external economic affairs. The SAR thus remained an independent party in the WTO, the APEC forum, and the Asian Development Bank. Contacts between SAR authorities and the Mainland authorities are coordinated by the Hong Kong-Macao Affairs Office at the State Council. The Hong Kong and Mainland Cross-Boundary Major Infrastructure Committee was set up in October 1997 to consider and coordinate major infrastructure projects straddling the Mainland and Hong Kong. Meanwhile, the Hong Kong SAR Government continues to negotiate and conclude bilateral agreements with foreign countries in the areas of air services, overflight, and reciprocal juridical assistance, in accordance with the relevant provisions of the Basic Law.

²This chapter was prepared by Dubravko Mihaljek.

³The 60-member Legislative Council will be made up of 20 seats to be returned from five geographical constituencies through direct elections, 30 seats from 28 functional constituencies, and 10 seats from the 800-member Election Committee, whose members for the most part will be returned through an election in early April 1998.

Box 1. The Policy Framework in Hong Kong¹

Monetary Policy Framework

The Hong Kong dollar has been linked to the U.S. dollar at a fixed rate of HK\$7.8 to US\$1 since 1983, under a currency board-type arrangement. This arrangement has continued following the transfer of sovereignty. The Basic Law—which provides the constitutional basis for the SAR—requires that the Hong Kong dollar be fully backed by a 100 percent reserve fund (foreign reserves are roughly five times the amount of notes and coins in circulation). The Basic Law also provides for Hong Kong's monetary independence. The Hong Kong Monetary Authority (HKMA) acts as the SAR's central bank, and is responsible for implementing monetary policy and administering the exchange rate system. It also acts as the supervisor and regulator of the banking system. There are no reserve requirements or system of deposit insurance.

While the linked exchange rate system resembles a currency board arrangement, the HKMA can affect domestic monetary conditions through the sale and purchase of foreign currencies, shifts in government deposits between commercial banks and the Exchange Fund, open market operations, and the extension of credit through the Liquidity Adjustment Facility. These tools are used sparingly to smooth unwarranted volatility in interbank interest rates, and such smoothing is considered very much a secondary objective to the primary task of preserving the exchange rate link.

Fiscal Policy

Historically, fiscal policy in Hong Kong has aimed at keeping government small and fostering a flexible and competitive private sector. Counter-cyclical fiscal policy has not been pursued, and the budget has focused on maintaining a simple and stable tax system with low tax rates, keeping current

expenditure in line with GDP growth, providing funding for key infrastructure projects, and maintaining an adequate level of fiscal reserves. As a result, the budget was in deficit only once during the past 15 years. The Basic Law provides for independent fiscal policies in the SAR; the financial resources of the SAR are not to be transferred to the Central People's Government, and the Central People's Government is not to levy taxes in the SAR. Article 107 of the Basic Law also provides for a continuation of the previous revenue and expenditure policies. In particular, the Law requires that the SAR's budgets be prepared on the principle that expenditures be kept within the limits of revenue, that spending growth should be kept in line with GDP growth, and that taxes should be kept low.

Exchange Fund, Fiscal Reserves, and the Land Fund

Foreign currency assets of the Exchange Fund, which is managed by the HKMA, totaled US\$79 billion at the end of November 1997. These reserves include the SAR's fiscal reserves, which comprise the accumulated fiscal surpluses of previous years (roughly 14½ percent of GDP at end-FY1996). The HKMA also manages, under a separate portfolio, the SAR Government Land Fund (the sum of half the net revenue from land transactions between 1986 and mid-1997).² Total assets of the Land Fund amounted to about 14¾ percent of GDP at July 1, 1997, of which about two-thirds (US\$15 billion) were foreign currency assets.

¹For a more detailed discussion see Chapter IV in Dodsworth and Mihaljek (1997).

²All land in the Hong Kong SAR is state property, and is provided to the private sector by means of auctions of long-term, transferrable leases; tender; and private treaty grants.

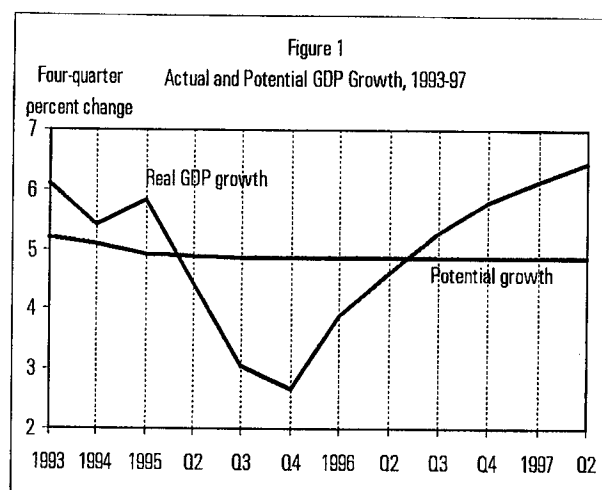
III. DEVELOPMENTS IN THE REAL AND EXTERNAL SECTORS⁴

A. Recovery in 1996

6. Following a period of below-trend growth and sharp adjustments in asset and factor markets, Hong Kong's economy began gradually to recover during 1996 and 1997.

Real GDP growth increased steadily from under 3 percent in late 1995, to over 6 percent in late 1996 and early 1997 (Figure 1, Table 1, and Appendix Tables 1-3). The recovery was led by private consumption and gross fixed investment, while the external sector contributed mainly through a slowdown in import growth in 1996, as import-intensive public infrastructure projects neared completion (see tabulation below).

Exports grew sluggishly, and the balance on goods and nonfactor services trade stayed negative throughout the recovery. However, inflation declined from around 8½ percent in 1994-95 to 6 percent in 1996-97.



Contributions to GDP Growth				
	1994	1995	1996	1997 January-June
	(In percent per annum)			
Real GDP growth	5.4	3.9	4.9	6.3
Total domestic demand	11.3	7.2	3.5	9.3
<i>Of which:</i>				
Private consumption	4.0	1.0	2.9	4.2
Gross fixed investment	4.3	3.1	3.9	6.1
Stockbuilding	2.6	2.8	-3.6	-1.3
External sector	-5.9	-3.3	1.4	-3.1

7. An early impetus to the recovery came from a revival in **asset markets**. Reflecting the global trend, share values in Hong Kong rose by a quarter in 1995, and by another third during 1996 (Figure 2). In the residential property market, where prices had fallen by up to 20 percent between mid-1994 and end-1995, sentiment shifted in early 1996, when

⁴This chapter was prepared by Dubravko Mihaljek.

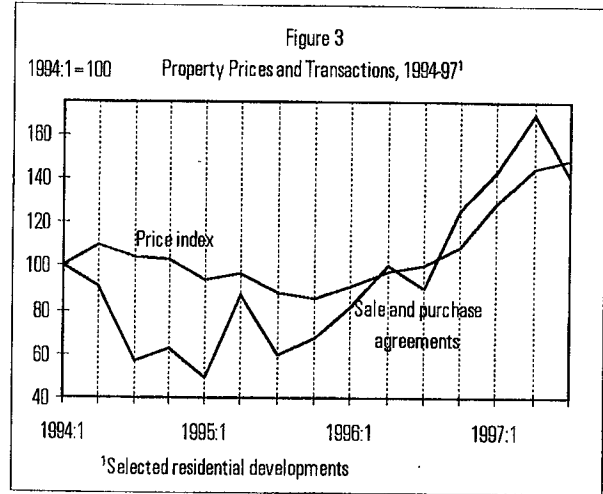
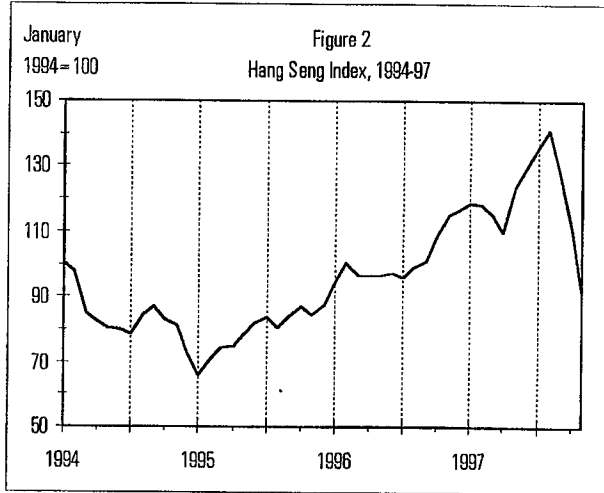
Table 1. Hong Kong SAR: Gross Domestic Product by Expenditure Component
at Constant (1990) Market Prices, 1992-97

	1992	1993	1994	1995	1996	<u>1997</u> Jan.-June 1/
(In billions of Hong Kong dollars)						
Consumption	439.3	469.6	499.6	509.2	533.3	276.8
Private	386.5	415.6	443.6	450.7	472.3	244.9
Government	52.8	53.9	56.1	58.5	61.1	31.9
Gross fixed capital formation	183.5	190.3	220.2	243.0	272.7	153.8
Private	163.3	162.2	187.3	203.7	227.2	131.4
Government	20.1	28.1	32.9	39.2	45.5	22.4
Final domestic demand	622.8	659.8	719.8	752.1	806.0	430.6
Private	549.9	577.8	630.9	654.4	699.5	376.3
Government	72.9	82.0	88.9	97.8	106.5	54.3
Change in stocks	8.5	2.2	20.1	40.1	12.9	8.2
Total domestic demand	631.2	662.0	739.9	792.2	818.9	438.8
Net exports of goods, nonfactor services	19.1	28.2	-12.4	-36.2	-25.7	-38.5
Gross domestic product	650.3	690.2	727.5	756.0	793.2	400.3
(Percentage change)						
Consumption	8.3	6.9	6.4	1.9	4.7	6.6
Private	7.7	7.5	6.7	1.6	4.8	6.8
Government	13.2	2.2	3.9	4.4	4.3	5.3
Gross fixed capital formation	9.2	3.7	15.7	10.4	12.2	17.5
Private	9.7	-0.7	15.5	8.8	11.5	21.5
Government	5.2	39.3	17.1	19.4	15.9	-1.4
Final domestic demand	8.6	5.9	9.1	4.5	7.2	10.3
Private	8.3	5.1	9.2	3.7	6.9	11.5
Government	10.9	12.4	8.4	9.9	9.0	2.4
Total domestic demand	9.2	4.9	11.8	7.1	3.4	8.7
Exports of goods and nonfactor services	18.3	12.7	9.8	11.0	4.9	4.9
Export of goods	19.8	13.5	10.4	12.0	4.8	5.2
Domestic exports	0.2	-4.5	-2.3	2.0	-8.4	-1.9
Reexports	28.3	19.6	13.8	14.3	7.5	6.4
Exports of nonfactor services	10.6	8.0	6.5	4.8	5.8	3.3
Imports of goods and nonfactor services	20.8	12.0	13.5	12.7	4.1	6.3
Import of goods	22.2	12.7	14.0	13.8	4.3	6.7
Import of nonfactor services	9.7	5.8	8.8	2.0	1.9	2.1
Gross domestic product	6.3	6.1	5.4	3.9	4.9	6.3
Memorandum items:						
Contribution to growth:						
From total domestic demand	8.7	4.7	11.3	7.2	3.5	9.3
Of which: From change in stocks	0.7	-1.0	2.6	2.8	-3.6	-1.3
From net exports of goods and nonfactor services	-2.5	1.4	-5.9	-3.3	1.4	-3.1

Sources: Census and Statistics Department, *Quarterly Report of GDP Estimates, Second Quarter 1997*.

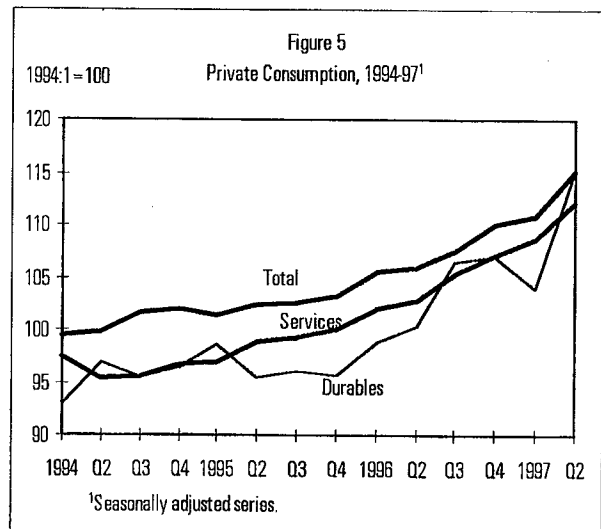
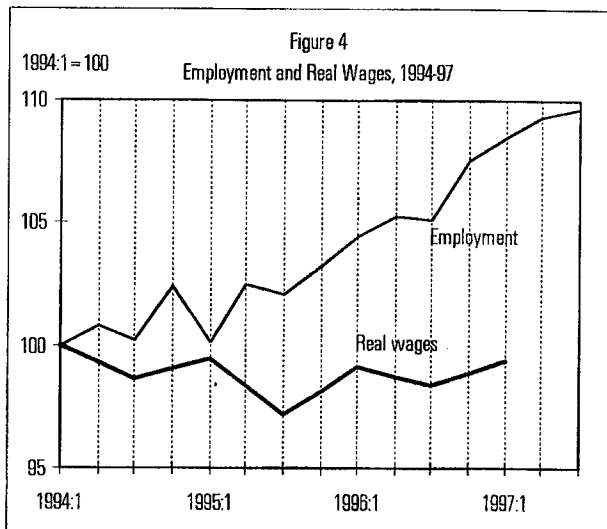
1/ Percentage changes calculated over January-June 1996.

Hong Kong banks, after a reduction in U.S. interest rates, lowered their lending rates amidst intensifying competition in the mortgage market. In response, property transactions accelerated sharply and prices began to rise rapidly (Figure 3).



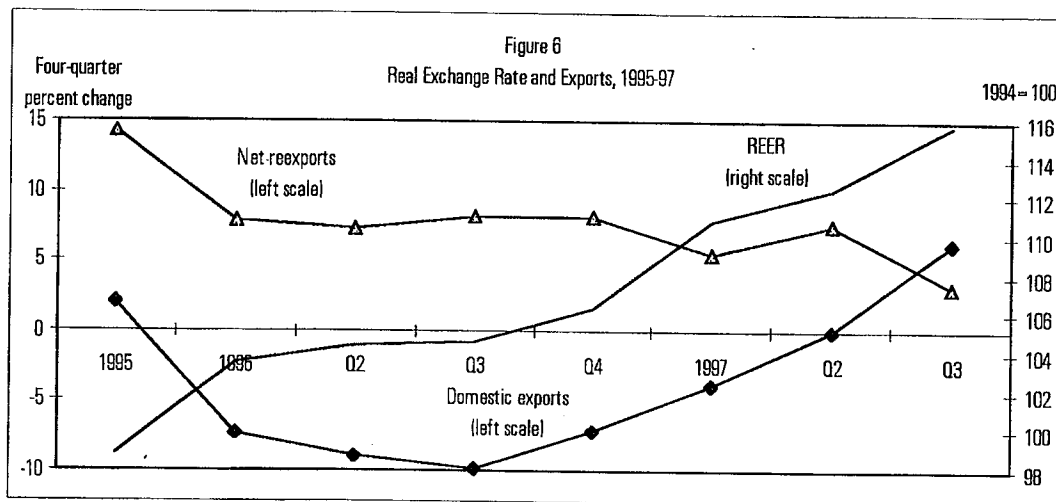
8. In the labor market, lower real wages and the revival in construction and retail trade raised the demand for labor and employment in the second half of 1996 (Figure 4). The improved outlook in the job market, in turn, strengthened consumer confidence and boosted private consumption (Figure 5). Private investment also resumed growth at a brisk pace. The completion of major works on the airport project freed up construction capacity, including for residential construction, which rebounded in response to the property market rally (Appendix Table 4).

9. Inflationary pressures receded in 1996 as the Hong Kong dollar, along with the U.S. dollar, strengthened in nominal effective terms, and as wage growth remained moderate and rents eased. In addition, lower inflation in China, resulting from successful implementation of



adjustment measures and a relatively good harvest, helped alleviate pressure from food prices. The rate of CPI(A) inflation for 1996 as a whole was 6 percent, compared with 8¾ percent in 1995 (Appendix Table 5).

10. Unlike domestic demand, **export sector** performance was slack during 1996. From mid-1995 to end-1996, the real effective exchange rate of the Hong Kong dollar appreciated by 12½ percent in line with the stronger U.S. dollar. This coincided with a weakening of external demand, which in 1996 affected most Asian economies, including China. As Hong Kong's own export performance in a large measure depends—through reexports and outprocessing activities in the mainland—on China's exports and regional trade developments, the impact on Hong Kong's exports was almost immediate; growth in reexports was halved to 7½ percent for the year as a whole, while domestic exports fell by over 8 percent (Figure 6 and Table 2).⁵ However, retained imports also slowed significantly in 1996, reflecting an adjustment to the large inventory buildup in 1995 and tapering off of import demand for airport construction, while non-retained imports slowed in line with a deceleration in reexports (Figure 7). As a result, the balance on goods and nonfactor services improved by 2½ percent of GDP during 1996 to a deficit of 1¾ percent of GDP (Table 3).



⁵The staff's econometric estimates suggest that a 1 percent increase in the real exchange rate leads to a ½ percent fall in export volume, whereas a 1 percent rise in the import volumes of trading partners generates an almost equivalent increase in export volume (see Appendix I in Dodsworth and Mihaljek (1997)).

Table 2. Hong Kong SAR: Foreign Trade Developments, 1991-97

(Percentage changes)

	1991	1992	1993	1994	1995	1996	1997 Jan.-Sep. 1/
Total exports							
Value	19.7	20.8	13.1	11.9	14.9	4.0	3.1
Unit value	2.6	0.9	-0.4	1.5	3.3	-0.4	-1.6
Volume	17.3	19.8	13.5	10.4	12.0	4.8	5.0
Domestic exports							
Value	2.3	1.3	-4.8	-0.4	4.4	-8.5	-1.2
Unit value	1.9	1.0	0.3	1.6	2.4	0.3	-2.2
Volume	0.5	0.2	-4.5	-2.3	1.9	-8.4	0.9
Re-exports							
Value	29.2	29.2	19.1	15.2	17.3	6.6	3.9
Unit value	2.2	0.8	-0.6	1.5	3.5	-0.5	-1.5
Volume	26.5	28.3	19.6	13.8	14.3	7.5	5.7
Imports							
Value	21.2	22.6	12.2	16.7	19.2	3.0	5.0
Unit value	1.9	0.2	-0.6	2.8	5.0	-1.3	-2.2
Volume	19.0	22.2	12.8	14.0	13.7	4.3	6.9
Terms of trade	0.7	0.7	0.2	-1.3	-1.6	1.0	0.6
Exports of nonfactor services 2/							
Value	13.2	17.5	13.8	11.6	10.4	8.6	5.3
Unit Value	8.2	6.2	5.4	4.8	5.3	2.7	1.9
Volume	4.7	10.6	8.0	6.5	4.8	5.8	3.3
Imports of nonfactor services 2/							
Value	15.0	13.3	7.7	17.1	11.5	3.9	4.4
Unit Value	3.3	3.3	1.7	7.7	9.4	1.9	2.2
Volume	11.3	9.7	5.8	8.8	2.0	1.9	2.1

Sources: Census and Statistics Department, *Hong Kong Monthly Digest of Statistics*, and *Quarterly Report of GDP Estimates, Second Quarter 1997*; and Financial Services Bureau, *Third Quarter Economic Report 1997*.

1/ Average of 12-month percentage changes.

2/ Data for 1997 are for the first half of 1997 over first half of 1996.

Table 3. Hong Kong SAR: External Balances, 1993-97

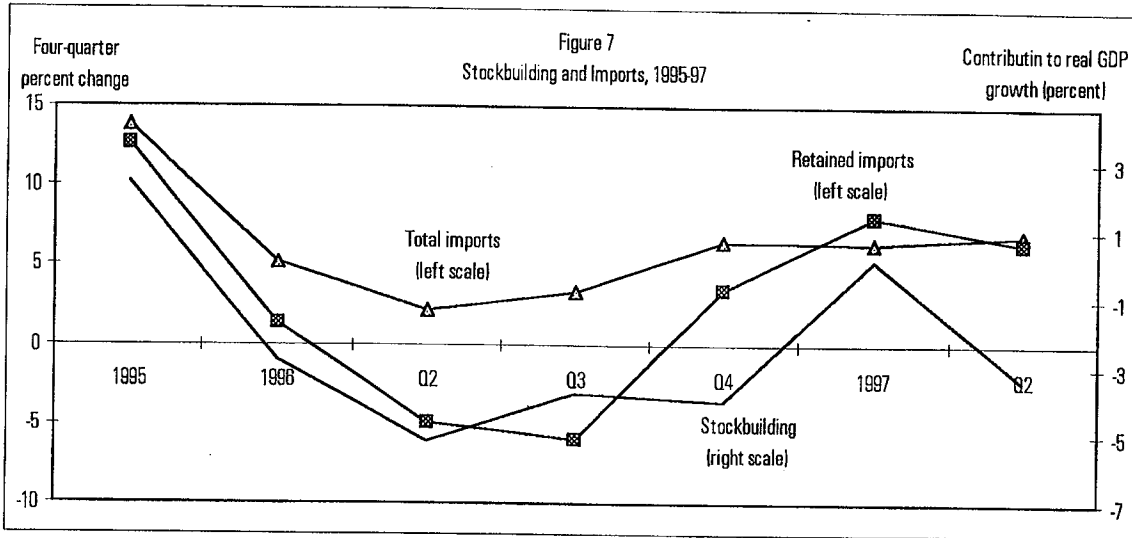
	1993	1994	1995	1996	1997		
					Staff Proj.	Jan.-June	July-Oct.
Merchandise trade balance							
In billions of U.S. dollars	-3.8	-10.9	-19.6	-18.4	-20.5	-12.7	-5.3
Net domestic exports 1/	-22.9	-30.9	-42.7	-44.3	-47.4	-25.3	...
Net reexports 2/	19.1	20.0	23.1	26.0	26.9	12.6	...
In percent of GDP	-3.3	-8.4	-14.1	-11.9	-11.8	-7.8	...
Services trade balance							
In billions of U.S. dollars	12.0	12.5	13.6	15.7	16.1	7.7	...
In percent of GDP	10.3	9.6	9.7	10.2	9.3	4.7	...
Balance on goods and nonfactor services trade							
In billions of U.S. dollars	8.2	1.6	-6.0	-2.6	-4.3	-5.0	...
In percent of GDP	7.0	1.2	-4.3	-1.7	-2.5	-3.0	...
Net external factor income flows							
In billions of U.S. dollars	1.3	0.9	1.9	...	...	...	...
Inflows	40.9	48.0	50.1	...	...	...	...
Outflows	39.6	47.1	48.2	...	...	...	...
In percent of GDP	1.2	0.7	1.3	...	...	...	...
Inflows	35.3	36.7	35.9	...	...	...	...
Outflows	34.1	36.0	34.6	...	...	...	...
Net current transfers (US\$ billion) 3/	-0.8	-1.0	...	...	...	...	...
Current account balance							
In billions of U.S. dollars	8.7	1.5	-4.1	...	...	...	...
In percent of GDP	7.5	1.1	-3.0	...	...	...	...

Sources: Census and Statistics Department, *Hong Kong Annual Digest of Statistics; Estimates of Gross Domestic Product, 1961 to 1996*; and *Quarterly Report of GDP Estimates, Second Quarter, 1996*; Ma and Hawkins (1997). and staff estimates and projections.

1/ Domestic exports less retained imports.

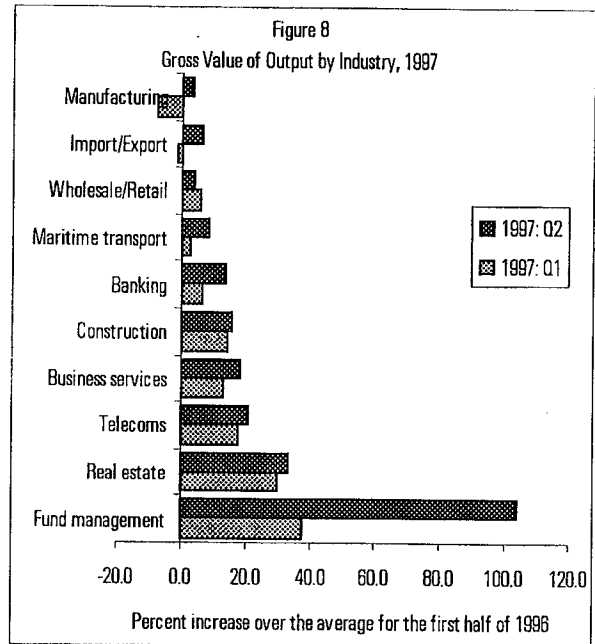
2/ Reexports less nonretained imports.

3/ Estimates provided by the HKMA in Ma and Hawkins (1997).

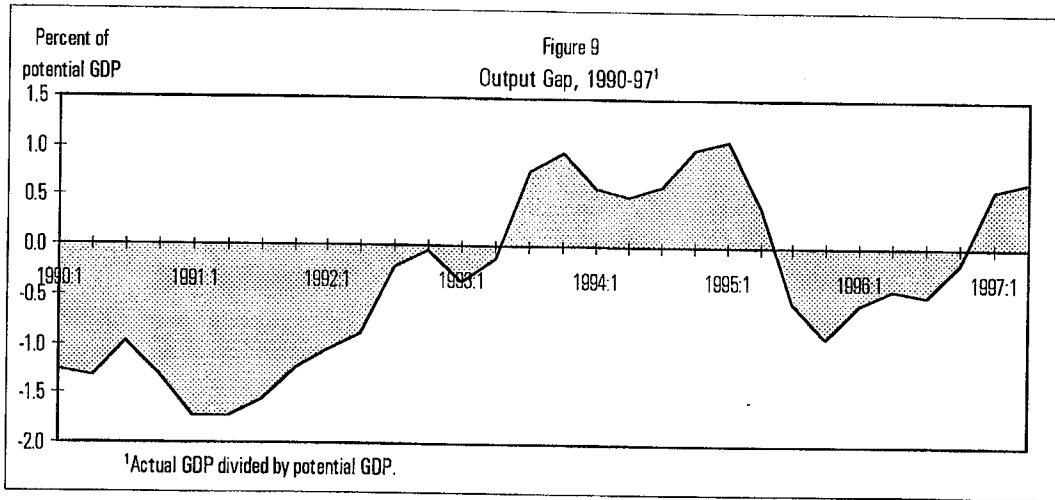


B. Expansion in the First Half of 1997

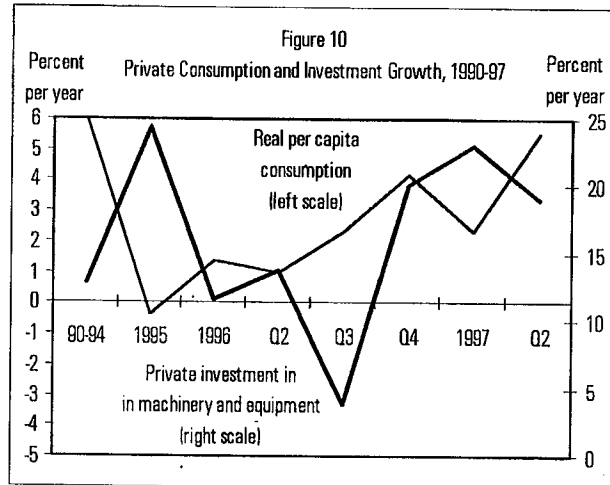
11. The recovery that was set in motion in 1996 gained momentum during the first half of 1997. **Output** expanded across a broad range of industries, especially in fund management, real estate, telecommunications, and construction (Figure 8). On the demand side, private investment and consumption accelerated noticeably, while inventories began to decumulate (Table 1). Export performance remained sluggish, and the crisis in Southeast Asia began to affect Hong Kong's tourism receipts in the second quarter. Overall, real GDP rose by 6 1/4 percent (year-on-year) in the first half of 1997, and is estimated to have exceeded potential output by 3/4 percent in the second quarter (Figure 9).⁶ **Inflation** remained in check, however, as import prices fell and wages rose moderately.



⁶Potential output was estimated by applying a Hodrick-Prescott filter to quarterly, seasonally adjusted GDP data.



12. Unlike the upturn in 1991–93, which was fueled by negative real interest rates, the revival in **domestic demand** through the first half of 1997 seems to have rested on more solid ground. Steady progress in resolving the remaining transition issues and encouraging macroeconomic trends in the mainland boosted consumer and investor confidence regarding the medium-term outlook, and allowed ongoing adjustments to pent-up consumer and investor demand to continue. Thus, growth in real per capita consumption returned to a more normal pace since mid-1996 (Figure 10). Likewise, after a two-year lull, in mid-1996 service establishments began to rebuild their stocks of office equipment and other machinery in anticipation of future expansion, as well as in an effort to stay competitive.



13. The broad-based pickup in activity accelerated the growth rate of **employment** to 4 percent in 1997 (average for the first three quarters), and lowered the unemployment rate to 2¼ percent (Appendix Table 6), just above the estimated non-accelerating-inflation rate of unemployment (NAIRU) of about 2 percent. As the labor market tightened, employers began offering more attractive salary packages. Thus, payroll per person engaged rose by 4½ percent (year-on-year) in real terms in the second quarter of 1997.

14. Despite the closing of the output gap and the boom in asset markets, pressures on **consumer prices** were contained in 1997, largely as a result of favorable developments in

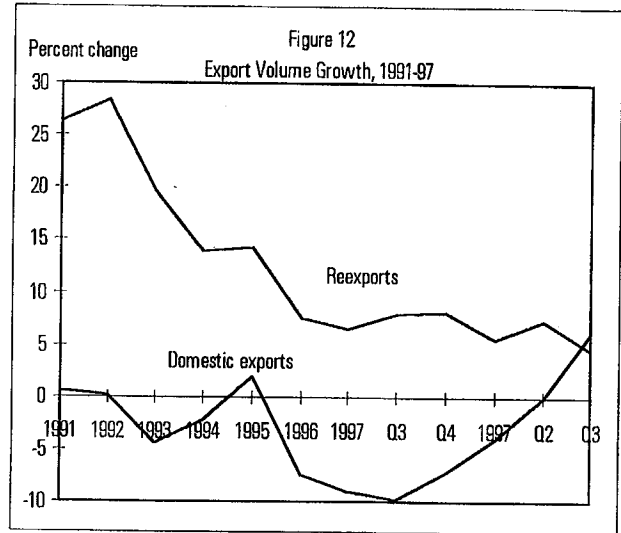
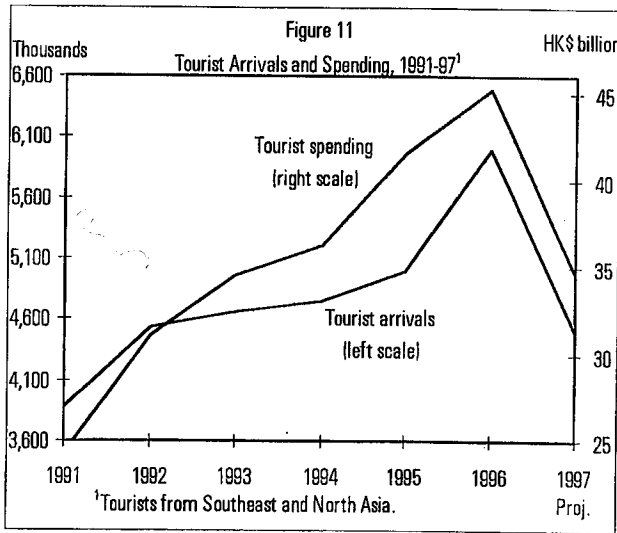
imported inflation and basic wages. As was the case in 1996, import prices declined in 1997 owing to the strong U.S. dollar, soft world commodity prices, and lower food prices and inflation in the mainland. Likewise, basic wage rates rose moderately (Appendix Table 7), although, as noted above, earnings per worker began to grow rapidly in the second quarter.⁷ However, property price inflation spilled over into the rental market and pushed the housing component of the CPI inflation rate to over 9 percent (year-on-year average for the first three quarters of the year). Nonetheless, consumer prices rose on the whole by 6 percent in 1997 (average for January–October), the same as in 1996 (Appendix Table 5). Meanwhile, the GDP deflator rose by 6½ percent over the first half of 1997, compared with a 5½ percent increase in 1996. The faster increase in the GDP deflator in 1997 reflected a combination of two factors: a smaller improvement in the terms of trade (export prices fell faster than in 1996 in response to regional currency devaluations (Table 2)); and a negative contribution of net exports to real GDP growth in the first half of 1997.

C. Developments in the Summer and Autumn of 1997

15. During the summer of 1997, the crisis in Southeast Asia began to affect the Hong Kong economy. First to feel the impact was the tourism sector. The total number of visitor arrivals fell in the third quarter by 27 percent over a year earlier (Figure 11), and the hotel room occupancy rate sank to 65 percent from an average of close to 90 percent.⁸ The reexport industry was also affected by the crisis, with reexport value growing by just 4¼ percent in the third quarter of 1997 over a year earlier, compared with growth rates of 20–30 percent in the early 1990s (Figure 12).

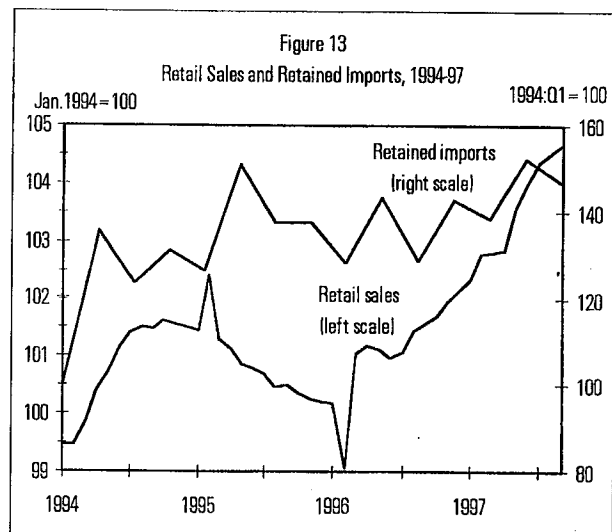
⁷Basic wage rates are usually adjusted semi-annually, so they tend to be a lagging indicator of the labor market. By contrast, bonuses and overtime allowances are adjusted more frequently, so the index of payroll per worker, which includes such receipts, provides a better indication of labor market conditions than the wage index.

⁸Problems in the tourism industry partly were of domestic origin; hotel rates were raised significantly in the expectation of inelastic demand for the handover events and the Annual Meetings of the IMF and the World Bank. Also, the Hong Kong press uncovered relatively widespread practice of two-tier pricing, aimed mainly at Japanese tourists, which may have contributed to a sharp fall in the number of Japanese tourists.



16. In the **stock market**, share prices peaked in early August, with the Hang Seng Index setting an all-time high of 16,673 on August 7. However, from mid-August onward, the market fell sharply, along with the stock markets in East Asia and amidst concerns about speculative attacks on the Hong Kong dollar. On October 28, following a currency attack that was fended off by a sharp rise in interest rates, the Hang Seng Index fell to 8,775, its lowest level for two-and-a-half years. The property market rally also lost momentum during the summer, as market participants awaited the announcement of the new administration's housing and land policies (see Section E).

17. **Growth in the third quarter** started to slow, and according to preliminary estimates, real GDP expanded by about 5 percent over a year earlier. Economic performance appears to have been affected mainly by the further slackening in exports of services and continued moderate growth in reexports, while consumer demand and investment spending remained on an uptrend. In particular, retail sales rose by 3 percent, and retained imports by 14 percent in the third quarter over a year earlier (Figure 13). Unexpectedly, domestic exports also revived in the third quarter, with export volume growing by 6¼ percent over a year earlier (Figure 12).



D. Macroeconomic Impact of Financial Market Turbulence

18. The severity of the currency and stock market turmoil that beset Hong Kong in late October caught most market participants by surprise. Further uncertainties for the outlook emerged in November and December, when the crisis in Korea intensified and signs of severe economic slowdown surfaced in Japan. The recent volatility of financial markets makes it exceedingly difficult to assess short-term macroeconomic prospects. Nonetheless, the likely persistence of higher interest rates, the fall in asset values, and general economic instability and contraction of trade within the region will likely slow growth in Hong Kong in 1998. The following describes how the components of domestic demand and the external balance are likely to be affected by higher interest rates and the outlook for regional slowdown.

- **Household consumption** (especially durable goods purchases) will likely be the first to respond to the rise in lending rates and the wealth effects of lower asset values. The staff's econometric estimates indicate that a one percentage point increase in real interest rates lowers consumption growth by about one-quarter of a percentage point in the short run, and close to half a percentage point within a year.⁹ The impact of wealth effects is difficult to estimate in the absence of the household balance sheet data, but anecdotal evidence from the 1994 downturn suggests that lower stock prices exert an immediate and strong effect on purchases of durable goods and nonessential services.
- The outlook for **investment** growth depends critically on overall investor sentiment.¹⁰ Projects already in the pipeline for the most part include residential and infrastructure construction, and are unlikely to be delayed given the underlying shortage of housing and the need to upgrade Hong Kong's transportation systems. Investment in machinery and equipment depends on the movements in the price of capital goods relative to labor, as well as the interest rate. The staff's econometric estimates indicate that a one percentage point increase in real interest rates lowers the real growth rate of gross fixed capital formation by about 0.4 percentage point, but with a lag of three quarters. The higher cost of financing capital goods purchases may thus be offset by the much faster trend decline in the price of capital goods relative to labor (see tabulation below). Meanwhile the completion of the Airport Core Program would help slow sector investment in 1998.

⁹See Appendix I in Dodsworth and Mihaljek (1997) for consumption function estimates.

¹⁰Private investment in Hong Kong traditionally is financed from retained earnings, as close to 90 percent of establishments are small (less than 100 employees) family-controlled companies. Larger companies, such as property developers, typically finance their investment projects through equity rather than debt issues.

Relative Price of Capital Goods With Respect to Labor 1/				
	1994	1995	1996	1997 Jan.-Sept.
	(Annual percentage change)			
Overall economy	-7.4	6.2	-5.4	-10.4
Manufacturing	-6.6	8.3	-5.7	-11.0
Services 2/	-6.5	5.1	-6.9	-10.2

1/ Derived from changes in the price of imported capital goods and changes in nominal wages.
2/ Financing, insurance, real estate, and business services.

- The regional crisis would likely have a negative effect on **domestic exports**, since Southeast Asian countries account for about 6 percent of Hong Kong's export market and Japan, Korea, and Taiwan Province of China for a further 11 percent (see tabulation below). There would be a further effect on Hong Kong's domestic exports by way of competition in third markets. However, this impact would be limited, as Hong Kong's merchandise exports are fairly diversified, and in only a few cases compete in third markets with exports of affected countries— Hong Kong's main export items include fashion clothes and accessories, electrical machinery and appliances, office equipment parts, travel accessories, watches and clocks, printed matter, and jewelry.

Share in Hong Kong's Trade, 1996		
	Exports	Imports
	(In percent of total trade)	
Southeast Asia	6.4	10.4
Indonesia	0.6	0.8
Malaysia	0.9	2.2
Philippines	1.2	0.5
Singapore	2.8	5.3
Thailand	1.0	1.6
North Asia	10.6	26.4
Japan	6.5	13.6
Korea	1.6	4.8
Taiwan P.O.C.	2.4	8.1
Total	17.0	36.7

- Since most of Hong Kong's **reexports** are of mainland origin or are destined to the mainland of China, a possible loss of the mainland's competitiveness vis-à-vis the Asian economies would imply potentially large losses for Hong Kong's reexport industry, which generates around 13 percent of GDP. However, these risks are

partially offset by the fact that the mainland's product mix, with its large share of relatively low-value-added consumer goods (including items subject to international quotas), does not compete directly in third markets with exports from affected countries. Recent cost surveys also indicate that, despite currency devaluations, labor costs in China remain below those in Southeast Asia.

- There would also be losses in **factor income receipts** from investments in the mainland if the overall growth in China slowed as a result of the regional crisis. However, the net impact on Hong Kong is unclear, as the factor income outflows from the SAR to the mainland, which amounted to HK\$29 billion (2½ percent of GDP) in 1995, are about 8 percent larger than the factor income inflows from the mainland.
- Spending by tourists from Southeast and North Asia represents roughly half of total **tourism receipts** (3¾ percent of GDP). Based on the data for the first half of 1997, the marked slowdown and currency depreciations within the region could reduce Hong Kong's tourism receipts by up to 1¼ percent of GDP (see tabulation below).¹¹ Exports of **transportation and financial services** also are exposed to the regional slowdown, but the risks to these industries are difficult to quantify in the absence of data on the direction of services trade.

Tourism Indicators				
	1995	1996	1997 1/	1990-96 Average
Tourist arrivals (million)	10.2	11.7	10.6	...
Southeast Asia	1.3	1.4	1.4	...
North Asia	3.8	4.6	3.3	...
Share in total (percent)	49.7	51.7	43.9	52.2
Spending by tourists (HK\$ billion)	72.9	82.5	77.5	...
Southeast Asia	9.1	10.0	10.2	...
North Asia	31.4	34.3	24.4	...
Share in total (percent)	55.6	53.8	44.7	58.7
Share in GDP (percent)	3.8	3.7	2.6	3.7

1/ Estimated on the basis of the data for January-September (tourist arrivals) and January-June (tourist spending).

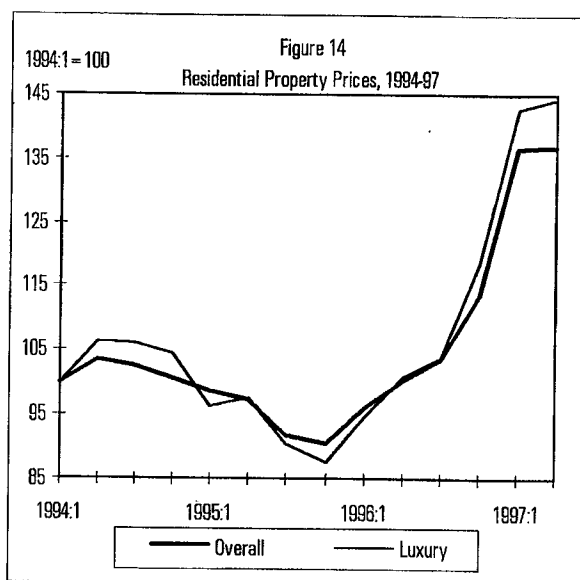
¹¹This estimate includes the imported content of tourist spending, which is likely to be high.

E. The Property Market, Public Housing, and Land Policy

Developments in the property market during 1996–97

19. Hong Kong's property market experienced a downturn from early 1994 to end-1995. By the end of 1995, residential property prices had fallen by 20 percent, and prices of office property by 25 percent, on average, from their peak levels recorded in April 1994. By late 1995, rental rates for prime office space had fallen to a level that was comparable to rates in Singapore. The decline in property prices, which was partly prompted by the government's anti-speculative measures and rising interest rates, quickly spilled over into the construction and real estate sectors, which account for a large share of GDP. This contributed to a slowing of overall growth from the second half of 1994 through the first half of 1996.

20. Sentiment in the residential property market shifted in early 1996, when labor market conditions began to improve and Hong Kong banks reduced their mortgage rates.¹² Reflecting the short supply of housing, prices rebounded sharply, rising by a third on average between mid-1996 and mid-1997 (Figure 14 and Appendix Table 10). In late 1996, concerns grew that price gains were being driven by speculative activities, particularly for luxury properties, and the government, in cooperation with property developers, took measures in early 1997 to curb speculation. In particular, the government announced in March 1997 that it would substantially increase the supply of land for housing development over the next five years, and further restrict activity in the forward market for apartments. Prices stabilized briefly following this announcement, but accelerated again in the run up to the handover.



21. The new SAR government has placed housing at the top of its policy agenda. The Chief Executive unveiled in October 1997 a ten-year housing plan that would increase substantially the supply of affordable housing and raise the home ownership rate to 70 percent from 52 percent at present (see details below). Residential property prices steadied in the third quarter, as market participants anticipated measures to ease supply constraints. The market briefly revived in October, following the announcement of the housing plan, but sentiment

¹²The average markup for mortgage rates declined from the previously customary level of 175 basis points above the Best Lending Rate to 50–75 basis points in February 1996. This decline helped to offset the impact of higher real interest rates, which rose in 1996 owing to declining inflation.

worsened following the October speculative attack on the Hong Kong dollar, and the resulting rise in short-term interest rates. By end-December, apartment prices reportedly had dropped by 10–20 percent from their mid-year peaks.

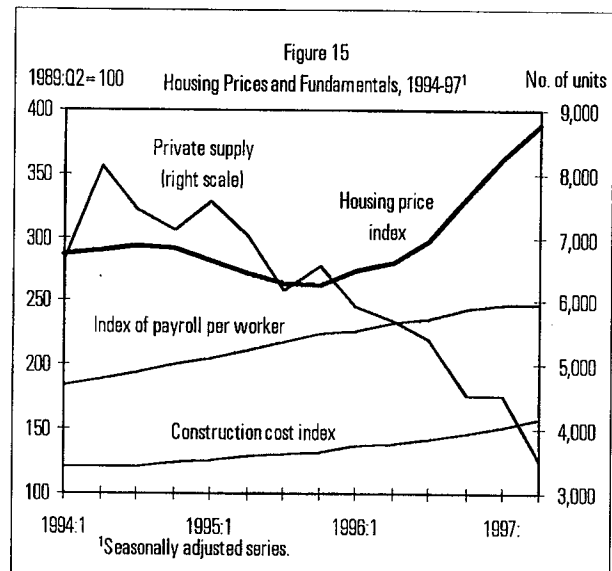
22. In other sectors of the property market, prices during 1996–97 were less volatile. Reflecting an improving supply situation, office prices remained about 7 percent below their peak 1994 levels, despite substantial gains during the first half of the year (Appendix Table 10). Prices of retail premises rebounded more strongly, as retail sales rose sharply and the supply of shopping space remained limited. Prices of industrial space remained depressed, reflecting continued relocation of manufacturing facilities to southern China and elsewhere in the region. The rental market mirrored these developments. Housing rents rose at double-digit rates during the first half of 1997 after falling slightly in 1996; rents for shopping space rose moderately; while rents for office and industrial space continued to fall in 1997.

An analysis of property price inflation

23. The rapid increase in property prices over 1996–97 raised concerns of a possible property bubble. However, residential property prices moved broadly in line with fundamentals. In particular, housing production in both the private and public sectors lagged behind the increase in the number of households over the past two years (see Lui (1997)). Only 7,000 private apartments were completed in the first half of 1997 (17,000 units in 1996), compared with an average of 30,000 units per year during 1991–95.

24. Meanwhile, population expanded by 3 percent a year in 1996–97, compared with the 1½ percent annual growth in 1991–95. Also, the 32 percent increase in residential property prices since the previous peak in the second quarter of 1994 has been in line with the increase in nominal payroll per person (which rose by 55 percent over the same period), and the cost of construction (which rose by 28 percent) (Figure 15).

25. Nonetheless, private sector analysis indicates that, in late 1996 and early 1997, apartment prices drifted above an “equilibrium” level that would be consistent with movements in key economic variables (Mushkat and Leong (1997)). Although the gap between actual prices and that level was not as wide as during the previous property market booms, the recent cooling off of demand pressures and plans to raise the housing supply are expected to align housing prices closer to their long-run equilibrium level.



26. The impact of a decline in residential property prices on the financial position of property companies would be moderated by a number of factors. The ratio of net debt to average shareholders' funds for 12 listed property companies was around 25 percent in late October 1997. Most property companies also had a solid interest cover (net debt times the interest rate, compared with rental income net of expenses) due to high rental income and low amounts of debt, and their capital cover (the market value of rental property compared with the amount of shareholders' funds) was considered by market analysts to be sufficiently high to withstand a relatively steep drop in property prices.¹³

Housing policy

27. Hong Kong's government operates an extensive public housing program, which covers almost half the population (about 3 million people). The program was started in 1954 in response to an acute housing crisis that developed after World War II.¹⁴ In the early 1980s, public housing policy shifted from massive production to construction of better-quality housing. Housing production in the public sector nevertheless continued to exceed that in the private sector, and by the end of 1996 the total housing stock of 2 million units included 660,000 public rental units and over 230,000 subsidized housing units. A number of concerns about the allocative efficiency and equity of the program have been expressed over the years, including the long waiting periods for public housing (about six and a half years on average), the large number of public housing tenants with sufficient means to move to private housing, and the growing number of families with incomes above cut-offs for public housing but unable to afford mortgages for private housing.

28. The new SAR administration has made a determined effort to limit the growth of public rental housing and increase the share of housing for sale on subsidized terms. Broad elements of this policy were first presented in a review of the long-term housing strategy (Housing Branch (1997)), and were subsequently articulated by the Chief Executive of the Hong Kong SAR (Tung (1997a) and (1997b)), who made three specific commitments: (i) to ensure the delivery of not less than 85,000 apartments a year starting from FY1999; (ii) to raise the home ownership rate from 52 percent in 1997 to 70 percent in 2007; and (iii) to reduce the waiting time for public rental housing to three years by the year 2005 (Box 2).

29. The target supply of not less than 85,000 apartments was determined on the basis of long-term housing demand projections. The authorities expected that roughly 35,000 flats

¹³Rental property in Hong Kong is revalued each year in companies' books, so property valuations are not considered to be unrealistically high by market analysts.

¹⁴For a review of the public housing program, see Dodsworth and Mihaljek (1997), Chapter IV.

Box 2: New Public Housing Policy and Home Ownership

The Chief Executive of the Hong Kong SAR pledged in his inaugural speech on July 1 and his October Policy Address to develop policies that would help achieve a home ownership rate of 70 percent in ten years and halve the average waiting time for public rental housing to three years. The authorities emphasized home ownership as a social objective, as this goal is believed to reflect cultural values and aspirations of large segments of the Hong Kong society (Tung (1997a)).¹

Several methods would be utilized to realize the 70 percent home ownership target:

- Selling 250,000 public rental apartments over the next ten years;
- Offering those on the waiting list the choice between buying, at significant discount, a new public housing unit and renting an old, refurbished unit;
- Expanding the existing home ownership schemes for lower and middle-income groups;
- Launching a new housing loan scheme targeted at first-time home buyers; and
- Facilitating operations of the newly established Mortgage Corporation.

It is expected that the scheme to sell off public rental housing will involve establishing parameters including the replacement cost, discounts, and resale restrictions. The replacement cost would be based on the historical cost of construction adjusted for appreciation of property values. Discounts would depend on location, age of property, and facilities on the premises. The Housing Authority, a public corporation which owns the bulk of the public rental housing stock, would provide maintenance and structural guarantees. Reselling units would be allowed after two years to other public housing tenants or to those on the waiting list for public housing, and after five years on the open market; in addition, special credits (up to 60 percent of the sale price) would be given for property buyouts in the first two years of the scheme. Market analysts expect that these provisions would result in substantial discounts over the market price of comparable apartments.²

After resale in the open market, the value of land that is imputed in the free-market price of property would be required to be repaid to the government.³ Thus, for example, if someone had bought an apartment for HK\$400,000 from the Housing Authority and sold it for HK\$1 million, the seller would have to pay the government the imputed value of land premium, which would be assessed on the basis of the discount given on the market price at the time of the original purchase.⁴

A number of approaches would also be utilized to reduce the waiting time for public rental housing from the current average of six and a half years to three years by 2005, including:

- Raising the number of apartments allocated to those on the waiting list from an average of 14,000 a year to 20,000 a year;
- Reducing significantly the number of people on the waiting list through clearance of temporary housing and squatter areas;
- Applying stricter eligibility criteria for public housing through a more rigorous means test, including an asset test, at the time of allocation of housing.⁵ In the future, "wealthy" tenants would be encouraged to buy apartments under the home ownership schemes.⁶

¹In the private sector, about 16 percent of households live in rented apartments. In the public sector, there has been growing interest to participate in home ownership schemes rather than rent in recent years.

²For example, apartments smaller than 40 square meters, which comprise 37 percent of Hong Kong's housing stock, are expected to sell for HK\$156,000 to HK\$252,000 if they are bought in the first year; the price of comparable apartments in the open market ranges from HK\$800,000 to HK\$2 million (US\$103,000 to US\$258,000).

³Public housing is built on land provided by the government at "cost of production," which is normally only a fraction of the land premium paid by private property developers and passed onto the property owners.

⁴It has been argued that such policy was necessary on fairness grounds—a public housing tenant would have been given another subsidy if allowed to resell his or her property at profit which included the land premium. Many observers have advocated, however, steep discounts on the imputed value of land, arguing that the government should get out of public housing at any cost (Wong and Stanley (1992), (Wong (1997))).

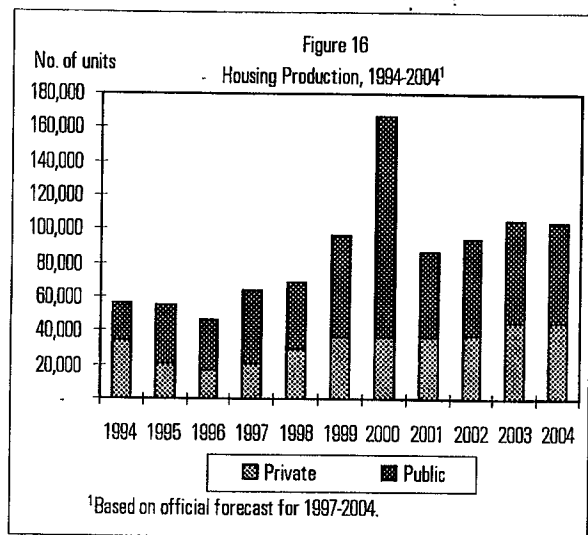
⁵The authorities estimate that only half of the 150,000 people currently on the waiting list are eligible for public housing. Presently, tenants are required to declare assets after ten years of tenancy and every two years thereafter.

⁶Currently, well-off tenants have to pay double rent after ten years of tenancy (rents for public housing estates are estimated at about one-third of market rent). In addition, since April 1977, tenants whose income and asset value exceed a certain level have been required to pay market rent.

would be delivered by the private sector, and the rest by the public sector. The split was determined on the basis of current eligibility criteria for public housing and was not considered a formal target; a portion of the newly supplied public housing would be privatized—those on the waiting list would be given the choice to buy or rent apartments in the future—and subsidized housing would be built mainly for sale instead of rent in the future.

30. To ensure better quality of housing units, appropriate sites will be disposed off to private developers. Upon completion of development, at least 30 percent of the units shall be handed over to the government for sale to eligible buyers. On the administrative side, a high-level Steering Committee on Land Supply for Housing, chaired by the Financial Secretary, was established in 1997 in order to streamline bureaucratic procedures and ensure faster delivery of housing.

31. The plan to accelerate housing construction to not less than 85,000 units a year beginning in 1999 would almost double the average annual housing output realized over 1994–97 (Figure 16). In order to meet the substantial increase in labor demand that this plan will require, the government has proposed to launch a Construction Labor Importation Scheme in March 1998, which could run for several years, subject to annual review. The scheme would be similar in operation to the Special Labor Importation Scheme for the new airport and related projects.¹⁵ The authorities estimated the net labor requirement to rise from near balance in 1997–98 to 9,500 in 1998–99, and to 21,800 in 2000–01.



Land policy

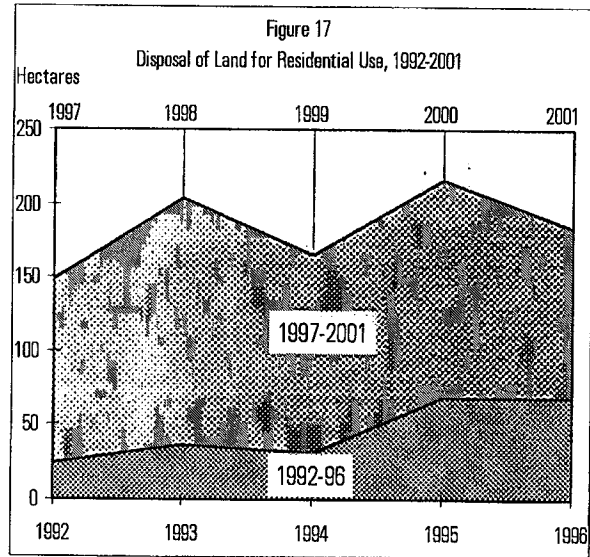
32. The transfer of sovereignty on July 1, 1997, also marked the transfer of ownership of all land in the Hong Kong SAR from the British Crown to the Government of the People's Republic of China. As in the past, the SAR government would continue to administer and manage land in Hong Kong by granting leases through public auction, tender, and private treaty grant.¹⁶ Another significant change for land policy since the handover is that the annual 50-hectare limit on land disposal, which was provided for in the Joint Declaration, was no longer applicable. As a result, the SAR government would again be in a position to control the

¹⁵For a review of labor importation schemes, see IMF (1997a).

¹⁶The standard lease term would be 50 years. In the past, some sites were granted on 75-year leases or 999-year leases. For a review of the land market, see Chapters IV and VI in Dodsworth and Mihaljek (1997).

supply of new land for development and, hence, could affect the market price through timing and size of land releases.

33. Because of limited land supply, difficult terrain, and the locational preferences of the population and businesses, land policy has played a key role in Hong Kong's property market. However, because of constraints imposed by the Joint Declaration, land disposal programs could only be formulated on an annual basis during the past 12 years. Realizing the importance of ensuring a steady supply of land for development, the authorities elaborated in July 1997 their first five-year land disposal program. As part of the program, details of land sales for the next two fiscal years were announced, and the types and amounts of land to be disposed of over the following three fiscal years were outlined. The program envisages a significant increase in the supply of land for housing development (to a total of 690 hectares) over the next five years, which would be sufficient to meet the ambitious housing production targets described above (Figure 17).



34. Market participants have welcomed the new land disposal program, as it is expected to help reduce uncertainty over the supply of land in the medium run. Despite the recent downturn in the property market, prices achieved in land auctions during fall of 1997 were generally higher than expected. As property companies typically acquire land long before developing the sites in order to build up strategic "land banks," the intensive bidding in land auctions indicated their confidence in the longer-term outlook for the property market.

IV. PUBLIC FINANCE⁹

A. Overview

35. Fiscal policy in Hong Kong historically has followed a noninterventionist approach, aimed at maintaining a small and efficient government and fostering private sector development. Following the transfer of sovereignty in July 1997, fiscal policy in Hong Kong SAR has been guided by the Basic Law.¹⁰ Article 107 of the Law states that “the Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits, and keep the budget commensurate with the growth rate of its gross domestic product.” The basic approach to taxation has been to derive revenue from a limited number of sources and to maintain low tax rates with a flat profile. Total government revenue in FY 1996 was equal to 17½ percent of GDP. Government spending as a share of GDP also has been kept low—about 15¼ percent of GDP in FY 1996—the lowest among industrial countries (Chart 1). A major reason for the low share of public expenditure in GDP is the absence of high spending on social welfare and defense. However, public expenditure on administration, education, and health also is fairly low, while spending on housing, community affairs, and economic services (such as transportation) is comparable to that in the OECD countries.

36. The Budget is comprised of a General Revenue Account (GRA) and five Consolidated Account Funds (CAF). The GRA records, on the revenue side, all current and a small portion of capital receipts to be credited to any of the eleven revenue heads, and, on the expenditure side, all current operational expenses of government departments together with minor capital purchases of a routine nature. The Consolidated Account Funds serve primarily to finance capital investments and expenditure. These funds derive income through transfers from the GRA and from a limited number of earmarked sources, such as land premia and dividends on government equity investments.

B. Recent Budgetary Developments

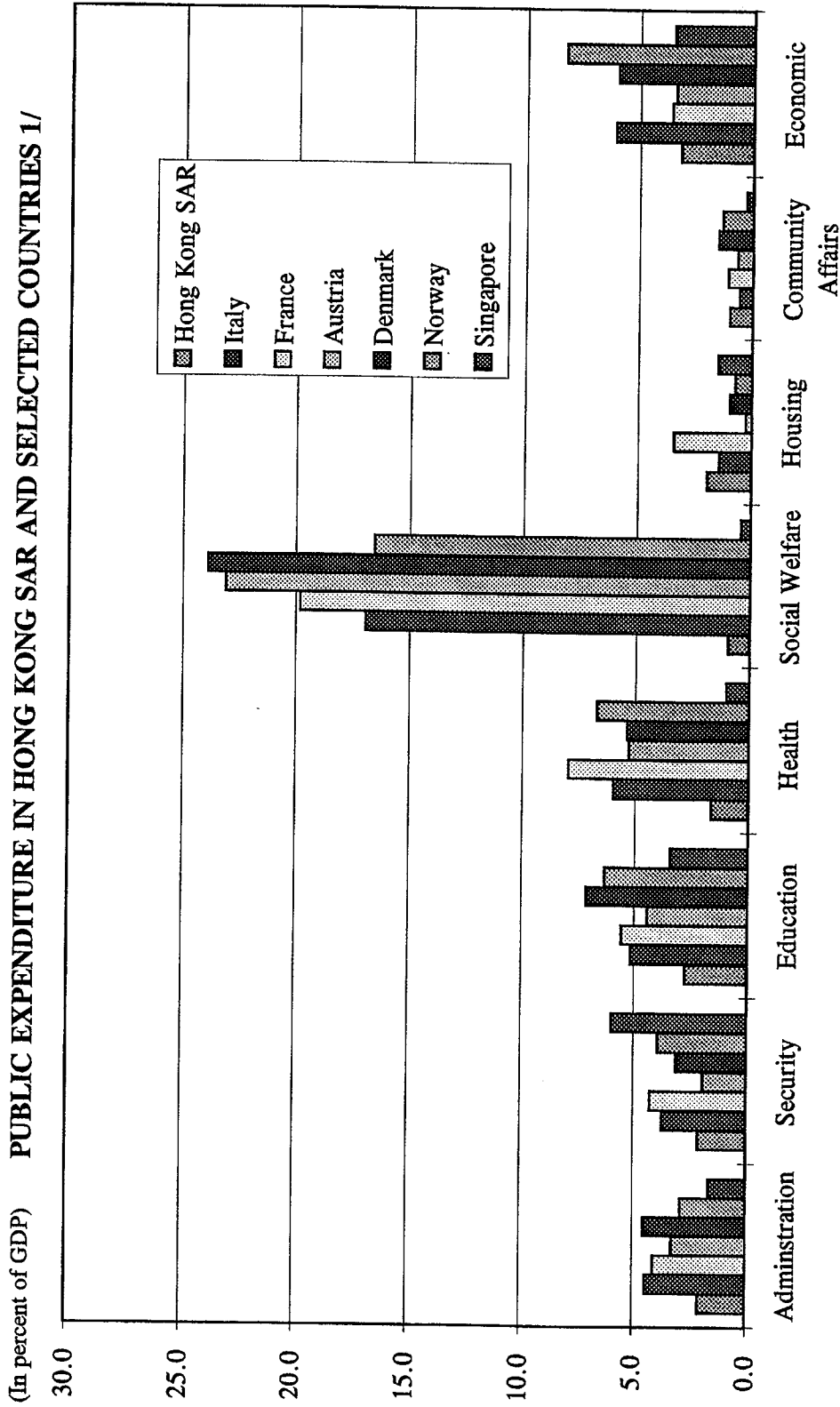
The FY 1996 Budget outturn and the FY 1997 Budget

37. FY 1996 budgetary performance was considerably stronger than expected, roughly equally due to better-than-expected revenues and lower outlays. The fiscal surplus was HK\$25.7 billion (2¼ percent of GDP), compared with the HK\$1.6 billion surplus projected in the FY 1996 Budget (Chart 2, Table 4, and Appendix Tables 11, 12, and 13). Expenditures

⁹This chapter was prepared by Valerie Cerra.

¹⁰For a description of constitutional arrangements, the budgetary process, and financial control, see IMF (1997b) and Chapters IV and VI in Dodsworth and Mihaljek (1997).

CHART 1
 HONG KONG SAR
 PUBLIC EXPENDITURE IN HONG KONG SAR AND SELECTED COUNTRIES 1/

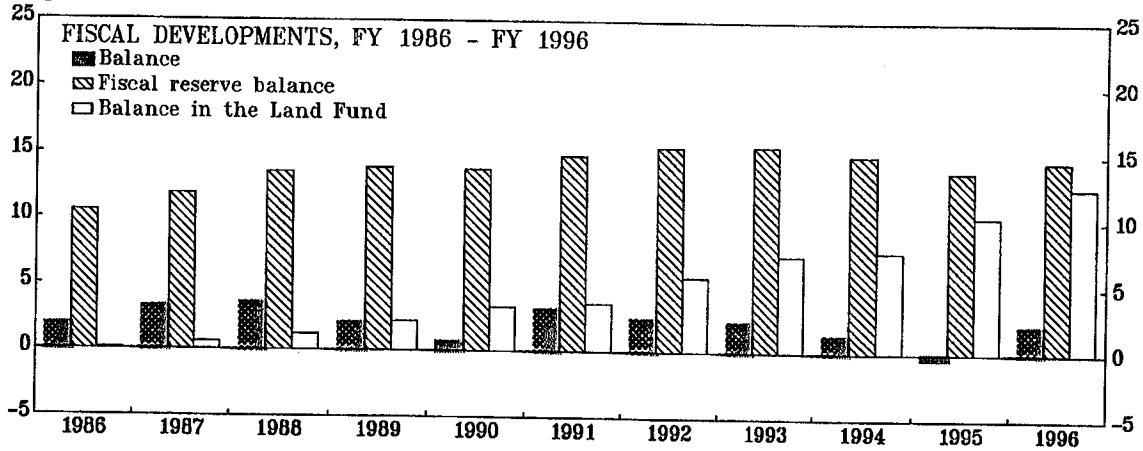


Sources: *National Accounts, Detailed Tables, Volume II, 1983-1995* (OECD 1997); data provided by the Government Secretariat, Finance Bureau (Hong Kong SAR); and the *Government Budget* (Singapore).

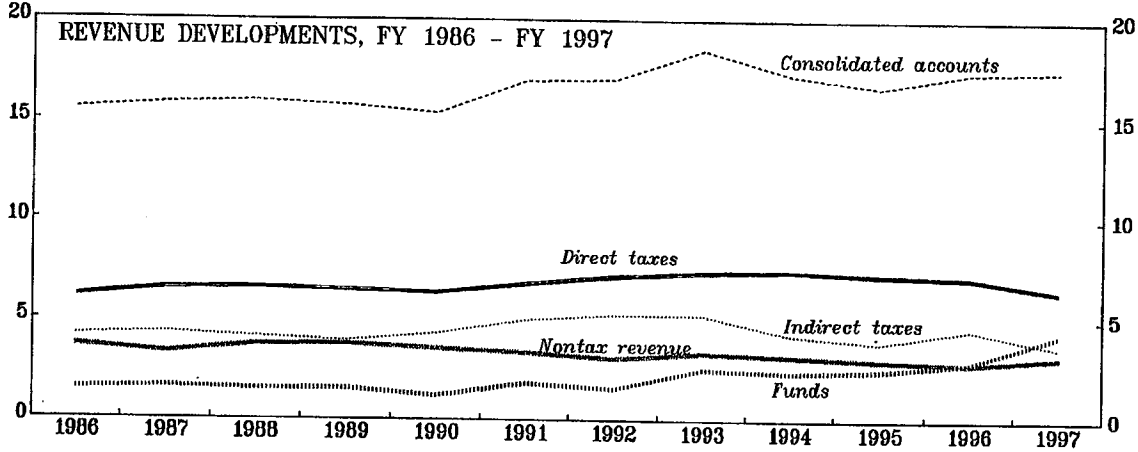
1/ Average shares in GDP for the period covered. Period coverage is (1985-1995) for Denmark, Hong Kong SAR, and Italy; (1985-1994) for Austria; (1985-1993) for France; (1985-91) for Norway; and (1988-1993) for Singapore.

CHART 2
HONG KONG SAR
FISCAL DEVELOPMENTS, FY 1986 - FY 1997

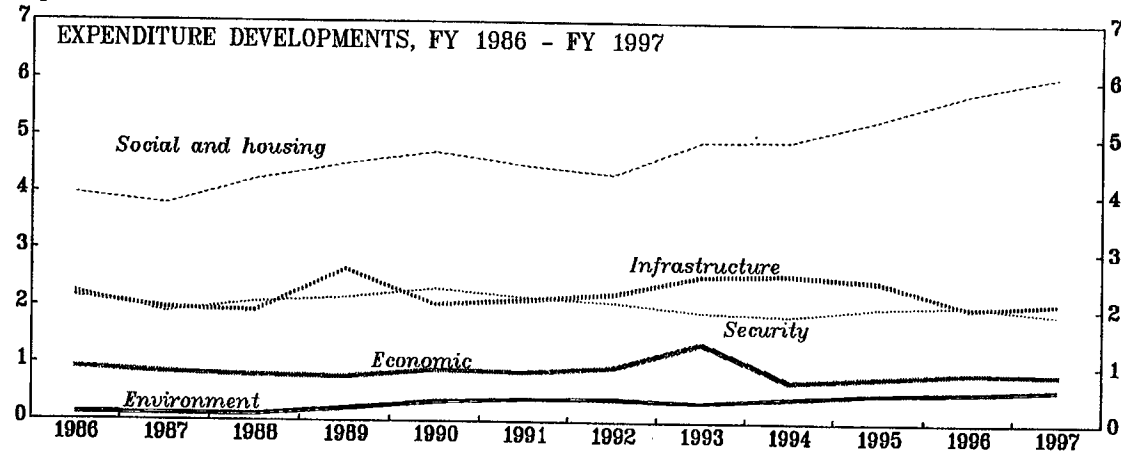
In percent of GDP



In percent of GDP



In percent of GDP



Sources: Data provided by the Government Secretariat, Finance Bureau.

Table 4. Hong Kong SAR: Consolidated Government Account, FY 1993–FY 1997 1/

	1993/94	1994/95	1995/96	1996/97		1997/98	
				Budget	Actual	Budget	Staff Proj.
(In billions of Hong Kong dollars)							
General Revenue Account							
Revenue	143.9	151.1	153.2	162.6	173.9	177.9	183.9
Expenditure	98.5	108.2	123.3	142.1	138.5	159.4	164.4
Current	93.2	106.0	120.3	137.9	134.7	154.4	159.4
Capital	5.3	2.2	3.0	4.2	3.8	5.0	5.0
Surplus before transfers	45.4	42.9	29.9	20.5	35.4	18.5	19.5
Transfers to funds	22.5	39.1	32.5	15.1	13.4	4.3	...
Balance after transfers	22.9	3.8	-2.6	5.4	22.0	14.2	...
Consolidated Account Funds 2/							
Revenue 3/	22.7	23.9	26.8	33.1	34.5	56.9	80.4
Capital expenditure 4/	47.7	53.6	59.8	52.0	44.2	43.7	48.9
Surplus before transfers	-25.0	-29.7	-33.0	-18.9	-9.7	13.2	31.5
Transfers from General Revenue Account	22.5	39.1	32.5	15.1	13.4	4.3	...
Balance after transfers	-2.5	9.4	-0.5	-3.8	3.7	17.5	...
Total Consolidated Account							
Revenue	166.6	175.0	180.0	195.7	208.4	234.8	264.3
Expenditure	146.2	161.8	183.1	194.1	182.7	203.1	213.3
Current	93.2	106.0	120.3	137.9	134.7	154.4	159.4
Capital	53.0	55.8	62.8	56.2	48.0	48.7	54.9
Surplus (+)/Deficit (-)	20.4	13.2	-3.1	1.6	25.7	31.7	51.0
Fiscal reserves balance, end of fiscal year 5/	140.2	151.0	147.9	150.2	173.6	194.7	224.6
(In percent of GDP)							
Total Consolidated Account							
Revenue	18.6	17.3	16.7	15.5	17.5	17.3	19.7
Expenditure	16.3	16.0	17.0	15.3	15.3	15.0	15.9
Current	10.4	10.5	11.2	10.9	11.3	11.4	11.9
Capital	5.9	5.5	5.8	4.4	4.0	3.6	4.0
Surplus (+)/Deficit (-)	2.3	1.3	-0.3	0.1	2.2	2.3	3.8
Fiscal reserves balance, end of fiscal year 5/	15.6	14.9	13.7	11.9	14.5	14.4	16.8
(Percentage change)							
Total Consolidated Account							
Revenue	25.5	5.0	2.9	8.7	15.8	12.7	26.8
Expenditure	29.0	10.6	13.2	6.0	-0.2	11.2	16.7
Current	14.2	13.7	13.5	14.6	12.0	14.6	18.3
Capital	67.2	5.3	12.5	-10.5	-23.6	1.5	12.3
Fiscal reserves balance, end of fiscal year 5/	15.9	7.7	-2.1	1.5	17.4	12.2	29.4

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

1/ The fiscal year begins April 1.

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

3/ Includes revenue from land sales.

4/ Includes direct financing of airport-related projects as well as Government equity injections into the Airport Authority and the Mass Transit Railway Corporation.

5/ Excluding the Land Fund.

reached HK\$183 billion (15¼ percent of GDP), about HK\$11 billion below the budget projection; the underspending reflected lower outlays on public works projects by the Capital Works Reserves Fund and across the board underspending on recurrent expenditure from the General Revenue Account. Revenues rose sharply to HK\$208 billion (17½ percent of GDP), almost HK\$13 billion above the budget projection. The better-than-expected revenue performance partly was due to a surge in stamp duty receipts from the buoyant stock and property markets, and partly to higher-than-anticipated revenues from the earnings and profits tax.

38. The Budget for FY 1997 was unusual in that it straddled the transfer to Chinese sovereignty. Accordingly, the Budget contained no major policy initiatives and was aimed at continuing Hong Kong's traditionally prudent and rules-based fiscal policies. The fiscal surplus for FY 1997 was projected to be HK\$32 billion (2¼ percent of GDP), an increase of HK\$6 billion relative to the FY 1996 outturn. Revenue and expenditure were both projected to fall by ¼ percentage point of GDP, to 17¼ percent of GDP and 15 percent of GDP, respectively.

39. In the event, the fiscal outturn in the first half of FY 1997 (April–September 1997) was considerably stronger than would have been expected on the basis of the Budget. In particular, stamp duty collections and land-related revenue increased sharply owing to the effect of higher asset prices and the increased volume of land sales. Overall, the results for the first half of the fiscal year suggest that the surplus could be as high as 3¾ percent of GDP.

Fiscal reserves and the Land Fund

40. The Land Fund of the Hong Kong Special Administrative Region (HKSAR) was established in 1986 under the terms of the Joint Declaration, and was managed on behalf of the government by an independent board of trustees prior to the handover.¹¹ The assets of the Land Fund, which amounted to HK\$197 billion as of June 30, 1997, were transferred to the SAR government on July 1, 1997. Fiscal reserves stemming from accumulated fiscal surpluses stood at HK\$174 billion as of March 31, 1997, so that the transfer of the Land Fund more than doubled the size of total reserves. Beginning on July 1, 1997, the budget also began to retain the full proceeds of land sales, and as a new source of revenue, the income from the extension of land leases in the New Territories and New Kowloon.¹² Fiscal reserves and the balance in the Land Fund have grown at annualized rates of 18 percent and 51 percent, respectively, from FY 1986–FY 1996 (Chart 2). The fiscal reserve balance is projected to

¹¹Until June 30, 1997, about half of all proceeds of land sales were credited to the Land Fund, and the other half were credited to a capital account of the Budget earmarked for capital projects.

¹²Provisions in the Basic Law relating to the extension of land leases are described in Chapters IV and VI in Dodsworth and Mihaljek (1997).

increase to HK\$225 billion by the end of FY 1997, excluding balances in the Land Fund which are projected to reach HK\$205 billion.

Infrastructure projects

41. The Airport Core Program (ACP) is the largest public infrastructure project in Hong Kong, and one of the largest in the world. The program includes a large new airport on the Chek Lap Kok Island and nine related projects providing urban infrastructure services to the airport.¹³ The latest estimate of the cost of the ACP is HK\$155.3 billion. Two-thirds of the cost (HK\$110 billion) is being met by the government in the form of direct funding of works on nine projects, and through equity injections into the Airport Authority (AA) and the Mass Transit Railway Corporation (MTRC). The remaining one-third of the cost came from the private sector, i.e., through borrowing by the AA and the MTRC in the domestic and international capital markets, and private sector investment in key service franchises at the airport. The Western Harbour Crossing was a wholly privately financed project. An additional investment totaling HK\$4.9 billion will be required for constructing a second runway and associated facilities. Of this amount, HK\$4.3 billion will be funded by the Airport Authority for the runway and passenger concourse, and HK\$602 million by the government for supporting air traffic control and meteorological facilities. Eight of the ten core projects have been completed on time and within budget. The ACP transport corridor, comprised of five road projects, linking Hong Kong Island with a new town near the airport on Lantau Island, was opened to traffic in May 1997. The new airport and the Airport Railway are on course to meet the respective completion dates in April and June 1998, and the airport is scheduled to open for regular traffic in early July 1998.

42. Other important infrastructure projects in the transportation sector include the expansion of Hong Kong's container handling capacity and construction of new railway and subway lines. Construction on Container Terminal Nine (CT9) is expected to commence during 1998, with the first berth becoming operational in 2000. CT9 will be privately financed. The government has also announced a Railway Development Strategy to construct additional railway, and has recommended three projects for high priority implementation. The Kowloon-Canton Railway Corporation and the MTRC will respectively undertake the construction and operation of Phase I of the West Rail (WR) and the Tseung Kwan O Extension (TKE).¹⁴ The costs for the two projects are currently estimated at HK\$64 billion and HK\$31 billion, respectively. The government has planned to inject equity of HK\$29 billion for implementa-

¹³These include: railway and highway links between the airport, Kowloon, and Hong Kong Island; a new town for 20,000 people near the airport; two large suspension bridges; a third harbor tunnel; and two major reclamation projects.

¹⁴WR Phase I will be a domestic passenger line running from Northwest New Territories to West Kowloon, and TKE will be an extension of the existing MTR line through the central and southeastern parts of the New Territories.

tion of WR, with the Kowloon-Canton Railway Corporation and the MTRC financing the balance of the project costs from internal resources and commercial borrowing.

C. The 1997 Policy Address and the Medium-Term Fiscal Outlook

43. The Medium Range Forecast (MRF), published in March 1997 in conjunction with the FY 1997 budget, estimated that the budgetary surplus during FY 1998–2000 would be about HK\$20 billion per year. However, the MRF did not take into account the government's potential investment in projects under the Railway Development Strategy, because the precise amount and timing of the investment outlays were not yet determined.

44. Current indications suggest that these forecasts of budgetary surpluses may be exceeded owing to the MRF's conservative assessment of volatile sources of revenue from stamp duties on asset transactions and land sales. In addition, the recently announced program to significantly expand the supply of land for residential development would likely increase land-related revenue to about 4–5 percent of GDP over the medium term, almost double the amount projected in the MRF for FY 1999–2002.

45. In October 1997, the Chief Executive delivered his first annual Policy Address, in which he outlined major public expenditure initiatives for FY 1998 and the medium term. In an effort to promote home ownership, the Chief Executive announced a home loan scheme targeted at first-time home buyers, which is expected to cost around HK\$3½ billion per year over the next five years. The Chief Executive also announced measures aimed at alleviating the shortage of housing (see Chapter III), improving primary and secondary education (details are provided below), and as discussed above, investing in additional infrastructure projects, particularly in the area of public transportation.

46. Given the Basic Law's constraint on overall spending growth, these measures are expected to be accommodated within the government's existing medium-term fiscal framework. In particular, current expenditure programs announced in the Policy Address are expected to expand in line with nominal GDP growth, as projected in the MRF. Capital expenditure programs may expand somewhat faster in some years due to the lumpy nature of investment projects, but over a five-year horizon are also expected to be kept in line with GDP growth. Thus, on the basis of present policies one might expect surpluses in the range of 1–2 percent of GDP over the next three years.

D. Recent Social Policy Initiatives¹⁵

Mandatory Provident Fund

47. The MPF scheme would require that all employees and self-employed persons between the ages of 18 and 65 participate as members of registered MPF schemes (Box 3). Statutory minimum contributions to be made by the employee and employer are 5 percent of the employee's cash income per month, except for self-employed persons (who will be required to contribute 5 percent of their cash income) and certain categories of daily workers (who will have different contribution requirements due to the volatile pattern of their employment). Contributions for the portion of monthly income above HK\$20,000, and the employee's contribution for monthly incomes below HK\$4,000 are voluntary. MPF schemes must be registered and operated by approved trustees from the private sector who must maintain specified management standards. Investment managers will be selected by the trustees and will be free to invest in investment-grade securities subject to certain quantitative constraints aimed at risk containment, including a 30 percent minimum Hong Kong dollar content of investments. (The proposal would permit 100 percent investment in non-Hong Kong dollar investment, so long as 30 percent of the currency risk was hedged.) The Mandatory Provident Fund (MPF) Schemes Ordinance was enacted in August 1995. The subsidiary legislation consisting of detailed regulations and rules needed for the implementation of the MPF System has been drafted, and the government aims to complete the legislative enactment process in FY 1997.

Education

48. Total expenditure on education in the FY 1997 Budget is projected at HK\$45 billion, around 18 percent of total public expenditure (Figure 18). Access to primary and secondary education has been free in Hong Kong since the late 1970s. In his October 1997 Policy Address, the Chief Executive announced a number of measures to improve the quality of education. The major initiatives include formulating a five-year strategy to promote the use of information technology in schools, building additional schools to raise the percentage of students in whole-day primary schools, establishing a HK\$5 billion Quality Education Development Fund to promote quality and innovation in education, strengthening support measures for schools adopting Chinese as the medium of instruction, and providing native-speaking English teachers to all secondary schools. Other new measures include reviewing the curriculum, examination system, and education-related executive and advisory bodies, and improving teacher training in areas such as information technology, and language and pre-school education. These measures would expand recurrent expenditure on education by more than HK\$2 billion in FY 1998, and would raise capital expenditure by about HK\$22 billion over the next five years.

¹⁵Social policies are described in detail in IMF (1997a).

Box 3. Mandatory Provident Fund Scheme

The main elements of the proposed Mandatory Provident Fund scheme are as follows.

Coverage: All employees and self-employed between the ages of 18 and 65 are covered, except civil servants, judicial officers, and teachers covered by statutory pension schemes, and domestic employees and persons who entered Hong Kong to work for a limited period or who already have a home country scheme.

Contributions: For monthly incomes of HK\$4,000–20,000, 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 income below HK\$4,000 is not required, but may elect to contribute; the employer must, however, contribute 5 percent of the employee's income.

Vesting and preservation of benefits: All contributions to the Fund must be fully and immediately vested with the employee's account. All benefits derived from the Fund 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 the previous employer.

Mandatory Provident Fund Schemes Authority will administer and regulate the system. The Authority will also approve trustees, regulate their operations, and make rules and guidelines for administration and regulation of the system.

Trustees are responsible for all aspects of a scheme and must comply with regulations and duties imposed by the Authority. Trustees may be corporate or individuals; overseas trustees and master trustees can be established if they meet certain requirements.

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.

Tax treatment: The employee's contribution would not be tax deductible, but the employer's contribution would be considered a deductible business expense. Withdrawals and earnings would be tax exempted, in line with the fact that Hong Kong does not tax interest income or capital gains.

Investment managers will be selected by the trustees and may invest in investment-grade securities subject to certain quantitative restrictions aimed at risk containment, including a 30 percent minimum Hong Kong dollar content of investments.

49. At the university level, efforts would be made to improve research, invest in areas of excellence, strengthen language skills, and promote Hong Kong as a regional education center attracting non-local students.

Labor policies

50. The principal focus of recent labor policy initiatives has been to improve the existing employee retraining and vocational training programs, and tighten the labor importation schemes. The Employees Retraining Scheme was introduced in 1992 to provide training courses, mainly in language and computer skills, to workers over 30 years of age and with only lower secondary education, who were for the most part displaced from the manufacturing sector.¹⁶ Following a recent review, the ERS has begun restructuring its training program into packaged training courses aimed at helping retrainees not only secure a job, but also remain employable.

51. The Vocational Training Council is a statutory body that provides courses to younger and better educated workers in order to help them meet changing industry needs.¹⁷ A recent review of the VTC recommended greater flexibility in providing training for the fast growing industries, better development of the VTC staff, greater use of manpower surveys in course design, regular audit of training courses, and a consolidation of training institutes. Most of these recommendations are expected to be implemented over the next five years as part of a strategic development plan.

52. Responding to public concerns about the impact of imported labor on unemployment, the authorities introduced in 1996 the Supplementary Labor Importation Scheme, which replaced the General Labor Importation Scheme that was in operation since 1989. The SLIS cut significantly the number of foreign low and semi-skilled workers that could be hired by Hong Kong companies (from a total of 25,000 workers to about 2,000 workers at any time). There are no industry-specific quotas under the SLIS and each application is considered on a case-by-case basis.¹⁸ The total quota under this new scheme has been fully utilized. In addition, there were in 1997 about 4,000 foreign workers under the Special Labor Importation Scheme for the New Airport and Related Projects, and about 600 foreign workers under the scheme for mainland professionals. In December 1997, the authorities proposed to launch a special Construction Labor Importation scheme to meet the substantial labor requirements of the new housing development strategy (see Chapter III).

¹⁶Since its establishment, the ERS has provided about 23,000 training places per year in various training programs.

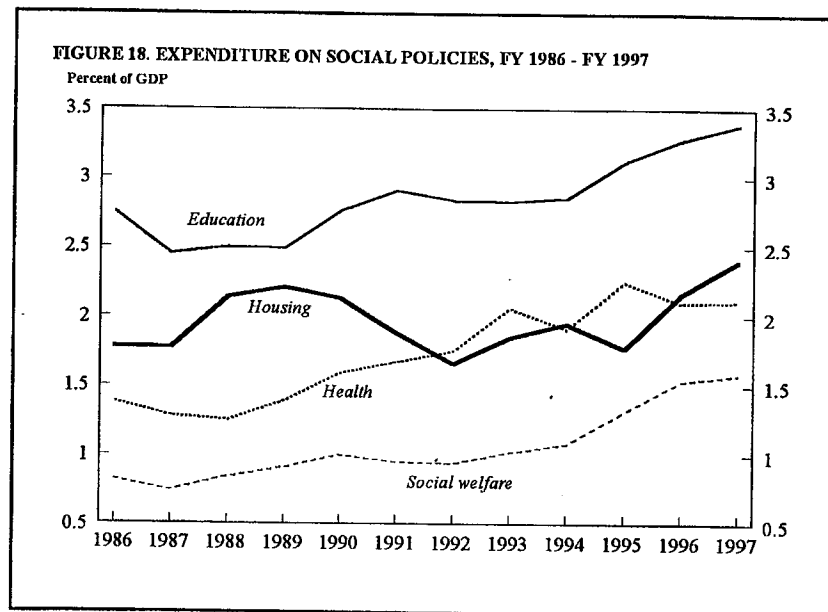
¹⁷The VTC currently provides about 113,000 training places a year, mostly in shorter courses.

¹⁸The old scheme was based on a quota per industry.

Health care and welfare policies

53. Health care services in Hong Kong are provided by a mix of private and public sector establishments. The public health care system provides services for free or at a nominal charge, and there is a triage system in place to ensure that urgent cases are accorded priority. However, public health care services are rationed by long waiting times (except in emergency cases) and unavailability of doctor choice. Also, there is no reimbursement for the use of private health care facilities. In 1995, total health care expenditure accounted for 4.8 percent of GDP, of which expenditure financed by the public sector amounted to 2.2 percent of GDP. The public health care system faces increasing pressures to improve the access to and the quality of public health care services, and to address the rise in operating costs associated with the introduction of new technology and the aging population. A comprehensive review of the health care delivery and financing systems was started in November 1997, and is expected to be completed in about a year.

54. The Hong Kong government traditionally has offered a relatively limited range of social security programs.¹⁹ Social welfare services are delivered by the Social Welfare Department (SWD) and nongovernmental organizations using government subvention in six major programs: elderly services; rehabilitation services for people with a disability; family services; youth



services; services for young offenders; and social security. The Social Welfare Department accounted for 11 percent of recurrent public expenditure in FY 1997, of which social security payments accounted for two-thirds. Public expenditures on social services have grown at an annualized rate of 22 percent from FY 1993 to FY 1997 (Figure 18).

¹⁹For a review of welfare programs, see IMF (1997a).

E. Longer-Term Implications of Demographic Changes

55. As in other advanced economies, Hong Kong faces the prospect of an aging population over the next several decades. Official projections (*Hong Kong Population Projections, 1997-2016*) indicate that the old-age dependency ratio (the population aged 65 or older as a share of the population aged 15–64) will reach 18.4 percent by the year 2016, up from 14.1 percent in 1996. A high and rising life expectancy implies that the old-age dependency ratio is likely to rise further beyond the twenty-year projection period.

56. This rapid increase in the elderly population is likely to place an increased burden on social safety nets.²⁰ Recurrent expenditure on the elderly, including for social security, health, and welfare services, has increased to 6½ percent of public recurrent expenditure in 1997 from 5 percent in 1992. The projected rise in the elderly population would, in the absence of cost-saving measures in government programs for the elderly, cause further increases in such outlays.

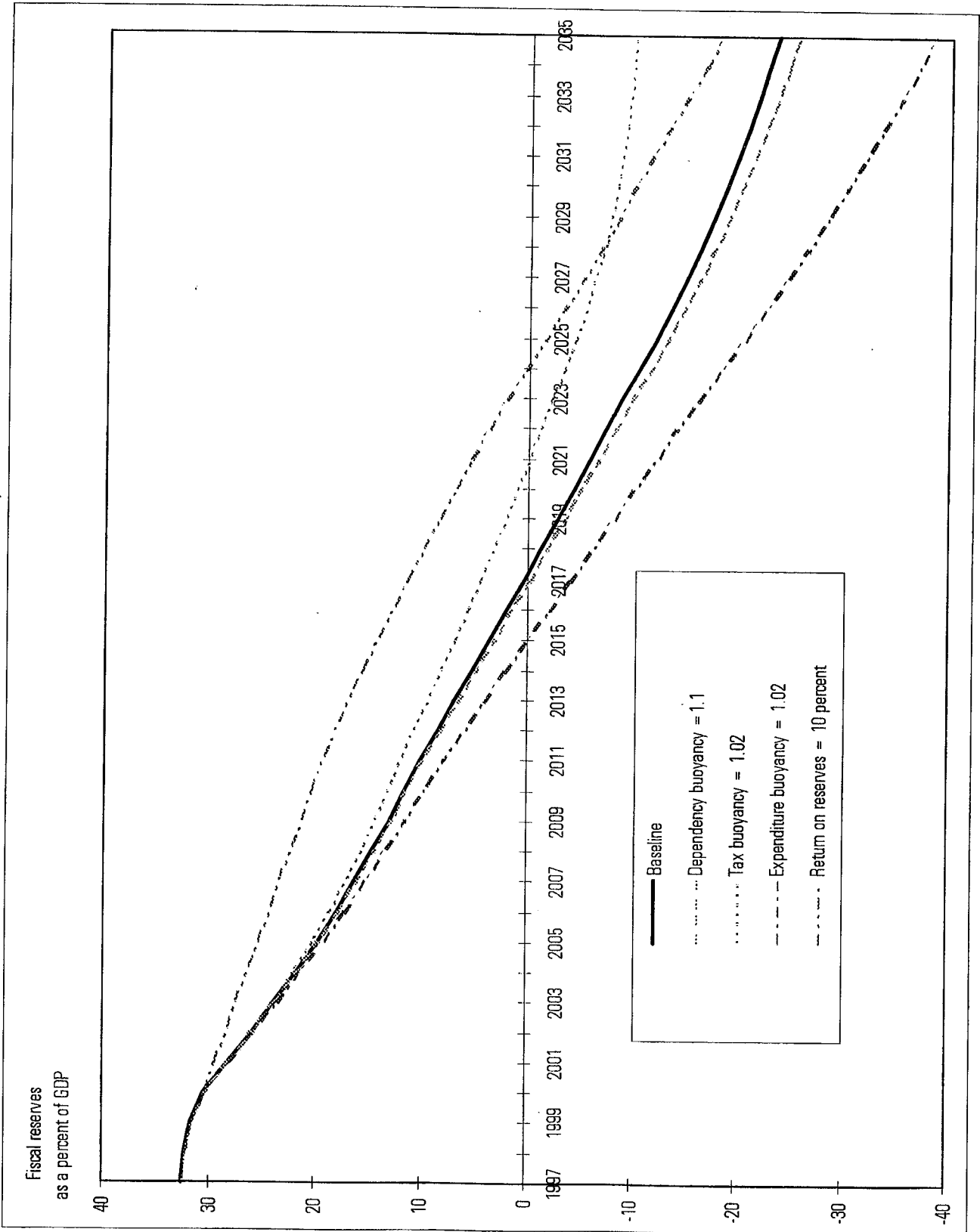
57. The potential impact of demographic changes on public finances is illustrated in Chart 3. Projections through FY 2000 are based on the government's medium-range forecast. During FY 2001–FY 2010, the staff's baseline projection assumes real growth of 5 percent, in line with the staff's estimate of potential output growth. Thereafter, growth is assumed to converge gradually to a 2½ percent annual rate, roughly the assumed long-run growth rate of the world economy. Non-interest fiscal revenues are projected to grow in line with GDP, whereas expenditures are projected to respond both to output growth and the age structure of the population. In particular, recurrent outlays are assumed to rise in proportion to GDP (i.e., with a buoyancy of unity). In addition, outlays on the elderly are assumed to have a unitary buoyancy with respect to the dependency ratio. The investment return on fiscal reserves is assumed to be 5 percent, broadly in line with historical performance, which has reflected a conservative investment policy oriented toward low credit risk and high liquidity.²¹

58. Projections based on these assumptions—which for illustrative purposes do not take into account the Basic Law's prohibition against fiscal deficits—suggest that pressures on public resources to provide services to the elderly, combined with the erosion of the fiscal reserves due to low investment returns, would lead to negative fiscal balances within twenty years, and a public debt-GDP ratio over 20 percent by the end of forty years.

²⁰The fiscal implications of aging in Asia are discussed in Heller (1997). The paper relies on World Bank population projections, which in the case of Hong Kong foresee a much faster increase in the old-age dependency ratio than the official projections.

²¹During 1981–1995, interest on reserves accruing to the budget has averaged about ½ percent of GDP, implying an effective rate of return of 5½ percent.

CHART 3
HONG KONG SAR
LONG-RUN FISCAL PROJECTIONS, FY1997-FY2035



59. However, the projected decline in the fiscal reserves is highly sensitive to the revenue and expenditure buoyancy assumptions. A buoyancy of 1.02 relative to the baseline assumption of 1.0 for either recurrent outlays or expenditures generates a marked deviation from the baseline projection (Chart 3). The decline is relatively insensitive to incremental changes in the elasticity of expenditures to the growth in the old age dependency ratio; however, steep increases in the ratio beyond 2016 contribute to a severe increase in public debt. Finally, the results are sensitive to the assumed rate of return on fiscal reserves; the fiscal situation is improved considerably as the rate of return rises. Chart 3 shows that as the return on reserves increases to 10 percent from the baseline assumption of 5 percent, the fiscal reserve balance at the end of the projection period improves by about 5 percent of GDP. If the prohibition against deficits remains a binding constraint, the simulations illustrate that taxes would need to rise, or other outlays would need to be compressed, to compensate for the effects of population aging.

V. FINANCIAL MARKET DEVELOPMENTS³⁰

A. Overview

60. The objectives and institutional framework for monetary policy in Hong Kong SAR have been established in the Joint Declaration and Basic Law. These specify the independence of monetary policy in the SAR, and require that the Hong Kong dollar be fully backed by foreign exchange. The SAR also is proscribed from adopting controls on the movement of capital and foreign exchange transactions. Monetary policy, the operation of the exchange rate system, and the supervision of the banking system is the responsibility of the Hong Kong Monetary Authority (HKMA).

61. The requirement that notes and coins be fully backed by foreign exchange reserves means that the exchange rate system operates as a currency board. In fact, Hong Kong dollar banknotes are provided to the public by three note-issuing commercial banks, which are required to deposit with the HKMA the U.S. dollar equivalent of the Hong Kong dollar notes they issue at the exchange rate of HK\$7.8/US\$1. Similarly, the HKMA stands ready to redeem Hong Kong dollar banknotes from the note-issuing banks at this exchange rate. The linked exchange rate system has been in effect since October 1983.

62. The system differs from a pure currency board arrangement, however, in two respects: first, the HKMA has a modest scope for affecting monetary conditions; and second, only transactions conducted for note-issuing purposes between the Exchange Fund and the note-issuing banks are carried out at the linked exchange rate, whereas all other transactions are conducted freely negotiated rates.³¹ Partly as a result of these differences, as well as strong capital inflows and the buoyant growth of the SAR economy, the market exchange rate for the Hong Kong dollar has tended to float at a somewhat more appreciated rate than the linked rate since 1991 (Chart 4). The instruments used by the HKMA to adjust domestic liquidity and achieve its policy objectives include the sales and purchases of foreign currencies against Hong Kong dollars, shifts in government deposits between the commercial banks and the Exchange Fund, open market operations in Exchange Fund bills and notes, and the extension of credit to banks through the Exchange Fund's Liquidity Adjustment Facility (LAF) (Appendix Table 14).³²

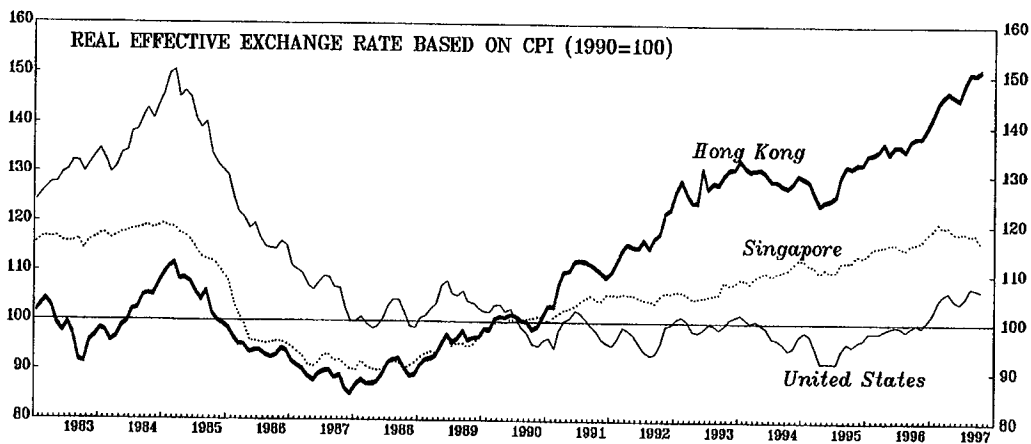
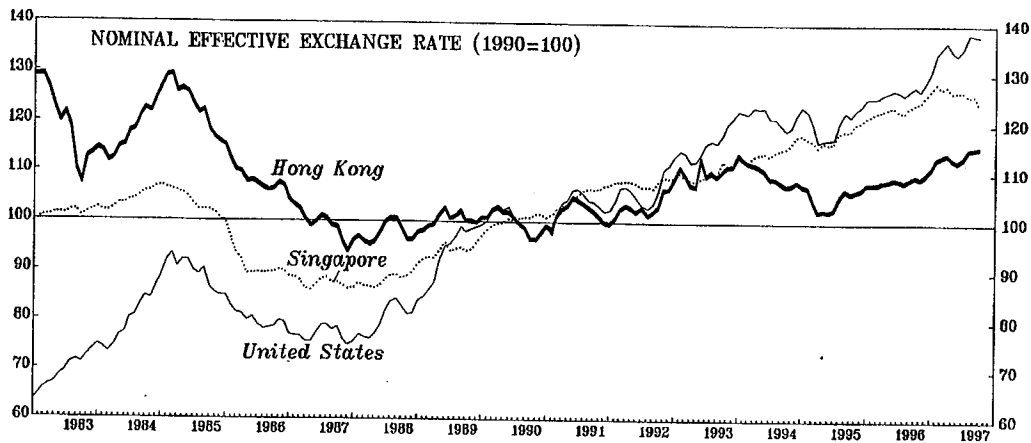
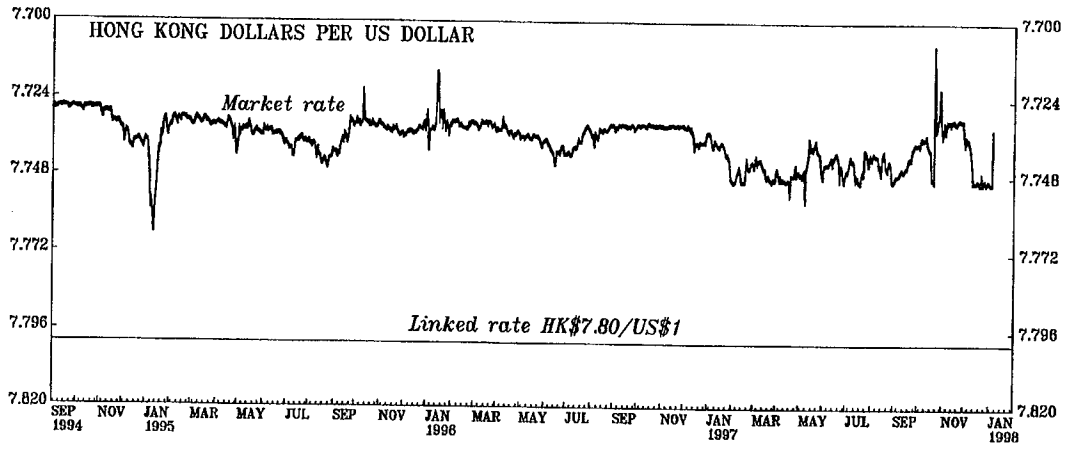
³⁰This chapter was prepared by Aasim Husain.

³¹In particular, foreign exchange transactions between the public and the banks (including the note-issuing banks), as well as all interbank transactions involving foreign exchange, are conducted at the market-determined rate.

³²The Exchange Fund, the SAR's currency board, was established under the Currency Ordinance of 1935 (later renamed the Exchange Fund Ordinance). Since the establishment of

(continued...)

CHART 4
HONG KONG SAR
FINANCIAL MARKET DEVELOPMENTS, 1983-97



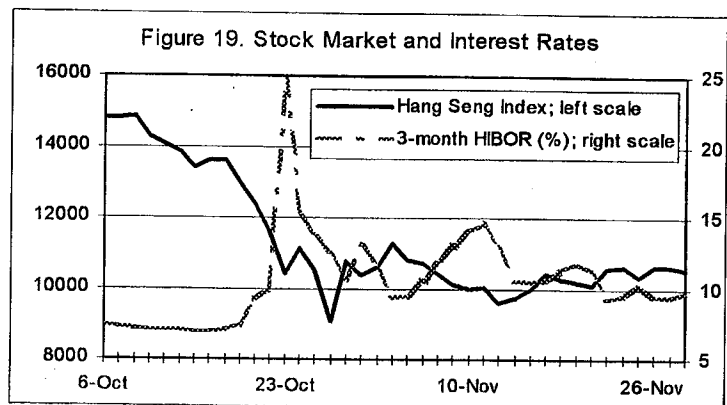
Sources: IMF staff estimates; WEFA/UKFT

B. Recent Financial Market Developments

Exchange rate and interest rate developments

63. Notwithstanding the stability of the spot exchange rate, the Hong Kong dollar has occasionally come under speculative attack, most recently in the summer and fall of 1997. With the onset of regional crisis, forward foreign exchange rate spreads on the Hong Kong dollar began to widen in May 1997. Speculative activity picked up by late July, and three-month and one-year forward exchange rates moved to levels that were 0.4 percent and 1.3 percent, respectively, depreciated relative to the spot rate.³³ Speculative pressures mounted again in mid-August, when the three-month and one-year forward rates depreciated to levels 1 percent and 2.5 percent, respectively, above the spot rate. Although the spot exchange rate remained roughly unchanged during this period, interbank interest rates rose steadily, and by mid-August the three-month HIBOR reached nearly 10 percent, compared with a rate of around 5¾ percent in March.

64. Pressures on the exchange rate eased following the August speculative attack, and interbank rates declined gradually to about 7 percent in mid-October. However, market turbulence within the region heightened in the week starting October 13, culminating in the float of the New Taiwan dollar on October 18. As a result, market confidence in the sustainability of the Hong Kong dollar's link to the



U.S. dollar weakened, and speculative pressure against the Hong Kong dollar intensified. In response to large scale purchase of U.S. dollars against the Hong Kong dollar, the HKMA responded by intervening in the foreign exchange market, which resulted in a sharp tightening of interbank liquidity when the HKMA debited the clearing accounts of the banks which had sold U.S. dollars to it. This action resulted in a sharp increase in interbank rates (Figure 19).

³²(...continued)

the HKMA in 1993, the Exchange Fund has been operated and managed by the HKMA. The LAF is a discount window at the HKMA which allows banks to make late adjustments (after the close of daily interbank trading) to their liquidity positions. Further details on the linked exchange rate system are contained in Dodsworth and Mihaljek (1997).

³³By way of comparison, the three-month forward rate was about equal to the spot rate prior to May 1997; the 12-month rate had been only 0.2 percent depreciated relative to the spot rate.

On October 23, the HKMA warned the banks that repeated recourse to the LAF would be subject to penal interest rates. Although such penalties were not imposed, overnight interbank rates rose to as high as 280 percent during the day. On October 25, the HKMA also raised the spread between the LAF's bid and offer rates by 1 percentage point to 3 percentage points. As a result, the selling pressure against the Hong Kong dollar quickly reversed.

65. Since the October episode, overnight Hong Kong dollar **interbank rates** have eased to roughly the same level as the U.S. dollar LIBOR. However, longer term rates remain high. The three-month interbank rate, which reached just over 37 percent on October 23, eased to 9–10 percent by end-1997.

66. The speculative activity also affected the **stock market**, where the Hang Seng index declined by almost 25 percent during October 17–23, and remained volatile during the following two weeks (stock market developments are discussed in more detail below). By end-December, the Hang Seng index had stabilized at a level around 35 percent below its early-August peak.

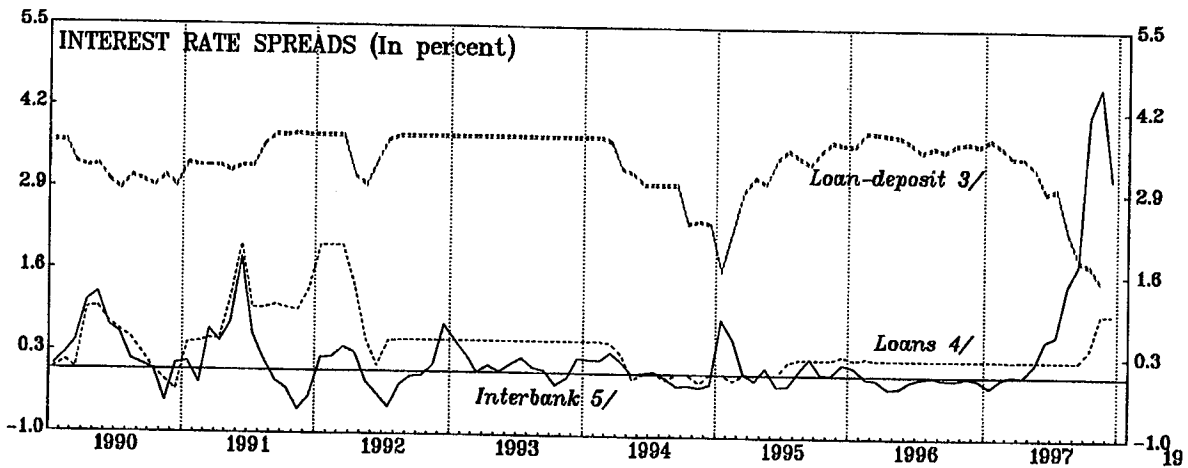
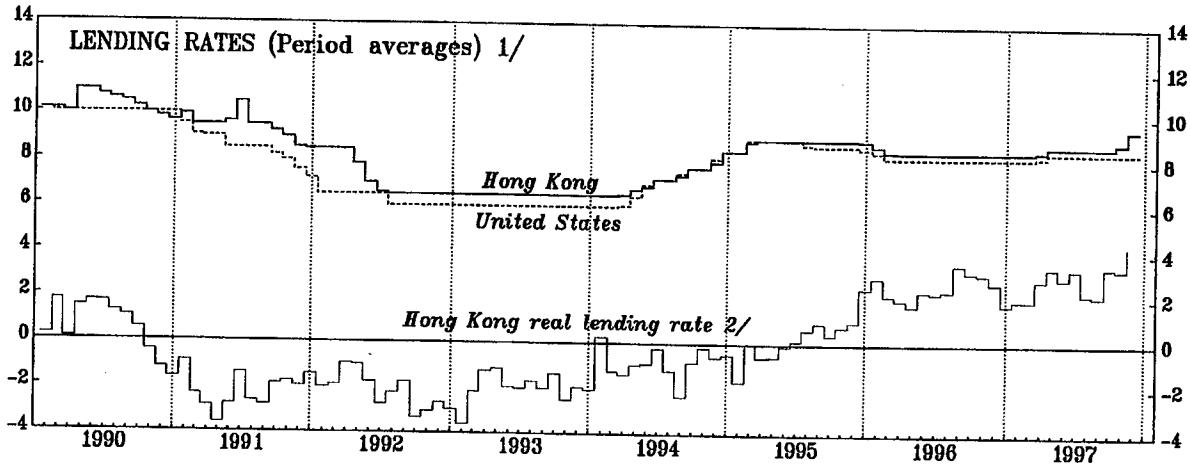
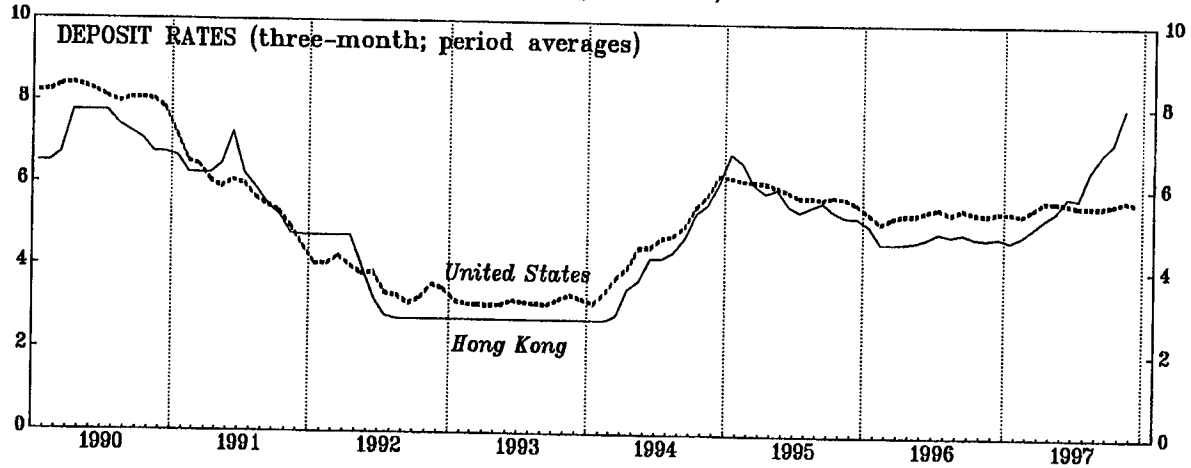
67. **Retail interest rates** have not yet fully responded to the recent speculative episode. Rates on deposits with maturities of less than one week, which are subject to a cap under the Interest Rate Rules of the Hong Kong Association of Banks, were not changed until late October, when the rate on savings deposits was raised by 75 basis points to 4.75 percent. On the lending side, commercial banks raised their best lending rate (BLR) by 25 basis points in March following the rise in U.S. rates, but otherwise left the BLR unchanged until late October, when it was increased by 75 basis points to 9.5 percent in response to the speculative attack on the Hong Kong dollar.

68. **Real interest rates**—measured as nominal interest rates less actual consumer price inflation over the past year—had been negative in the early 1990s. Since early 1994, however, reflecting the rise in U.S. interest rates and a decline in the SAR's inflation rate, real rates began to rise. By mid-1997, the three-month time deposit rate and best lending rate in real terms were 1 percent and 3 percent, respectively, around 4 percentage points higher than in late 1994 (Chart 5).

Developments in the monetary and credit aggregates

69. Owing to the commitment to maintaining the exchange rate link, movements in the **monetary aggregates** are chiefly determined by money demand, which in turn reflects changes in income growth, interest rates, and activity in asset markets. Broad money (M3) growth picked up from 10 percent in mid-1996 to 15 percent in mid-1997, owing to the pick-up in activity from the slowdown in 1994–95. Narrow money (M1) growth also rose from 6 percent to 15 percent during the same period. However, by October 1997, as asset prices

CHART 5
HONG KONG SAR
INTEREST RATE DEVELOPMENTS, 1990-97
(Percent per annum)



Sources: Hong Kong Monetary Authority, Monthly Statistical Bulletin; and IMF, International Financial Statistics; and Census and Statistics Department, Consumer Price Index Report.

1/ U.S. prime lending rate and Hongkong and Shanghai Banking Corporation's (HSBC) quoted best lending rate.

2/ HSBC's best lending rate less CPI(A) inflation.

3/ Spread between the HSBC's best lending rate and the three-month Hong Kong dollar time deposit rate.

4/ Spread between the HSBC's best lending rate and the U.S. prime lending rate.

5/ Spread between three-month HIBOR and LIBOR.

started to ease and interest rates rose, broad money growth eased to 12 percent, and narrow money growth decelerated to 6 percent (Chart 6 and Appendix Table 15).

70. **Credit** growth has also reflected the pickup in activity. Total credit expanded by 12 percent in September 1997 (12-month basis); Hong Kong dollar credit rose by 29 percent. Loans for use in Hong Kong, which exclude offshore lending and loans to finance external trade, rose by 31 percent (Appendix Tables 16 and 17). Within this category, property-related loans, particularly for property construction and property investment, and loans to stockbrokers, expanded most rapidly. As of September 1997, property-related loans and loans to financial concerns and stockbrokers comprised 44 percent and 14½ percent, respectively, of total loans for use in Hong Kong.

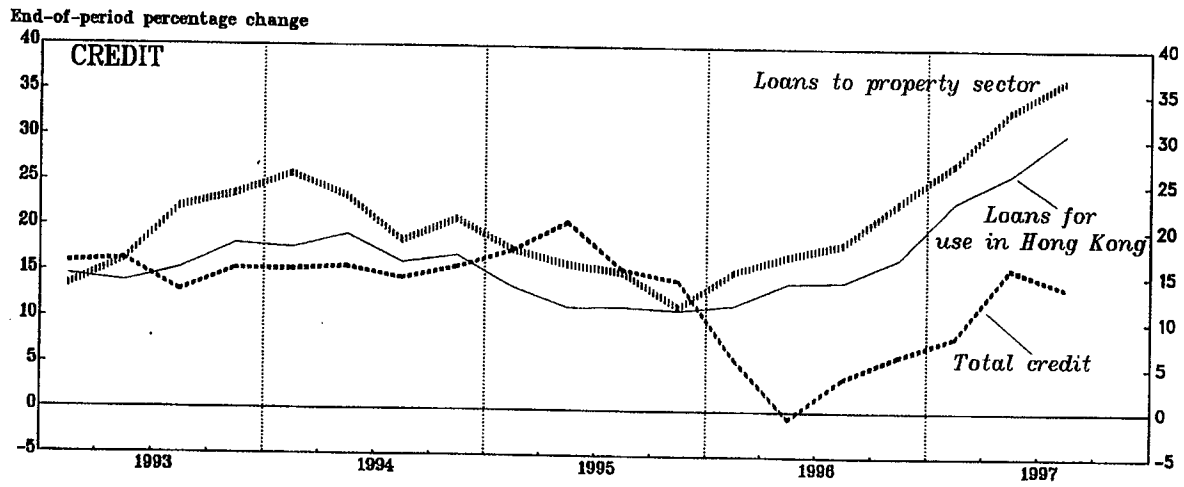
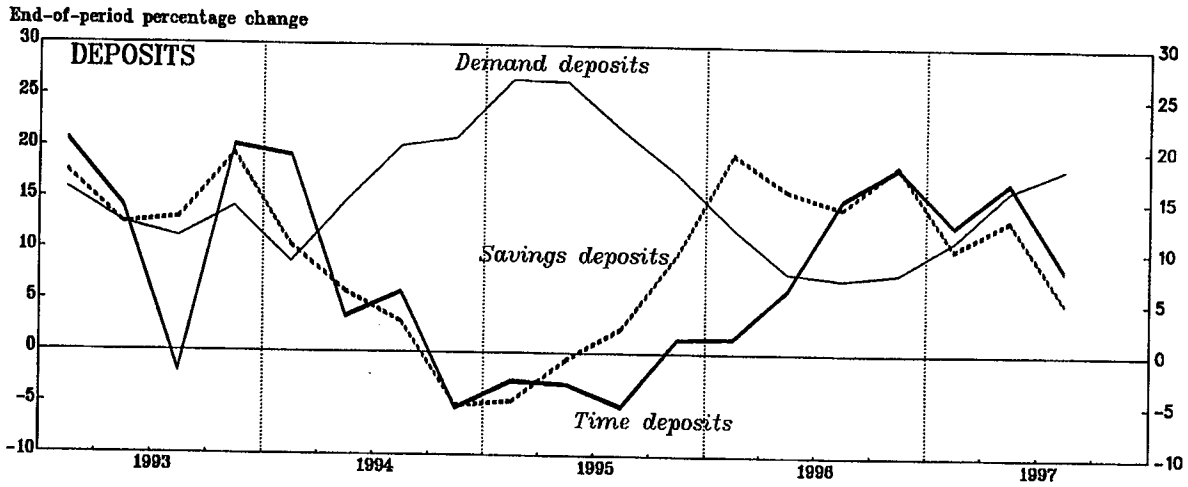
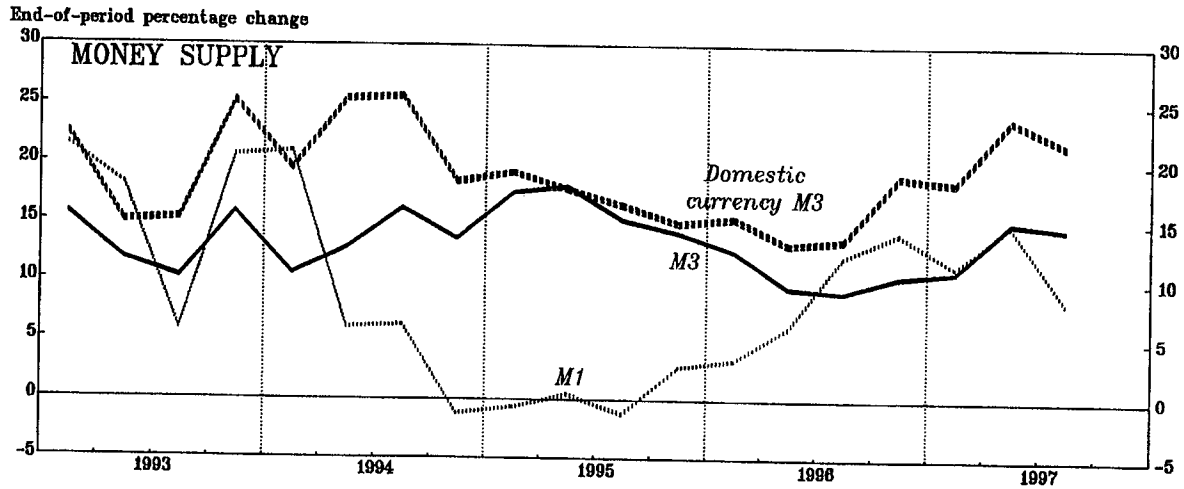
C. Recent Institutional Developments

71. **A Real Time Gross Settlement System (RTGS)** was introduced in December 1996. Under the previous system, banks maintained clearing balances with the Hongkong and Shanghai Banking Corporation (HSBC), which in turn maintained a clearing balance with the Exchange Fund. Under this system, settlement occurred on a net basis on the day following interbank transactions. Under the RTGS, each licensed bank now maintains a clearing account with the Exchange Fund, and settlement occurs on a gross, same-day basis. As a result, the new system provides for a more rapid transmission of monetary policy, and allows the HKMA to monitor individual banks' reserve position on a real-time basis.³⁴ The RTGS is to be linked to the settlement system for the stock exchange in mid-1998, thereby helping reduce the settlement lag for stock transactions.

72. **The Hong Kong Mortgage Corporation (HKMC)** is intended to develop a secondary market for mortgages in the SAR, thereby providing a mechanism for banks to reduce their exposure to the property sector. The HKMC was incorporated in March 1997, and began operations in late 1997. Initially, the HKMC will purchase qualifying mortgage loans from banks and fund these purchases by issuing unsecured debt instruments. Qualifying criteria for mortgage purchases, announced in mid-1997, include guidelines on loan-to-value and debt-to-household income ratios, loan size, maturity structure, and delinquency status. The HKMC is expected to begin to issue mortgage-backed securities to fund its purchases of mortgage loans only after the market has gained familiarity with the HKMC and its instruments. The HKMC is wholly-owned by the Hong Kong SAR government, which has provided HK\$1 billion as start-up capital. It is expected to maintain a capital to asset ratio of at least 5 percent, and will run on corporate principles. Eventually, the HKMC is expected to be privatized.

³⁴A disadvantage of the old clearing system was that reductions in the HSBC's settlement balance with the Exchange Fund were not always matched with equal reductions in the aggregate balance of other banks with the HSBC, thereby dampening the impact of the HKMA's liquidity operations.

CHART 6
HONG KONG SAR
MONETARY DEVELOPMENTS, 1993-97



Source: Hong Kong Monetary Authority, Monthly Statistical Bulletin.

73. The HKMA has participated in efforts to enhance **cooperation among central banks**, particularly within the region. Bilateral repurchase agreements to increase the liquidity of foreign exchange reserves have been signed with ten central banks, and bilateral linkages between the clearing and settlement systems for debt securities in the SAR and other economies. In addition, the HKMA became a member of the BIS in November 1996, and a participant in the Fund's NAB in January 1997.

D. Banking Sector

74. Hong Kong SAR's banking system—which consists of 182 licensed banks and close to 200 restricted license banks and deposit-taking companies—possesses a high degree of capital strength. The average risk-weighted capital adequacy ratio of all locally-incorporated authorized institutions was in excess of 17 percent in mid-1997, well above the minimum standard recommended by the Basle Committee on Banking Supervision. Banks' average after-tax return on assets has been close to 2 percent in recent years, compared with around 1 percent for banks in the United States and the United Kingdom and less than 0.2 percent for banks in Japan. Nonperforming loans constitute a relatively small share of total loans, and loan default rates are low (see tabulation below).

Banking Sector Indicators¹

(In percent of interest bearing assets, unless otherwise noted)

	1992	1993	1994	1995	1996	1997 June
Net interest margin	2.14	2.19	2.18	2.33	2.41	2.31
After-tax profits	1.85	1.92	1.85	1.82	1.79	1.62
Nonperforming assets (in percent of total credit exposure)	...	...	...	2.38	2.31	1.81
Default rate ² (in percent)	0.08	0.23	0.20	0.13	0.10	0.10
Capital adequacy ratio (in percent)	16.0	17.0	17.4	17.5	17.8	17.1

Sources: Data provided by the Hong Kong SAR authorities; and HKMA, *1996 Annual Report*.

¹Data refer to locally-incorporated banks only.

²Write-offs as percent of average total loans.

75. Bank profitability during the first half of 1997 remained strong. Pre-tax operating profits of locally-incorporated banks expanded by almost 18 percent over the corresponding period of 1996, although relatively rapid asset growth was associated with an easing of the average after-tax rate of return. Strong domestic credit expansion, together with a decline in

bad debt charges boosted profits, partly offsetting the impact of narrower interest margins that resulted from intensifying interest rate competition for mortgage loans.

76. An important feature of the SAR banking system is the large and rising share of lending to the property sector (Table 5 and Appendix Table 16). During 1987–96, property-related lending expanded at an average annual rate of 25 percent. Loans to the property sector rose by 38 percent in September 1997 compared with 12 months earlier, reflecting the strength of the residential property market. Residential mortgages, excluding loans under the Home Ownership Scheme and the Private Sector Participation Scheme, grew by 36½ percent, while loans for property development and investment rose by 39 percent.

77. The banks' exposure to the property sector is considerably lower when account is taken of banks' offshore activities. For example, at end-September property loans accounted for 44 percent of loans for use in Hong Kong but only 21 percent of total loans and advances (Appendix Table 18).³⁵ Moreover, risks associated with mortgage loans, which account for over one half of total property lending, are offset by the banks' observance of the HKMA's recommended maximum loan-to-value ratio of 70 percent for standard residential properties, and 60 percent for certain luxury apartments. Moreover, property developers, which account for around 7½ percent of total loans for use in Hong Kong, generally maintain strong balance sheets and low gearing ratios. As a result, loan default rates have remained low, even during the sharp decline in property prices in 1994–95.

78. Locally-incorporated banks are not considered by market participants to be heavily exposed to interest rate risk, given the preponderance of floating rate mortgages. Estimates by the HKMA suggest that close to 90 percent of assets, and slightly over 90 percent of liabilities, reprice within three months.

79. The Hong Kong SAR banking system appears relatively insulated from the recent turbulence in regional markets, since assets and liabilities to bank and nonbank customers in the most affected economies constitute a small share in total external assets and liabilities. For example, entities in Indonesia, Korea, Malaysia, the Philippines, and Thailand constituted around 8 percent of the Hong Kong SAR banking system's total external claims, and 3 percent of total external liabilities in June 1997.

80. The HKMA has sought to strengthen market discipline by tightening disclosure requirements and improving banks' internal risk management systems (Box 4). In 1995, banks were required to publish information on the level of their inner reserves. Starting with their published accounts for 1997, local banks must disclose a more detailed and standardized

³⁵The HKMA has established guidelines for the banks' exposure—loans to the property sector should not exceed 40 percent of loans for use in Hong Kong. However, adherence to this ceiling is voluntary.

Table 5. Hong Kong SAR: Share of Property-Related Loans in Total Lending, 1993-97

	1993	1994	1995	1996	1997 1/
(In percent)					
Loans for property development and investment					
As a share of loans for use in Hong Kong SAR 2/	15.9	18.5	17.7	19.3	20.1
As a share of total loans and advances	6.0	7.1	6.6	8.1	9.6
Residential mortgages 3/					
As a share of loans for use in Hong Kong SAR 2/	21.7	20.5	21.5	22.6	23.2
As a share of total loans and advances	8.2	7.9	8.0	9.4	11.0
Total real property-related loans 4/					
As a share of loans for use in Hong Kong SAR 2/	37.5	39.1	39.2	41.9	43.3
As a share of total loans and advances	14.1	15.1	14.6	17.5	20.6

Sources: Hong Kong Monetary Authority, *Monthly Statistical Bulletin*; and staff estimates.

1/ As of end-September 1997.

2/ Excludes loans to finance external trade.

3/ Excludes loans under Home Ownership Scheme (HOS) and Private Sector Participation Scheme (PSPS).

4/ Total property-related loans are the sum of loans for property development and investment, and loans for residential mortgages, excluding loans under the HOS and PSPS.

analysis of their advances to customers (including, in particular, property-related loans), as well as the maturity profile of their major assets and liabilities. In addition, the method for calculating banks' capital adequacy ratios has been enhanced in line with BIS standards, and as of end-1997 incorporate adjustments for market risk.³⁶

Box 4. The Banking Supervision System¹

The Hong Kong SAR's banking supervision system is based on on-site bank examinations—which take place with each bank once every 1–2 years—supplemented by off-site annual reviews followed by prudential interviews with banks' senior managers. The HKMA employs approximately 250 bank examiners, representing around one half of the total staff. The HKMA's banking supervision department was restructured in 1997, and off-site and on-site supervision activities were separated.

Banks are required to maintain 25 percent of their assets in the form of liquid assets, and must report liquidity ratios to the HKMA on a monthly basis. In addition, banks must report their capital-adequacy ratio on a quarterly basis, as well as other data for prudential analysis at monthly, quarterly, and annual frequencies.

Banks are also subject to prudential limits on lending. Loans to a single borrower may not exceed 25 percent of the capital base. Limits on unsecured liabilities to connected parties, holdings of shares, and real estate holdings exist, and there are guidelines, which banks are asked to comply with on a voluntary basis, on property lending and loan-to-value ratios for mortgage lending.

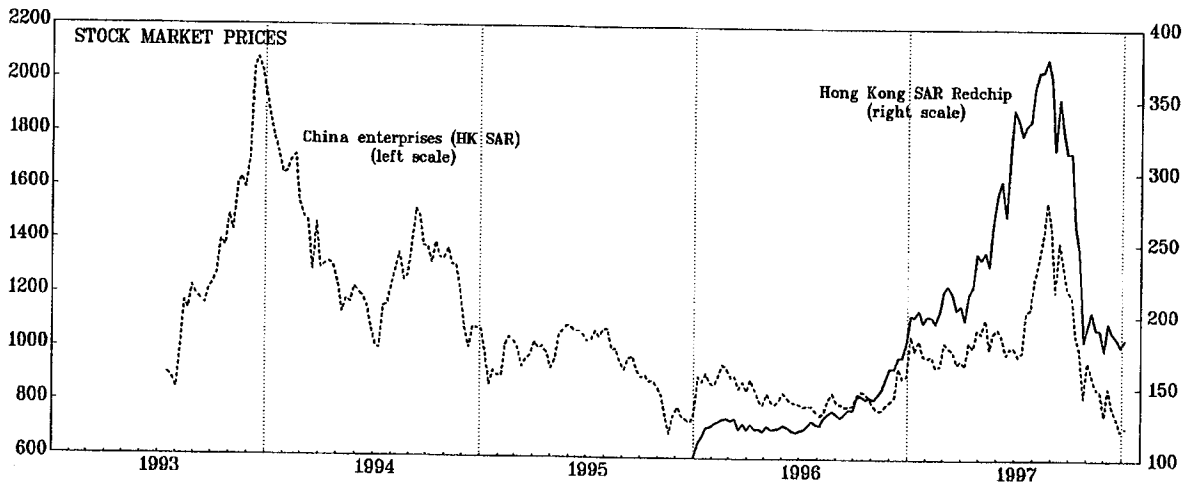
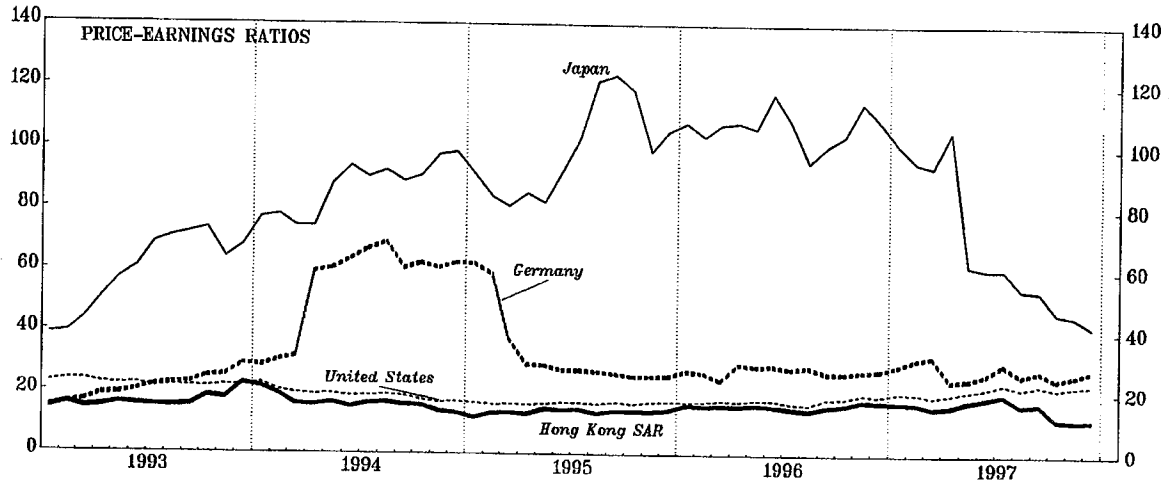
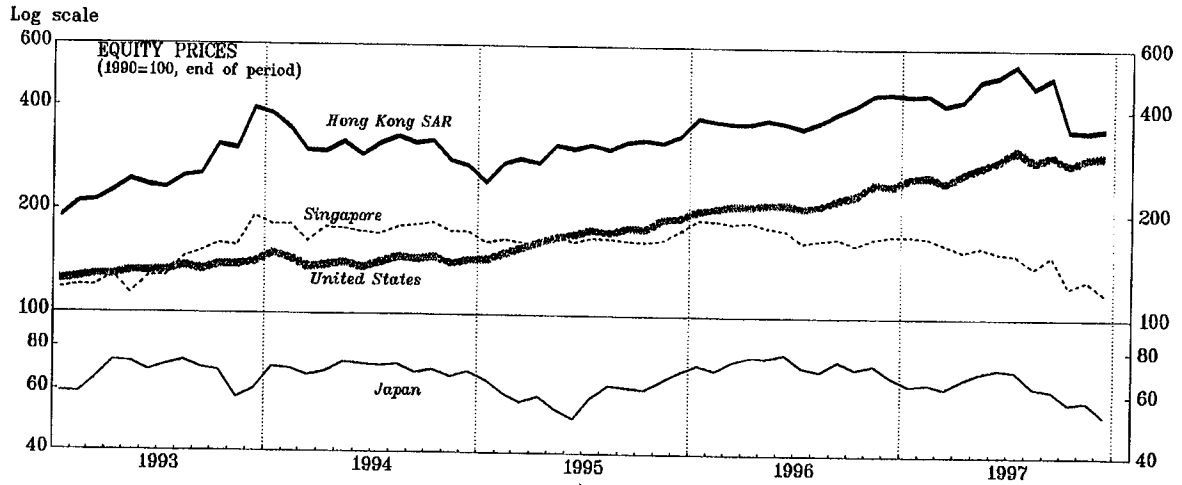
¹For a detailed description of the supervision system and banking regulations, see Chapter IV in Dodsworth and Mihaljek (1997).

E. Recent Developments in the Stock Market

81. The Stock Exchange of Hong Kong (SEHK) is one of the largest stock markets in the world and the second largest in Asia in terms of market capitalization, turnover, number of listed companies, and average company size. The Hang Seng Index (HSI), which represents around 60 percent of market capitalization on the SEHK, surged during the first seven months of 1997, and in early August was close to 25 percent above its end-1996 level. The finance and utilities subindices of the HSI performed most strongly, rising by around 46 percent and 42 percent, respectively, from end 1996 to July 1997. The property subindex, by contrast, rose by 37 percent during the last five months of 1996, reflecting the similar gains in property prices, but then remained at broadly the same level through the first seven months of 1997 (Chart 7 and Table 6).

³⁶The adjustment is expected to affect only a few banks and its impact on calculated capital adequacy ratios is likely to be small.

Chart 7
HONG KONG SAR
STOCK MARKET DEVELOPMENTS, 1993-97



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

Table 6. Hong Kong SAR: Equity Price Developments, 1992-97

	1992	1993	1994	1995	1996	1997 1/
(Index of share prices)						
Hang Seng Index						
End of year	5,512.4	11,888.4	8,191.0	10,073.4	13,451.5	10,722.8
Average of end of month	5,546.0	7,696.0	9,453.5	9,098.5	11,646.5	13,294.7
Sector indices						
(Average of end of month)						
Finance	4,643.6	6,282.8	7,988.8	8,381.4	11,411.8	16,865.4
Utilities	6,698.1	8,993.7	10 708.0	10,323.0	10,243.4	11,743.9
Property	9,215.7	12,362.5	16,556.6	15,550.8	21,926.0	24,841.9
Commerce and industry	4,379.3	5,733.2	7,331.1	6,719.8	8,647.5	9,600.7
(Percentage change)						
Hang Seng Index						
End of year	28.3	115.7	-31.1	23.0	33.5	-20.3
Average of end of month	59.8	38.8	22.8	-3.8	28.0	14.2
Sector indices						
Finance	101.5	53.9	27.2	4.9	36.2	47.8
Utilities	50.4	35.3	19.1	-3.6	-0.8	14.6
Property	57.7	34.1	33.9	-6.1	41.0	13.3
Commerce and industry	46.9	30.9	27.9	-8.3	28.7	11.0

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

1/ Sector indices as of end-September 1997.

82. Prices of mainland China-related stocks, which are regarded by investors as more speculative than stocks in the HSI, also rose sharply during the first half of 1997. The "red chips" index, which consists of stocks of firms that are controlled by mainland China entities or in which mainland entities have at least a 35 percent shareholding interest, surged by 160 percent between end-1996 and August 1997. The China Enterprises Index of mainland enterprises listed on the SEHK (also known as "H" shares) rose by 50 percent over the same period.

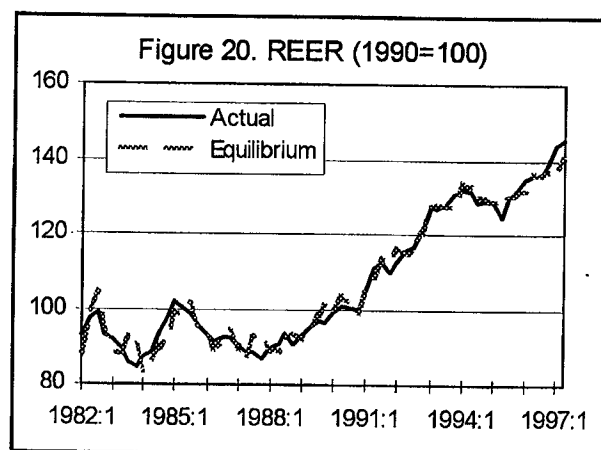
83. The regional market turbulence since August led to a sharp increase in volatility and a reversal of stock price gains during the previous seven months. By end-1997, the HSI appeared to have stabilized at the level prevailing during the first three quarters of 1996, nearly 40 percent off its peak in early August and 15 percent lower than at the start of the year. Red chips and H shares declined most sharply (each by 50 percent between end-August and end-December). Within the HSI, the property subindex declined by 40 percent over the same period, while the commerce and industry and finance subindices fell by 30 percent and 20 percent, respectively.

VI. COMPETITIVENESS AND INDUSTRIAL POLICY³⁷

A. Determinants of the Long-Run Real Exchange Rate

84. The exchange rate link to the U.S. dollar, together with the persistence of higher consumer price inflation than in trading partner countries, has led to a steady appreciation of the Hong Kong dollar in real effective terms over the past fifteen years. While the cumulative appreciation has been sizable—around 45 percent as measured by the Fund’s CPI-based real effective exchange rate (REER) index—this appears to have reflected an equilibrating phenomenon consistent with rapid productivity growth, and not an erosion in the SAR’s external competitiveness.

85. The presence of the Balassa-Samuelson phenomenon—in which rapid productivity in the tradable sector causes wages and prices to be bid up in the nontradable sector—in the SAR may be gauged by examining different indices of the REER. These indices yield sharply different conclusions about the extent, and even the direction, of trend real exchange rate changes over the past 15 years. For example, an REER index constructed using export unit values in the SAR and its trading partners has been broadly stable since 1987, implying that the real appreciation was confined to the nontradable sector (Figure 20). By contrast, a REER index based on unit labor costs in the SAR’s and trading partners’ manufacturing sectors depreciated steadily during 1982–97, suggesting that productivity growth in the SAR’s manufacturing (tradable) sector more than offset the nominal appreciation.³⁸



86. Econometric estimates of the long-run cointegrating relationship between the REER and its determinants indicate that the appreciation of the SAR’s CPI-based REER has been in

³⁷The first two sections of this chapter were prepared by Aasim Husain; the third section was prepared by Dubravko Mihajek.

³⁸Owing to data limitations, the ULC- and export unit value-based indices employ data from nine industrial-country trading partners, while the CPI-based REER index uses data from 16 trading partners, which include developing countries. Movements in the CPI-based index, however, do not appear to be sensitive to data for the seven trading partners that were omitted from the ULC- and export unit value-based indices, since the CPI-based index moved closely in line with an alternate CPI-based index calculated using data from the same nine trading partners as in the ULC- and export unit value-based indices.

with economic fundamentals, thereby representing an equilibrating phenomenon.³⁹ In particular, the estimates indicate that the structural shift toward a high value-added, services-based economy—proxied by the share of manufacturing output in the SAR's GDP—accounted for roughly 90 percent of the appreciation of the equilibrium REER between 1982 and mid-1997.

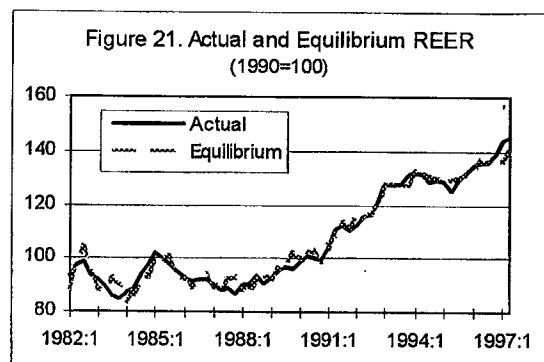
Estimates of Cointegrating REER Equation¹
(Dependent variable: CPI-based REER index (log); 1990=100)

Constant	-3.790
Share of manufacturing sector in GDP (in percent)	-0.027 (0.001) **
Terms of trade (log)	1.921 (0.263) **
Government investment to GDP ratio (in percent)	0.014 (0.003) **
World inflation (proxied by U.S. inflation, in percent)	-0.008 (0.003) *
Likelihood ratio	133.705 **

1/ Standard errors of the estimates are in parentheses; ** denotes significance at the 1 percent level; * at the 5 percent level. Quarterly data from 1982:1 to 1997:2 were used in the estimation.

87. The estimates also identify developments in the SAR's terms of trade, world inflation, and fiscal policy as important determinants of the equilibrium REER. For example, a 1 percent improvement in the SAR's terms of trade was associated with close to a 2 percent appreciation in the equilibrium REER, while a 1 percentage point increase in the ratio of public investment to GDP was accompanied by an appreciation of 1½ percent.

88. In addition, the econometric analysis indicates that deviations of the actual REER from its equilibrium have generally remained within a narrow band of ±5 percent, and that the deviations generally taper off within a short period. This suggests that goods and factor markets in the SAR are relatively flexible (Figure 21).



³⁹For estimates of equilibrium real exchange rate equations in the Southeast Asian economies, see Montiel (1997).

89. As regards the experience in 1997, the REER is estimated to have been about 3¾ percent above its equilibrium value in the second quarter. However, the depreciation in the second half of 1997 of trading partners' currencies—most notably Japan, Taiwan Province of China, Korea, Singapore, and Malaysia—has led to a further appreciation of the actual REER. Assuming no major changes in the main determinants of the equilibrium REER during this period, this would leave the actual REER even further above its equilibrium level.

B. Economic and Financial Integration with Mainland China

90. The Hong Kong SAR economy has undergone dramatic structural change since the late 1970s, and has transformed from a manufacturing-based economy to one that is mainly services-based.⁴⁰ The share of the manufacturing sector in GDP fell from almost one fourth in 1980 to less than 10 percent in the mid-1990s. During the same period, employment in manufacturing fell from one half to 15 percent of private sector employment. The GDP share of trade and financial services rose from just over 40 percent to more than one-half, and its share in private employment increased from under one-third to over 60 percent.

91. The SAR also has become considerably more open. Total exports of goods and services rose from around 70 percent of GDP (in constant prices) in the early 1980s to almost 200 percent of GDP in recent years. The structure of exports has changed significantly, in line with the increased role of services in domestic production. Domestic merchandise exports have declined in the 1990s, while exports of services and reexports have increased steadily, both in absolute terms and in relation to GDP.

92. The change in economic structure has been accompanied by increased economic and financial integration between the economies of the SAR and mainland China. Since the late 1970s, when mainland China began its transition to a market-oriented economy, SAR manufacturing facilities have relocated to the mainland, and have gradually diversified both geographically and into new industries. In the early 1980s, SAR investment was mainly in Guangdong province in labor-intensive industries such as textiles, food processing, garments, toys, and electronics. In recent years, SAR investment has increasingly been directed to other provinces as well as into more capital-intensive industries. According to private estimates, SAR firms presently employ 4–5 million workers in the mainland, more than the SAR's entire labor force.

93. With the relocation of manufacturing operations to the mainland and the development of supporting services industries in the SAR, cyclical fluctuations in economic activity in the two economies have become more closely linked. For example, the correlation between the

⁴⁰For a detailed review, see Chapter II in Dodsworth and Mihaljek (1997).

cyclical components of the SAR's GDP and industrial production in the mainland rose sharply in the 1980s and remained high during the 1990s.⁴¹

94. The cumulative value of foreign direct investment from the SAR to the mainland during 1978–96 is estimated at US\$100 billion, accounting for almost 60 percent of total direct investment inflows into the mainland. This figure likely overstates the SAR's role, however, as it includes flows canaled through companies established in the SAR that may have originated elsewhere, including the mainland itself or Taiwan Province of China. As regards foreign direct investment in the SAR, mainland China is the second largest investor, accounting for around 20 percent of total foreign direct investment in the SAR in recent years. At end-1995, the mainland's cumulative investment in the SAR was an estimated US\$14 billion.

95. Bilateral trade links have risen steadily. The mainland is the SAR's largest export market, accounting for over one third of total exports. Similarly, around one third of the SAR's imports are from the mainland, although the share of the mainland in the SAR's retained imports is less than 10 percent.

96. Financial links between the SAR and the mainland are significant. Mainland banks operating in the SAR account for over one fourth of total Hong Kong dollar deposits in the banking system, and around 15 percent of total foreign currency deposits. While claims of Hong Kong banks on mainland entities account for less than 8 percent of their total external assets, it is estimated that 90 percent of the syndicated loans for use in the mainland were arranged in the SAR.⁴²

97. Mainland firms have also raised considerable funds through the SAR's capital market. Around 50 mainland-controlled companies are listed on the Stock Exchange of Hong Kong (SEHK). The market capitalization of these companies—known as red chips—was around \$70 billion in mid-1997, representing close to 12 percent of the total market capitalization of the SEHK. In addition, 36 mainland-registered enterprises—known as "H" shares—are listed on the SEHK, with capitalization of around \$10 billion in mid-1997.

C. Industrial Policy in Hong Kong

Overview

98. The government in Hong Kong has traditionally adopted a policy of nonintervention toward the regulation of private business and industry, and has actively promoted a free-

⁴¹For a detailed discussion, see Husain (1997).

⁴²Liabilities to entities in mainland China constitute around 6½ percent of Hong Kong banks' total external liabilities.

enterprise, free-trade economy. In particular, investment has been strongly encouraged from all sources, domestic and foreign, and special concessions have not been offered to particular classes of investors (Box 5). Also, the degree of regulation in Hong Kong remains low by international standards (Box 6). On the institutional side, the government has established several organizations in an effort to promote Hong Kong's manufacturing and services industries both regionally and internationally, including the Hong Kong Productivity Council, the Hong Kong Trade Development Council, the Industry Department, the Hong Kong Export Credit Insurance Corporation, and, most recently, the Business and Services Promotion Unit.⁴³

99. In his first Policy Address, the Chief Executive of the Hong Kong SAR reiterated that Hong Kong's development strategy would continue to be based on the principles of a free-market economy, prudent fiscal policy, and maintaining a sound legal system (Tung (1997a)). The new administration would set up a commission on strategic development to carry out studies on the economy, human resources, education, housing, and land supply, and would strive to improve Hong Kong's external competitiveness and the domestic competitive environment. However, no specific measures to support manufacturing or any particular service industry were anticipated.

Views on industrial policy

100. Industrial policy has been almost completely absent from the public debate in Hong Kong until a few years ago. Most observers and virtually all policy makers accepted the view that it was futile, possibly even damaging, to the growth of Hong Kong's externally-oriented economy for the government to attempt to plan the allocation of resources available to the private sector, and to frustrate the operation of market forces (Haddon-Cave (1982)).

101. However, the slowdown of 1994-95 highlighted the extent of the decline of manufacturing and the rapid growth of service industries over the past decade and half, and triggered debate on industrial policy. While it is widely agreed that deindustrialization in Hong Kong resulted from the globalization of economic activity, rapid growth and economic integration in the Asia and Pacific region, and the opening up of China, the views on implications of structural change have differed sharply.

⁴³This unit, established in 1997 with the aim of promoting Hong Kong's role as a leading business and services center in Asia, focuses on deregulation, cost of compliance assessment, transfer of services from the public to the private sector, improvement of existing services and introduction of new ones, and support for Hong Kong service industries (see Government Secretariat (1997)).

Box 5. Tax and Investment Regimes

The main aspects of Hong Kong tax law that invite foreign and domestic investment may be summarized as follows.

- Corporations are taxed at a low fixed rate (16½ percent) with no surcharges. This corporate tax rate is lowest of any industrial country or developing country in the Asia and Pacific region.
- Hong Kong has no capital gains tax.
- Hong Kong has no withholding tax.
- Dividends are exempt from income tax.
- Tax losses may be carried forward indefinitely, unless there has been a change in shareholding of a company to take advantage of its tax losses.
- The concept of corporate residence is of little practical importance—all persons carrying on business in Hong Kong pay tax only on Hong Kong source income.
- Income from sources outside Hong Kong is not taxed.
- Interest income from within Hong Kong is taxed only if received by a corporation carrying on business in Hong Kong.
- There is no income tax on property used for business purposes in Hong Kong.
- Some types of commission income are exempt.
- Special low rates of tax apply to some types of royalty income.
- High statutory depreciation allowances (60 percent initial allowance and 10 percent, 20 percent, or 30 percent annual allowances) are given to most items of plant and machinery. Certain allowances also are granted for capital expenditure incurred in the construction of industrial buildings and structures for use in certain trades.¹

As incentives to investment are believed to be inherent in the above provisions of the tax law and the noninterventionist policy environment (Price Waterhouse (1997)), there are no specially enacted tax incentives. In particular:

- No concessions are offered to attract investment to particular areas or industries or for special-use companies.
- There are no specially enacted incentives for foreign investment. Hong Kong has recently entered into bilateral investment treaties with a number of countries, mainly in order to improve investor protection.
- All forms of business are available to foreign investors.
- By virtue of its free-port status, no duties are imposed on imported goods, and excise taxes are levied on only a small number of goods, whether imported or manufactured locally.
- No special legislation applies to holding companies, investment vehicles, regional headquarters, administrative offices, or tax haven activities.
- No special legislation encourages export incentives.
- No specific incentives are offered to invest in other countries. Because only Hong Kong profits are taxed, however, the tax system encourages offshore business generally, not favoring any particular territory.

¹These depreciation rules have been criticized recently as being biased in favor of manufacturing. The government has agreed to examine this issue in the context of the profits tax review that is underway.

Box 6. Regulatory Regime

The main aspects of Hong Kong's regulatory system that are relevant for industrial activity are as follows.

- Hong Kong has no exchange controls, no rules governing inward investment, and no special exchange rates for specific transactions.
- Companies have total flexibility in the movement of capital and the repatriation of profits. Funds invested in Hong Kong can be repatriated at will; dividends, interest, royalties, service fees, branch profits, etc. are freely remittable.
- There is no differentiation between Hong Kong residents and foreign investors with regard to currency accounts.
- No specific registration or reporting requirements are imposed for foreign capital, loans, technology agreements, or other types of agreements.
- The government makes no distinction between local and foreign companies; 100 percent foreign-owned ventures are common. The only exception is of the ownership of licenced broadcasters, where collective foreign ownership ceiling is 49 percent of the voting power.
- There is no comprehensive regulatory policy toward competition, although the government encourages and supports healthy competition in virtually all sector of the economy.
- Hong Kong has no antitrust laws. Utility companies offering electricity, certain telephone services, and some modes of transportation are regulated under schemes of control.
- The only enterprises directly controlled by the government are the postal system, water supply, harbor, airport, Mass Transit Railway Corporation, Kowloon-Canton Railroad, and Radio Television Hong Kong.

- The government does not have any direct control over prices, except over tariffs for electricity, telephone services, and most forms of public transportation.
- The Independent Commission Against Corruption has vigorously pursued numerous prosecutions and has helped reduce the level of corruption in Hong Kong to one of the lowest in Asia according to private sector surveys (Political and Economic Risk Consultancy (1997)).

There are certain areas, however, where Hong Kong is considered to have lagged behind international regulatory standards.

- Legislation on the protection of intellectual property rights meets all international standards and penalties for infringement of intellectual property rights have been stiffened, but it will probably take some time for the effects of the enhanced penalties to be felt.
- The deregulation of nontraded services, including telecommunications, public utilities, deposit banking, and supermarkets, as well as the legal, accounting, and medical professions, has lagged behind industrial economy trends (Consumer Council (1996), Enright, Scott, and Dodwell (1997)).
- The overall environmental quality is widely considered not to be commensurate with Hong Kong's economic wealth. Legislation on environmental protection is in place, but the penalties that apply to violators are low and not considered by many as a deterrent (Barron (1996), Ng and Ng (1997)).

102. In broad terms, three basic views have emerged from the debate on industrial policy. According to the first view, manufacturing and manufacturing-related services still represent the core economic activity of Hong Kong businesses, although much of production capacity has been relocated from Hong Kong itself to the mainland of China and other Asian economies.⁴⁴ In order to preserve its industrial strength, however, Hong Kong needs to strengthen its manufacturing capabilities through government-sponsored research and development, as well as government investment in technology. According to the second view, Hong Kong already is in a post-industrial stage of development, and its future growth opportunities lie in strengthening the capacity of businesses to provide high value-added services. The private sector, however, is not capable—or does not have sufficient incentives—to build up this capacity on its own, so the government should actively support high value-added services through industrial policy. Finally, the opponents of industrial policy have argued that Hong Kong's transformation from a manufacturing into a service-based economy is proceeding smoothly, and policies to support any specific industry would be inefficient and could not reverse the loss of comparative advantage in such industries in the long run. Maintaining adaptability of the private sector is, therefore, key to maintaining growth in the future.

103. The following is a brief outline of main policy recommendations by these three groups.

104. The advocates of support for the manufacturing sector encompass a wide range of groups, including Hong Kong's industrialists, academics, and labor unions. Although these heterogeneous groups have not argued their case from a common platform, they have come to similar policy conclusions. These have been articulated in large-scale study of the Hong Kong economy prepared by a team of researchers from the Massachusetts Institute of Technology (the "Made By Hong Kong Study," Berger and Lester (1997)). The main conclusion of this study is that an evolution of Hong Kong's manufacturing and manufacturing-related service industries, as well as the supporting public institutions, will not take place from the present stage of development spontaneously. In order to become leaders in creating a new generation of products, Hong Kong's industry, government and the educational community have to take measures including:

- Strengthening the capacity to create products and processes through substantial increase in the overall level of private and public investment in research and development;

⁴⁴In 1995, there were close to 25,000 trading firms with manufacturing-related functions, employing a total of about 150,000 persons in addition to the total employment of about 370,000 persons in the manufacturing sector (Census and Statistics Department (1997)). These firms grew out of the companies that moved all manufacturing processes to the mainland, leaving only such functions as marketing, materials sourcing, design, product development, and quality control within the original Hong Kong firms.

- Upgrading the capabilities of Hong Kong's industrial workforce through increased expenditure on education and training programs; and
- Increasing the rate of formation of new technology-based enterprises through government support to start-up technology companies, and the establishment of a second stock exchange for technology companies.

105. The advocates of support measures for the high value-added service industries accept the inevitability of Hong Kong's evolution into a business center for the region as well as for China, but call for substantial government support for the services sector. In particular, high value-added services with growth potential generally are training-intensive and knowledge-intensive, and require a highly developed physical and institutional infrastructure. If these industries are to grow, there must be a well-targeted support from the education system. In addition, these industries themselves have to make an ongoing investment in training, especially at the managerial level, since firms with a strong customer orientation require constant upgrading of organizational skills (Mole (1996)). Government infrastructure development also is needed, so as to allow for the rapid movement of people, information, and goods, as well as the rapid recognition and take-up of sophisticated technologies that support such activities.

106. This latter approach has provided a useful regional perspective on Hong Kong's industrial policy. Hong Kong's service economy remains largely based on the development of southern China's industrial base, which in turn depends on the same narrow range of down-market products that Hong Kong used to produce itself (T. Wong (1996)). It is sometimes argued, therefore, that the problems raised by dependence on these industries have been postponed, not resolved. By contrast, Singapore and Taiwan Province of China have not had the luxury of relatively easy access to a rapidly industrializing hinterland, and have been forced to pursue the more difficult strategy of shifting their manufacturing base to higher value-added products. While this strategy involves considerable costs of adjustment in the medium run, high value-added industries typically earn high and durable returns, because specialized knowledge and organization resulting from tight interaction of designers, managers, and shop-floor workers cannot be imitated easily. Some observers argue, therefore, that Hong Kong needs to keep pace with these regional competitors by transforming the rump of its manufacturing sector and by pulling its mainland-based operations in new directions (Mole (1996), T. Wong (1996)). To address these challenges, a government technology policy is advocated, which would nurture R&D activities, identify and promote knowledge-intensive services, and create skills and organizations necessary for Hong Kong businesses to learn more quickly and adopt useful technologies more smoothly.

107. The proponents of the status quo with regard to industrial policy have argued that structural transformation into a service economy is a natural outcome of market conditions that are not unique to Hong Kong. In the long run, policies designed to reverse the decline of manufacturing or any particular service sector are neither desirable nor feasible (R. Wong (1996)). Moreover, the private sector is already adapting to the new circumstances (Chen and

Li (1996) Maintaining this flexibility and adaptability is a key to keeping pace with changing international business environment and rapid technological progress. The government should, therefore, remain committed to providing a superior physical infrastructure, a sound regulatory framework, and forward-looking education, health, and social assistance systems, but it should resist pressure for more direct involvement in the workings of the free market economy and its natural adjustment mechanisms (Fung (1997)).

Evidence on the effects of structural transformation

108. The policy recommendations outlined above have been motivated by different interpretations of the effects of structural transformation. In particular, the debate has focused on the effects of structural transformation on the labor market, investment, and overall growth and productivity.

109. **Effects on the labor market.** The recent bouts of unemployment—for example, in 1995, when the unemployment rate rose to close to 4 percent at one point, compared with a long-run average of 2 percent—were concentrated in the restaurant and retail sectors, which traditionally have absorbed a large part of the low-skilled work force released from manufacturing. As the manufacturing employment continued to decline rapidly, the weakening of the demand for low-skilled service jobs was interpreted by some as a structural phenomenon. In addition, the skill mismatches between the unemployed and job vacancies had increased in recent years and prolonged the job search process. These developments have led many observers—including labor union groups—to argue that the government should abandon its noninterventionist policies to improve employment conditions. Specific measures proposed included banning labor importation, expanding retraining and job-matching programs, and investing part of fiscal reserves in job-creating public infrastructure projects. The evidence suggests, however, that the long-run unemployment rate has been fairly stable. For example, the decline in real wages over 1995–96 quickly led to increased demand for labor, which restored the unemployment rate around its long-run level in less than a year. Nonetheless, the government responded to a number of concerns expressed by labor unions in recent years, and tightened considerably the General Labor Importation Scheme in 1996. In addition, greater emphasis was put on retraining and job-matching schemes.

110. **Effects on investment.** A major argument of the proponents of measures to support the manufacturing sector is that the strategy of maintaining profitability by moving production facilities rather than shifting into new, higher value-added products, is nearly played out (Berger and Lester (1997)). Wages and property costs in much of southern mainland China have risen toward Hong Kong levels, and moving production further into the mainland in search of lower costs makes it harder for Hong Kong-based entrepreneurs and designers to coordinate with their factory managers. Hence, this study recommends to keep factories in or close to Hong Kong, and use high technology to cut the costs of production. This would require more government investment in basic research and the provision of venture capital and

tax incentives to the private sector, while businesses would have to put more emphasis on training, investment in R&D, and building up of brand names (see also Kwong (1997)).

111. Several observers have countered that Hong Kong has built its entrepreneurial reputation largely on its ability to build networks of contacts and put buyers and sellers together, i.e., on developing the “software” rather than the “hardware” end of manufacturing business (Fung (1997), Enright et al. (1997)).⁴⁵ Hence, to the extent there is a need to make Hong Kong more technology-intensive, investment should be directed toward information technology, telecommunications, transportation infrastructure, and financial services, not toward basic research and manufacturing technology. To a large extent, the Hong Kong government and businesses are already investing in these areas, so the optimal response for Hong Kong is not to imitate other Asian producers, but rather to capitalize and build upon precisely those features of its economy that competitors from other countries find the hardest to duplicate (Enright et al. (1997)).

112. **Effects on overall growth.** There seems little evidence that retrenchment in manufacturing has reduced significantly the growth rate of productivity and Hong Kong’s GDP. In recent studies of growth in Asian newly industrialized countries, Hong Kong is generally an exception, showing significant increases in total factor productivity (TFP).⁴⁶ However, introduction of technology that is “new to the world” in the sense of providing superior best practice generally did not play a major role in Hong Kong’s development (except perhaps in certain narrow segments of manufacturing), given the relatively low level of investment in research and development (Davies (1996)). Technical progress generally took form of improved technical efficiency, i.e., catching up with best practice available by introducing technology which was new to Hong Kong but already in use elsewhere. Productivity of existing techniques was thus increased by a series of small improvements on otherwise unchanged technologies. These improvements most likely were made in the organization of work, the elicitation of effort from workers, and the compression of activities in time.

113. Research also suggests that improved allocative efficiency—shifting resources from low-productivity to high-productivity uses in response to relative price changes and relative wage differentials, while remaining at the same technological level—may have been a significant source of TFP increases in Hong Kong (Dodsworth and Mihaljek (1997)). As a result of superior resource mobility, output of tradable services—along with manufacturing—expanded, on average, twice as fast as nontradable services (about 10 percent per year over

⁴⁵A frequently used example is that of a product that costs US\$1 when it leaves a factory gate in Asia, and sells for US\$4 by the time it reaches international retail outlets. Unlike producers elsewhere in Asia, who make profit by reducing the US\$1 production cost, Hong Kong businesses are said to make profit by reducing the US\$3 distribution cost (Fung (1996)).

⁴⁶See, e.g., Young (1995) and Hawkins (1995).

1983–94), and experienced output price increases only half those in nontradable industries. As employment growth was generally much slower in tradable industries, labor productivity growth in tradable industries was, on average, about 8 percentage points a year higher than in nontradable industries. This productivity differential was much higher than in Hong Kong's trading partners, suggesting, *inter alia*, that the long-run appreciation of the real exchange rate of the Hong Kong dollar was consistent with movements in the equilibrium real exchange rate, and that higher inflation in Hong Kong was essentially an equilibrating factor.

Conclusion

114. Deindustrialization in Hong Kong has for the most part been accepted as a natural feature of the process of economic development, associated with rising living standards⁴⁷. For a review of deindustrialization in advanced economies, see IMF (1997c). Indeed, Hong Kong is often compared with Manhattan and other business and financial centers that have continued to prosper despite the loss of their manufacturing base to surrounding regions or other countries (Tsang (1997)). Nonetheless, structural transformation may have hurt certain segments of the workforce more than others (for instance, workers with low skills or older workers), which has resulted in calls on the government to support specific industries. Given that much of Hong Kong's dynamism can be traced to the openness of its economy and the flexibility of its factor markets, it seems unlikely that targeted industrial support would be effective. Rather, the best way to address such problems seems to be focussing on specific programs at the microeconomic level, without changing the noninterventionist framework of economic policy. At the same time, continued productivity gains will also require an expanding pool of highly skilled labor, suggesting a need for expanding and improving higher education.

⁴⁷For a review of deindustrialization in advanced economies, see IMF (1997c).

Table 1. Hong Kong SAR: Basic Long-Term Economic Indicators, 1980-96

(Annual percentage changes)

	Period average				1996
	1980-96	1980-85	1986-90	1991-95	
Real GDP	6.3	6.3	7.5	5.4	4.9
GDP deflator	8.2	9.2	8.4	7.4	5.5
Consumer price inflation 1/	8.9	10.4	7.1	9.3	6.0
Employment	2.2	3.4	1.3	1.5	3.5
Unemployment (percent)	2.6	3.8	1.6	2.2	2.8
Nominal wages	10.3	11.4	10.1	9.9	6.3
Real wages	1.2	0.6	2.9	0.4	0.4
Labor productivity	4.0	2.8	6.1	3.9	1.3
Unit labor costs	6.0	8.4	3.8	5.6	4.9
Nominal effective exchange rate	-1.5	-2.2	-4.3	1.0	3.5
Real effective exchange rate	2.0	1.3	-1.3	5.2	6.0
Per capita nominal GDP, in U.S. dollars 2/	...	5,630	7,250	14,950	24,500

Sources: Census and Statistics Department, *Estimates of Gross Domestic Product, 1961 to 1996*, and *Annual Digest of Statistics* (various editions); IMF, Information Notice System; and IMF staff estimates.

1/ Based on consumer price index (A), which is based on expenditure patterns of about 50 percent of households.
2/ Data shown are as of 1980, 1986, 1991, and 1996.

Table 2. Hong Kong SAR: Gross Domestic Product by Expenditure Component at Current Market Prices, 1992-97

	1992	1993	1994	1995	1996	1997 Jan.-June
(In billions of Hong Kong dollars)						
Consumption	515.7	586.9	676.3	750.1	828.0	444.0
Private	451.7	514.2	592.7	654.8	722.2	386.0
Government	64.1	72.6	83.7	95.3	105.9	58.0
Gross fixed capital formation	213.8	245.2	301.1	329.1	373.5	224.9
Private	191.5	212.1	261.1	277.6	311.9	193.7
Government	22.3	33.1	40.0	51.4	61.6	31.2
Final domestic demand	729.5	832.0	977.4	1,079.1	1,201.5	668.8
Change in stocks	8.2	2.3	21.3	45.7	12.7	7.5
Total domestic demand	737.7	834.3	998.7	1,124.8	1,214.2	676.3
Net exports of goods and nonfactor services	41.6	63.1	12.2	-46.6	-20.3	-38.7
Exports of goods and nonfactor services	1,114.3	1,261.8	1,410.7	1,609.8	1,686.5	816.6
Exports of goods	925.0	1,046.3	1,170.0	1,344.1	1,397.9	671.0
Domestic exports	234.1	223.0	222.1	231.7	212.2	95.9
Re-exports	690.8	823.2	947.9	1,112.5	1,185.8	575.1
Exports of nonfactor services	189.4	215.6	240.7	265.6	288.5	145.6
Imports of goods and nonfactor services	1,072.7	1,198.7	1,398.5	1,656.3	1,706.7	855.3
Imports of goods	958.5	1,075.7	1,254.4	1,495.7	1,540.0	770.0
Of which:						
Retained imports	383.3	400.0	461.1	562.2	555.0	291.8
Imports of nonfactor services	114.2	123.0	144.1	160.6	166.9	85.7
Factor income inflows	...	316.7	371.3	387.3	..	...
Factor income outflows	...	306.4	364.0	372.8	...	...
Net factor income flows	...	10.3	7.3	14.5	...	...
Gross national product	...	907.8	1,018.2	1,092.7	...	...
Gross domestic product	779.3	897.5	1,010.9	1,078.2	1,193.9	637.6
(In percent of GDP)						
Memorandum items:						
Consumption	66.2	65.4	66.9	69.6	69.4	69.6
Gross fixed capital formation	27.4	27.3	29.8	30.5	31.3	35.3
Change in stocks						
Total domestic demand	94.7	93.0	98.8	104.3	101.7	104.9
Net exports of goods and nonfactor services	5.3	7.0	1.2	-4.3	-1.7	-6.1

Sources: Census and Statistics Department, *Estimates of Gross Domestic Product, 1961 to 1996*; and *Quarterly Report of GDP Estimates, Second Quarter 1997*.

Table 3. Hong Kong SAR: Gross Domestic Product by Sector at Current Prices, 1991-95

	1991	1992	1993	1994	1995
	(In millions of Hong Kong dollars)				
Agriculture and fishing	1,441	1,468	1,612	1,596	1,453
Mining and quarrying	222	205	197	249	317
Manufacturing	97,223	99,764	92,582	87,354	84,770
Electricity, gas, and water	13,521	15,637	17,591	22,175	23,578
Construction	34,659	37,337	43,089	46,325	54,761
Wholesale, retail and export/import trades, restaurants and hotels	163,284	190,760	224,462	249,167	270,521
Transportation, storage, and communications	60,604	71,227	78,993	92,109	101,357
Financing, insurance, real estate, and business services	143,296	178,923	214,550	254,346	249,391
Community, social, and personal services	94,293	110,703	130,408	151,293	176,798
Ownership of premises 1/	68,873	80,941	89,862	115,659	134,416
Adjustment for financial intermediation services 2/	-45,902	-54,846	-63,177	-70,101	-81,262
Gross domestic product at factor cost (production-based estimates)	<u>631,514</u>	<u>732,120</u>	<u>830,169</u>	<u>950,172</u>	<u>1,016,101</u>
Indirect taxes	36,323	48,777	53,278	56,286	52,971
Gross domestic product at market prices (production-based estimates) 3/	<u>667,837</u>	<u>780,897</u>	<u>883,447</u>	<u>1,006,458</u>	<u>1,069,072</u>
	(In percent of GDP)				
Memorandum items: 4/					
Manufacturing	15.4	13.7	11.2	9.2	8.3
Wholesale, retail and export/import trades, restaurants and hotels	25.9	26.1	27.0	26.2	26.6
Financing, insurance, real estate, and business services	22.7	24.4	25.8	26.8	24.5
Transportation, storage, and communications	9.6	9.7	9.5	9.7	10.0

Source: Census and Statistics Department, *Quarterly Report of Gross Domestic Product Estimates, Second Quarter 1997*.

1/ An imputed rental charge for owner-occupied premises.

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

3/ Difference between production-based estimates and expenditure-based estimates reflects statistical discrepancy.

4/ Measured relative to production-based GDP at factor cost.

Table 4. Hong Kong SAR: Gross Fixed Capital Formation, 1992-97

	1992	1993	1994	1995	1996	1997 Jan.-Jun.
(In billions of Hong Kong dollars, at current prices)						
Gross domestic fixed capital formation	213.8	245.2	301.1	329.0	373.5	224.9
Private	191.5	212.1	261.1	277.6	311.9	193.7
Public	22.3	33.1	40.0	51.4	61.6	31.2
Construction	63.1	73.2	90.0	99.9	114.7	62.8
Private	42.6	42.9	53.8	54.3	61.4	36.8
Public	20.4	30.3	36.3	45.6	53.3	26.0
Residential buildings	24.5	25.7	28.7	28.3	35.2	21.7
Private	18.9	20.3	23.5	21.8	26.5	16.6
Public	5.6	5.4	5.2	6.6	8.7	5.1
Nonresidential buildings	22.1	21.7	24.2	27.9	31.9	19.4
Private	18.4	17.1	21.5	23.9	26.7	16.4
Public	3.7	4.6	2.6	4.0	5.2	3.0
Infrastructure construction	16.5	25.7	37.1	43.7	47.6	21.8
Private	5.3	5.4	8.7	8.6	8.2	3.8
Public	11.2	20.3	28.4	35.0	39.4	18.0
Machinery and equipment	88.2	95.3	114.9	156.8	168.8	93.0
Private	86.3	92.5	111.1	151.0	160.4	87.9
Public	1.9	2.7	3.7	5.8	8.3	5.2
Transfer costs of land and buildings	17.9	19.9	21.3	13.9	22.2	21.1
Real estate developers' margin	44.6	56.8	74.9	58.4	67.9	48.0
(Share in total, in current prices)						
Private capital formation	89.6	86.5	86.7	84.4	83.5	86.1
Public capital formation	10.4	13.5	13.3	15.6	16.5	13.9
Construction	29.5	29.9	29.9	30.4	30.7	27.9
Machinery and equipment	41.3	38.9	38.2	47.6	45.2	41.4
Transfer costs of land and buildings	8.4	8.1	7.1	4.2	5.9	9.4
Real estate developers' margin	20.9	23.2	24.9	17.8	18.2	21.3
(Percentage change, in constant prices)						
Gross domestic fixed capital formation	9.2	3.7	15.7	10.4	12.2	17.5
Private	9.7	-0.7	15.5	8.8	11.5	21.5
Public	5.2	39.3	17.1	19.4	15.9	-1.4
Private investment in residential construction	-1.1	6.0	12.0	-13.4	11.2	22.9
Public infrastructure construction	12.5	67.6	36.9	13.6	7.7	-14.9
Private investment in machinery and equipment	22.2	1.9	17.3	24.4	13.2	19.3

Sources: Census and Statistics Department, *Annual Digest of Statistics, Estimates of Gross Domestic Product, 1961-96*, and *Quarterly Report of GDP Estimates, Second Quarter 1997*.

Table 5. Hong Kong SAR: Selected Price Indicators, 1992-97

	Weight in the Index (Percent)	(Percentage changes)					1997 1/		
		1992	1993	1994	1995	1996	Q1	Q2	Q3
CPI (A) 2/	100.0	9.3	8.5	8.1	8.7	6.0	6.2	5.5	6.1
Food - overall	37.3	8.8	7.3	6.4	7.2	3.9	3.2	2.4	5.3
Meals away from home	20.4	10.6	8.7	7.7	7.1	4.2	4.0	4.0	4.5
Excluding meals away from home	16.9	6.9	5.6	4.8	7.4	3.7	2.3	0.4	6.2
Housing	25.3	13.0	12.6	11.2	12.2	9.4	9.3	9.2	9.2
Fuel and light	3.4	5.2	3.8	3.5	7.6	5.2	7.8	6.0	5.6
Alcohol and tobacco	2.1	9.7	10.5	5.6	6.3	5.8	6.2	6.3	5.3
Clothing and footwear	5.1	8.5	7.6	8.9	8.7	9.5	10.5	10.4	9.0
Durable goods	4.3	2.3	2.2	2.8	4.2	1.7	2.6	3.1	1.9
Miscellaneous goods	6.6	6.8	6.8	6.8	6.7	2.5	10.8	6.6	6.0
Transportation and vehicles	7.2	7.2	8.3	9.3	7.5	6.4	5.4	3.0	2.9
Miscellaneous services	9.3	11.8	9.6	11.8	11.4	7.0	6.6	6.0	4.1
Composite CPI 2/	...	9.6	8.8	8.8	9.1	6.3	6.1	5.7	6.1
Residential price index	...	40.5	10.2	23.6	-7.2	9.9	41.9	36.3	...
GDP deflator	...	9.7	8.5	6.9	2.6	5.5	6.8	7.0	...
Domestic demand deflator	...	8.1	7.8	7.1	5.2	4.4	4.9	5.7	...
Export prices 3/									
Goods deflator	...	0.8	-0.4	1.3	2.6	-0.7	-1.8	-1.9	-2.0
Services deflator	...	6.2	5.4	4.8	5.3	2.7	2.0	3.0	...
Import prices 3/									
Goods deflator	...	0.3	-0.4	2.3	4.8	-1.3	-1.9	-2.0	-1.6
Services deflator	...	3.3	1.7	7.7	9.4	1.9	2.6	1.9	...

Sources: Census and Statistics Department, *Consumer Price Index Report*, *Hong Kong Monthly Digest of Statistics*, and *Quarterly Report of GDP Estimates, Second Quarter 1997*.

1/ Average of four-quarter percentage changes.

2/ Based on the October 1989-September 1990 series of CPI through 1995 and the October 1994-September 1995 series since 1996.

3/ Data are on a national accounts basis.

Table 6. Hong Kong SAR: Labor Force, Employment, and Unemployment, 1991-97 1/

	1991	1992	1993	1994	1995	1996	1997		
							Q1	Q2	Q3
Labor force	2,804	2,792	2,856	2,929	3,001	3,094	3,161	3,181	3,192
Employed	2,754	2,738	2,800	2,873	2,905	3,008	3,090	3,113	3,123
Unemployed	50	55	56	56	96	86	71	68	70
	(In thousands)								
Unemployment rate	1.8	2.0	2.0	1.9	3.2	2.8	2.2	2.1	2.2
Labor force participation rate	63.4	62.3	62.3	62.0	62.0	61.8	61.6	61.5	61.2
	(In percent)								
Labor force growth	2.0	-0.4	2.3	2.5	2.4	3.1	3.1	2.9	3.8
Employment growth	1.6	-0.6	2.3	2.6	1.1	3.5	3.9	3.8	4.3
	(Percent changes)								
	(In percent of total employed)								
Employment in selected sectors									
Manufacturing	24	21	18	15	13	11	10	10	..
Financing, insurance, real estate, and business services	10	11	12	12	12	13	13	13	..
Trade and tourism 2/	31	32	33	35	34	34	34	32	..
Building and construction	2	2	2	2	2	2	3	3	..
Community, social, and personal services	9	10	10	10	10	10	11	10	..
Transportation, storage, and communications	5	5	5	6	6	6	6	6	..
Civil service	7	7	6	6	6	6	6	6	..

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

1/ Based on revised population estimates released in September 1996. All data are period averages.

2/ Wholesale, retail, import and export trade, restaurants, and hotels.

Table 7. Hong Kong SAR: Wages, Labor Productivity,
and Unit Labor Costs, 1992-97

(Percentage change)

	1992	1993	1994	1995	1996	1997 1/
Nominal wages 2/						
Overall economy	9.8	10.8	9.7	8.0	6.3	6.0
Manufacturing	9.5	10.7	8.9	5.9	6.6	6.8
Trade and tourism 3/	9.6	9.2	10.0	8.6	5.2	5.8
Financial services 4/	11.1	12.1	8.7	9.2	7.9	5.8
Real wages 2/						
Overall economy	0.2	2.8	1.3	-1.1	0.4	0.3
Manufacturing	-0.2	2.8	0.7	-3.0	0.7	1.1
Trade and tourism 3/	0.0	1.5	1.6	-0.5	-0.5	0.1
Financial services 4/	1.4	3.2	0.3	0.0	2.0	0.1
Labor productivity 5/						
Overall economy	6.9	3.8	2.8	2.8	1.3	2.3
Manufacturing	16.5	13.3	15.9	14.6	11.7	7.4
Unit labor costs 5/						
Overall economy	2.9	6.6	6.6	4.7	4.9	3.8
Manufacturing	-5.7	-2.4	-6.4	-7.5	-4.7	-1.9

Sources: Census and Statistics Department, *Hong Kong Annual Digest of Statistics*; *Hong Kong Monthly Digest of Statistics*; *Estimates of Gross Domestic Product, 1961 to 1995*; *Quarterly Report of GDP Estimates, Second Quarter 1996*; and staff estimates.

1/ Data on wages are based on March 1997 wage indices; data on productivity are based on data for the first half of 1997; data on unit labor costs are for the first quarter of 1997. Percentage changes are calculated over corresponding year-earlier periods.

2/ Based on averages of semiannual (March and September) data.

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

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

5/ Based on employment data; data on person-hours are unavailable. Employment data for 1992-97 are based on revised population estimates released in September 1996.

Table 8. Hong Kong SAR: Estimates of External Factor Income Flows
by Income Component and by Business Sector, 1993-94

(At current market prices, in millions of Hong Kong dollars)

Type of income components	1993	1994	1995
Direct investment Income			
Inflow total	80,743	111,562	106,810
Banking	6,610	6,156	7,558
Others	74,133	105,405	99,252
Outflow total	153,550	169,026	177,942
Banking	59,074	55,890	61,630
Others	94,475	113,136	113,312
Portfolio investment income			
Inflow total	68,656	66,482	78,575
Banking	32,767	19,088	24,300
Others	35,889	47,394	54,276
Outflow total	10,838	20,257	24,089
Banking	2,476	3,587	4,171
Others	8,362	16,670	19,918
Other investment income			
Inflow total	167,196	193,120	201,623
Banking	163,696	187,188	192,710
Others	3,500	5,932	8,913
Outflow total	141,863	174,542	170,466
Banking	137,295	169,064	162,310
Others	4,567	5,477	8,156
Compensation of employees			
Inflow total	100	141	270
Outflow total	100	141	270
Banking	11	10	45
Others	89	131	225
Total external factor income flows			
Inflow total	316,696	371,305	387,278
Banking	203,073	212,432	224,568
Others	113,622	158,872	162,710
Outflow total	306,350	363,965	372,767
Banking	198,857	228,551	228,156
Others	107,494	135,414	144,611
Net flow total	10,345	7,340	14,511
Banking	4,217	-16,118	-3,589
Others	6,129	23,458	18,099

Source: Census and Statistics Department, *Annual Digest of Statistics*.

Table 9. Hong Kong SAR: Exports and Imports of Services, 1991-95

	1991	1992	1993	1994	1995	Share in 1995
	(At current prices, in billions of Hong Kong dollars)					(In percent)
Value indices						
Exports	161.1	189.4	215.6	240.7	278.8	100.0
Transportation	64.7	73.5	80.1	90.4	100.7	36.1
Travel	42.7	53.2	61.2	64.3	74.9	26.9
Insurance	1.5	2.3	3.5	3.5	3.9	1.3
Financial	7.7	9.2	14.7	18.1	19.1	5.9
Trade-related	31.8	35.9	40.5	46.9	59.6	21.4
Other business	12.8	15.2	15.7	17.5	20.6	7.4
Imports	100.8	114.2	123.0	144.1	166.1	100.0
Transportation	28.0	32.3	33.8	37.3	42.2	25.4
Travel	43.7	47.5	54.9	66.7	81.0	48.7
Insurance	2.7	3.6	3.3	5.1	5.7	3.4
Financial	2.9	3.2	5.0	6.6	7.4	4.4
Trade-related	10.6	12.3	9.9	10.3	10.2	6.2
Other business	12.9	15.4	16.1	18.0	19.8	11.9
Net exports of services	60.3	75.1	92.6	96.6	112.6	...
Volume indices						
	(Percent change) 1/					
Exports	4.7	10.6	8.0	6.5	11.3	...
Transportation	10.5	9.8	7.4	8.7	8.4	...
Travel	-2.7	16.3	7.5	-3.5	10.2	...
Insurance	0.3	39.8	32.7	-2.9	7.9	...
Financial	12.4	8.8	45.5	22.7	2.8	...
Trade-related	2.7	3.8	5.2	11.3	21.4	...
Other business	4.2	10.0	-6.0	10.3	14.4	...
Imports	11.3	9.7	5.8	8.8	5.8	...
Transportation	2.4	13.2	6.0	8.5	7.9	...
Travel	16.6	3.7	10.4	6.6	6.8	...
Insurance	4.5	30.2	-8.3	47.3	7.2	...
Financial	5.8	10.1	56.5	24.2	7.2	...
Trade-related	22.8	15.1	-18.8	2.0	-5.4	...
Other business	6.2	14.6	4.4	8.2	4.2	...
Net exports of services	-6.0	12.4	12.0	2.6	21.3	...

Source: Census and Statistics Department; *Estimates of Gross Domestic Product 1961-1996, and Annual Digest of Statistics*.

1/ Calculated from constant-price series.

Table 10. Hong Kong SAR: Property Market Developments, 1992-97 1/

	1992	1993	1994	1995	1996	1997 2/	
						Q1	Q2
	(1989 = 100)						
Price indices							
Private domestic premises	215	237	293	272	299	393	394
Of which:							
40 to 70 square meters	219	244	306	282	310	408	408
100 square meters and above	205	250	351	314	353	481	487
Private retail premises	200	244	285	277	284	330	364
Offices	133	159	222	188	185	212	214
Flatted factories	147	177	189	166	142	142	146
	(Percent change)						
Private domestic premises	40.5	10.2	23.6	-7.2	9.9	41.9	36.3
Of which:							
40 to 70 square meters	41.3	11.4	25.4	-7.8	9.9	41.2	36.0
100 square meters and above	51.9	22.0	40.4	-10.5	12.4	50.8	43.2
Private retail premises	39.9	22.0	16.8	-2.8	2.5	17.4	28.6
Offices	37.1	19.5	39.6	-15.3	-1.6	16.5	16.9
Flatted factories	28.9	20.4	6.8	-12.2	-14.5	-4.7	-2.1
	(1989 = 100)						
Rental indices							
Private domestic premises	130	140	170	174	171	183	192
Private retail premises	149	167	192	192	192	203	202
Offices	101	110	134	132	112	114	116
Flatted factories	117	129	133	131	118	118	117
	(Percent change)						
Private domestic premises	9.2	7.7	21.4	2.4	-1.7	8.9	13.6
Private retail premises	18.3	12.1	15.0	0.0	0.0	7.4	8.0
Offices	6.3	8.9	21.8	-1.5	-15.2	-0.9	-4.5
Flatted factories	7.3	10.3	3.1	-1.5	-9.9	-3.3	-0.8

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.

Table 11. Hong Kong SAR: Revenue (General Revenue Account), 1993/94–1997/98

(In millions of Hong Kong dollars)

	1993/94	1994/95	1995/96	1996/97		1997/98 Budget
				Budget	Actual	
Taxes	113,790	118,643	120,545	127,663	139,767	135,234
Direct taxes	66,625	75,754	78,696	82,941	85,476	86,328
Earnings and profits tax	65,439	74,295	77,419	81,916	83,966	85,140
Estate duty	1,186	1,459	1,277	1,025	1,510	1,188
Indirect taxes	47,165	42,889	41,849	44,722	54,291	48,906
Duties	7,113	7,583	7,899	8,862	8,450	8,597
General rates	4,461	5,156	5,806	6,390	6,285	6,312
Internal revenue	30,020	23,202	23,491	23,999	34,552	28,639
Bets and sweeps tax	10,082	9,352	11,051	11,688	12,191	13,879
Entertainment tax	1	0.0	0.0	0.0	0.0	0.0
Hotel accommodation tax	375	445	501	560	580	644
Stamp duties	17,976	12,714	11,215	10,440	20,461	12,760
Air passengers' departure tax	1,383	488	522	1,109	1,121	1,187
Cross Harbor Tunnel passage tax	203	203	202	202	199	169
Motor vehicles taxes	4,192	4,662	2,880	3,123	3,249	3,258
Royalties and concessions	1,379	1,653	1,773	1,889	1,755	1,857
Taxi concessions	0.0	633	0.0	459	0.0	243
Nontax revenue	30,109	32,409	32,649	34,935	34,090	42,606
Fines and penalties	1,123	1,520	1,607	1,697	1,592	1,691
Properties, investments, and interest	8,256	8,376	8,735	9,653	9,347	14,774
Of which: interest	3,387	4,942	5,910	5,540	5,616	6,350
Reimbursements and contributions	3,842	4,166	4,811	5,421	5,326	8,020
Utilities	7,997	8,392	7,199	6,827	6,608	6,977
Fees and charges	8,627	9,562	9,879	10,903	10,766	10,765
Land transactions 2/	264	393	418	434	451	379
Other	0.0	0.0	0.0	0.0	0.0	0.0
Total Revenue	143,899	151,052	153,194	162,598	173,857	177,840

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

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 12. Hong Kong SAR: Government Expenditure Under the General Revenue Account, 1993/94-1997/98

(In millions of Hong Kong dollars)

	1993/94	1994/95	1995/96	1996/97		1997/98 Budget
				Budget	Actual	
Current expenditure	93,191	106,022	120,284	137,928	134,737	154,411
Personal emoluments	28,702	32,077	34,832	38,971	37,404	42,151
Personnel-related expenses	8,695	9,835	11,304	13,806	12,853	15,232
Departmental expenses	4,910	5,568	6,199	7,301	7,062	8,529
Other charges	13,904	15,633	17,928	21,241	21,147	24,101
Subventions	36,980	42,909	50,021	56,609	56,271	64,398
Capital expenditure 2/	27,849	41,238	35,573	19,229	17,195	9,266
Plant, equipment, and works	466	545	581	894	616	1,281
Other nonrecurrent	3,767	598	1,619	2,093	1,116	2,554
Subventions	1,116	995	838	1,212	2,043	1,154
Transfers to funds	22,500	39,100	32,535	15,030	13,420	4,277
Capital Works Reserve Fund						
/Public Works	13,650	15,500	11,500	8,500	6,390	0.0
Capital Investment Fund	8,500	7,500	19,500	3,500	3,500	0.0
Loan Fund	300	9,100	1,500	3,000	3,500	3,750
Disaster Relief Fund	50	0.0	35	30	30	27
Civil Service Pension Reserve Fund	0.0	7,000	0.0	0.0	0.0	500
Total expenditure	121,040	147,260	155,857	157,157	151,932	163,677

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

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 13. Hong Kong SAR: Public Expenditure by Function, 1993/94-1997/98 1/
(In millions of Hong Kong dollars)

	1993/94		1994/95		1995/96 Actual		1996/97 Revised Budget		1997/98 Budget				
	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital			
Economic	5,959	6,488	6,380	994	6,734	1,973	8,707	7,891	2,651	10,542	9,207	2,420	11,627
Security	16,643	679	18,137	838	19,501	2,363	21,864	21,718	3,015	24,733	23,312	2,281	25,593
Internal security	13,597	612	14,661	755	15,635	2,155	17,790	17,179	2,804	19,983	18,169	1,983	20,152
Immigration	1,310	48	1,358	62	1,604	115	1,719	1,827	54	1,881	1,920	123	2,043
Other	1,736	19	1,755	21	2,262	93	2,355	2,712	157	2,869	3,223	175	3,398
Social services	23,307	4,320	27,627	27,485	30,270	5,273	38,432	39,488	3,790	43,278	45,292	4,117	49,409
Social welfare	8,787	383	9,170	10,458	13,196	951	14,147	16,748	1,479	18,227	19,497	1,697	21,194
Health	14,520	3,937	18,457	17,027	19,322	4,322	24,285	22,740	2,311	25,051	25,795	2,420	28,215
Education	22,572	2,837	25,409	26,186	28,873	3,294	33,610	34,350	4,813	39,163	38,113	7,200	45,313
Environment	1,266	1,868	3,134	1,748	2,653	3,470	5,626	2,539	4,011	6,550	3,141	4,941	8,082
Community and external affairs	6,627	1,699	8,326	7,563	9,229	2,045	10,584	10,016	3,000	13,016	11,065	3,038	14,103
Recreation, culture, and amenities	5,541	1,663	7,204	6,289	7,924	2,004	9,120	8,307	2,825	11,132	9,125	2,832	11,957
District and community relations	734	18	752	872	891	973	993	1,184	153	1,337	1,366	176	1,542
Other	352	18	370	402	414	21	471	525	22	547	574	30	604
Infrastructure	6,240	16,811	23,051	6,972	19,259	26,231	26,845	9,135	15,045	24,180	10,432	17,704	28,136
Transportation	1,549	7,464	9,013	1,574	9,108	10,682	10,204	2,079	6,999	9,078	2,470	5,037	7,507
Land and buildings	1,865	7,873	9,738	2,261	8,312	10,573	10,787	2,885	6,168	9,053	3,301	10,812	14,113
Water supply	2,826	1,474	4,300	3,137	1,839	4,976	5,854	4,171	7,878	6,049	4,661	1,855	6,516
Civil service support services	15,562	5,722	21,284	17,635	3,256	20,891	26,601	22,914	6,973	29,887	25,366	8,610	33,976
Housing	7,079	9,528	16,607	7,814	11,887	19,701	19,069	11,694	14,151	25,845	13,630	18,508	32,138
Total public expenditure	105,254	49,952	155,207	119,920	46,030	165,950	191,338	159,745	57,449	217,194	179,558	68,819	248,377

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

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.

Table 14. Hong Kong SAR: Exchange Fund Balance Sheet, 1992-97

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

	1992	1993	1994	1995	1996	1997 June
Assets						
Foreign currency	274,948	335,499	381,233	428,547	493,802	523,891
Hong Kong dollar	12,546	12,987	24,617	32,187	40,715	44,863
Total	287,494	348,486	405,850	460,734	534,517	568,754
Liabilities						
Certificates of indebtedness 1/	58,130	68,801	74,301	77,600	82,480	91,985
Transfers of fiscal reserves 2/	96,145	115,683	131,240	125,916	145,898	182,168
Coins in circulation	2,559	2,604	3,372	3,597	4,164	4,564
Exchange Fund bills	19,324	25,157	46,140	53,125	83,509	89,338
Balance of banking system	3,220	7,314	22,815	38,600	45,130	18,332
Other 3/	1,480	1,385	2,208	1,762	474	480
Total	180,858	220,944	280,076	300,600	361,655	386,867
Accumulated earnings	106,636	127,542	125,774	160,134	172,862	181,887

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.

Table 15. Hong Kong SAR: Monetary Indicators, 1992-97 1/

	1992	1993	1994	1995	1996	1997 2/		
						March	June	Sept.
(Percentage change)								
M1	21.1	20.6	-1.2	2.8	14.2	11.3	14.9	8.4
M2	10.8	16.2	12.9	14.6	10.9	11.1	15.4	14.8
M3	9.5	15.8	13.6	14.2	10.5	10.9	15.1	14.6
Hong Kong dollars 3/	13.7	25.2	18.4	14.9	18.9	18.4	23.8	21.6
Foreign currency 4/	6.0	7.2	8.5	13.2	0.5	1.8	4.2	5.4
Total credit	9.8	15.2	15.9	13.8	6.2	8.4	16.4	14.0
Hong Kong dollars	13.0	20.2	21.5	6.4	19.9	25.3	31.2	34.4
Foreign currency	8.4	13.0	13.3	17.5	0.0	0.0	8.7	3.3
<i>Of which</i>								
Total loans and advances	10.1	15.7	14.3	14.5	4.7	6.4	13.2	12.0
Hong Kong dollars	12.2	17.9	16.9	10.5	17.0	22.9	24.5	29.5
Foreign currency	9.0	14.6	12.9	16.6	-1.4	2.4	7.0	2.0
Currency composition								
						(Percent of total)		
M1								
Hong Kong dollars 3/	89.7	89.8	90.6	90.1	91.2	91.1	90.3	91.2
Foreign currency 4/	10.3	10.2	9.4	9.9	8.8	8.9	9.7	8.8
M3								
Hong Kong dollars 3/	47.7	51.5	53.7	54.1	58.2	58.3	59.8	60.2
Foreign currency 4/	52.3	48.5	46.3	45.9	41.8	41.7	40.2	39.8
Velocity								
M2	0.51	0.51	0.51	0.47	0.47	0.47	0.47	...
M3	0.50	0.49	0.49	0.46	0.46	0.46	0.45	...
Memorandum items:								
Nominal GDP (HK\$ billions) 5/	779.3	897.5	1,010.8	1,078.2	1,193.9	1,230.1	1,270.4	...
Nominal growth of GDP (percent)	16.6	15.2	12.6	6.7	10.7	11.7	12.6	...

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 16. Hong Kong SAR: Loans for Use in Hong Kong, 1992-97 1/

(Twelve-month percentage change)

	1992	1993	1994	1995	1996	1997		
						March	June	Sept.
Loans for use in Hong Kong	11.4	18.2	17.1	11.1	17.1	23.2	26.1	30.7
Of which:								
Manufacturing	16.9	15.7	16.4	16.6	7.4	9.5	9.2	3.6
Transportation and equipment	13.3	8.0	14.5	-3.9	20.1	18.8	16.2	19.8
Building, construction, and property development	15.0	24.8	38.1	5.2	27.1	31.9	39.8	38.9
Wholesale and retail trade	9.3	12.8	38.3	21.0	6.1	12.3	15.2	9.9
Miscellaneous	10.3	18.5	7.4	12.1	17.2	24.7	26.8	37.1
Of which:								
To purchase flats in the Home Ownership Scheme and private sector participation scheme	13.4	61.3	14.5	18.9	6.6	11.6	16.0	19.7
To purchase other residential property	12.5	15.1	10.9	16.7	23.0	25.7	29.5	36.5
To financial concerns	7.9	27.6	2.6	9.6	17.7	30.5	26.9	33.4
To stockbrokers	-7.1	72.1	30.6	32.5	27.3	18.1	14.8	207.5

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 17. Hong Kong SAR: Loans and Advances by Type, September 1997

	Hong Kong Dollar (In billions of Hong Kong dollars)	Foreign Currency	Total	Share of HK\$ loans in total Loans (In percent)	Share of loan type in total Loans
Loans for use in Hong Kong	1,748	466	2,213	79.0	51.8
Trade-related	75	100	175	42.9	4.1
Other	1,673	366	2,038	82.1	47.7
Loans for use outside Hong Kong	35	1,979	2,015	1.7	47.1
Trade-related	4	18	22	19.1	0.5
Other	31	1,961	1,993	1.6	46.6
Loans for which the place of use is not known	10	39	49	20.0	1.1
Total loans	1,793	2,484	4,278	41.9	100.0

Source: Hong Kong Monetary Authority, *Monthly Statistical Bulletin*.

Table 18. Hong Kong SAR: Balance Sheet of All Authorized Institutions, September 1997

	Hong Kong dollar	Foreign currency	Total	Share of total assets/ liabilities	Share of Hong Kong dollar assets/ liabilities
	(In billions of Hong Kong dollars)			(In percent)	
Liabilities					
Amount due to authorized institutions in Hong Kong	545	288	833	9.6	65.4
Amount due to banks abroad	285	3,877	4,162	48.1	6.9
Deposits from customers 1/ Negotiable certificates of deposit (NCDs) outstanding	1,564	1,147	2,711	31.3	57.7
Other debt instruments outstanding	166	51	217	2.5	76.4
Capital, reserves and other liabilities	3	55	58	0.7	5.0
	416	261	677	7.8	61.4
Total liabilities	2,978	5,680	8,658	100.0	34.4
Assets					
Notes and coins	12	2	13	0.2	88.8
Amount due from authorized institutions in Hong Kong	544	288	832	9.6	65.4
Amount due from banks abroad	179	2,180	2,359	29.3	7.6
Loans and advances to customers	1,743	2,484	4,278	49.4	41.9
NCDs held	120	57	177	2.0	67.9
Negotiable debt instruments held, other than NCDs	210	461	671	7.8	31.3
Investments in shareholdings	17	3	20	0.2	83.1
Interest in land and buildings	50	1	51	0.6	98.2
Other	71	186	256	3.0	27.5
Total assets	2,996	5,662	8,658	100.0	34.6
Memorandum items:					
Number of reporting institutions	363				
Number of branches	1,577				

Source: Hong Kong Monetary Authority, *Monthly Statistical Bulletin*.

1/ Unadjusted for foreign currency swap deposits.

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