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

This Recent Economic Developments report on the People's Republic of China—Hong Kong Special Administrative Region was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with this member country. As such, the views expressed in this document are those of the staff team and do not necessarily reflect the views of the Government of the People's Republic of China—Hong Kong Special Administrative Region or the Executive Board of the IMF.

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PEOPLE'S REPUBLIC OF CHINA—HONG KONG
SPECIAL ADMINISTRATIVE REGION¹

Recent Economic Developments

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Approved by the Asia and Pacific Department

April 9, 1999

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

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I. INTRODUCTION

1. Since mid-1997, the Asian financial crisis has had a major impact on the Hong Kong SAR economy. External demand has weakened dramatically, the Hong Kong dollar has come under speculative pressure, and economic activity has fallen sharply. Under the linked exchange rate system, the economy has adjusted very rapidly to these shocks, demonstrating its remarkable flexibility. Asset prices have dropped sharply, consumer prices and housing rentals have started to decline, and labor costs are moderating. Nevertheless, the costs of adjustment have been substantial—unemployment has risen sharply and the fiscal position has weakened.
2. With international financial markets starting to stabilize, economic activity in Hong Kong SAR is expected to begin to recover in 1999, once the adjustment process reaches completion. The outlook over the medium term looks promising. Hong Kong SAR's rules-based economic policy framework and its position as an international financial center will allow the economy to benefit from the vast growth potential of the Mainland.
3. Developments over the past year in the real and external sectors are outlined in Chapter II, while Chapter III summarizes recent property market developments. Chapter IV discusses recent budgetary trends. Developments in financial markets and in the banking and corporate sectors are reviewed in Chapter V. Data reported in this paper are based on information available as of mid-December 1998.

II. REAL AND EXTERNAL SECTOR DEVELOPMENTS

A. Overview

4. Following a period of above-trend growth and a sharp runup in asset prices, the Hong Kong SAR economy was hard hit by the Asian financial crisis. The weakening of external demand—together with the increase in interest rates and the appreciation of the Hong Kong dollar in real effective terms—caused economic activity to slow sharply and triggered the deflation of the asset price bubble that had emerged over the previous year. Real GDP growth fell markedly in the third quarter of 1997 (based on seasonally adjusted data), and turned negative in the fourth quarter (Chart 1, Table 1, and Appendix Tables 10 and 11).
5. Activity continued to contract in the first three quarters of 1998, as external demand continued to weaken and domestic demand fell sharply. By the end of the third quarter, a sizable gap between actual and estimated potential output had emerged. The deflation in asset prices spread to consumer and factor prices, causing inflation to turn negative and wages to slow markedly. The unemployment rate rose to its highest level in 17 years.

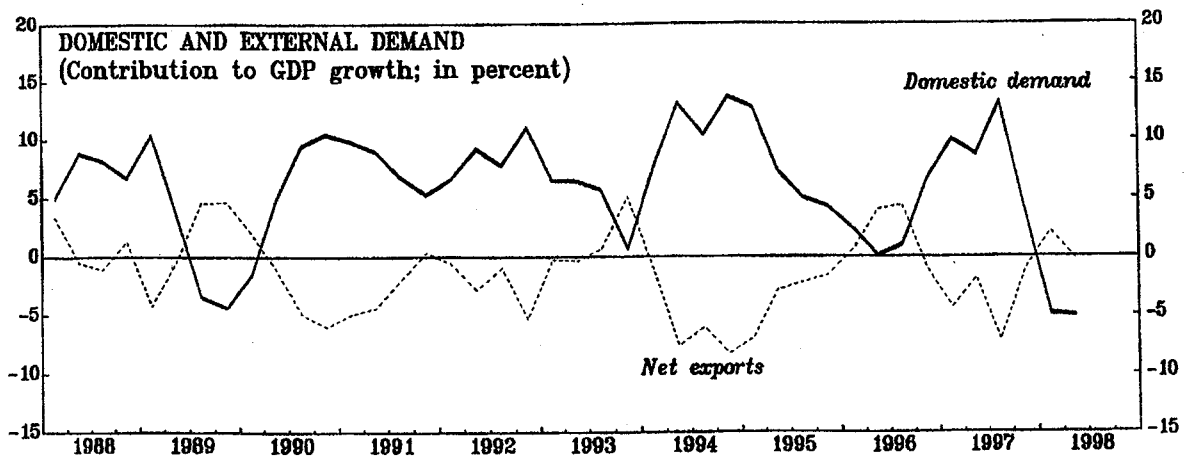
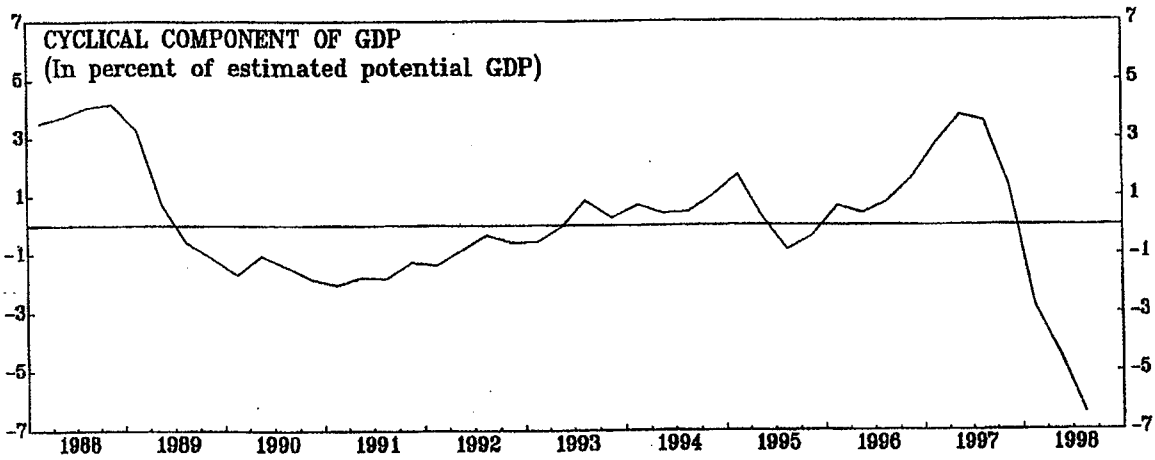
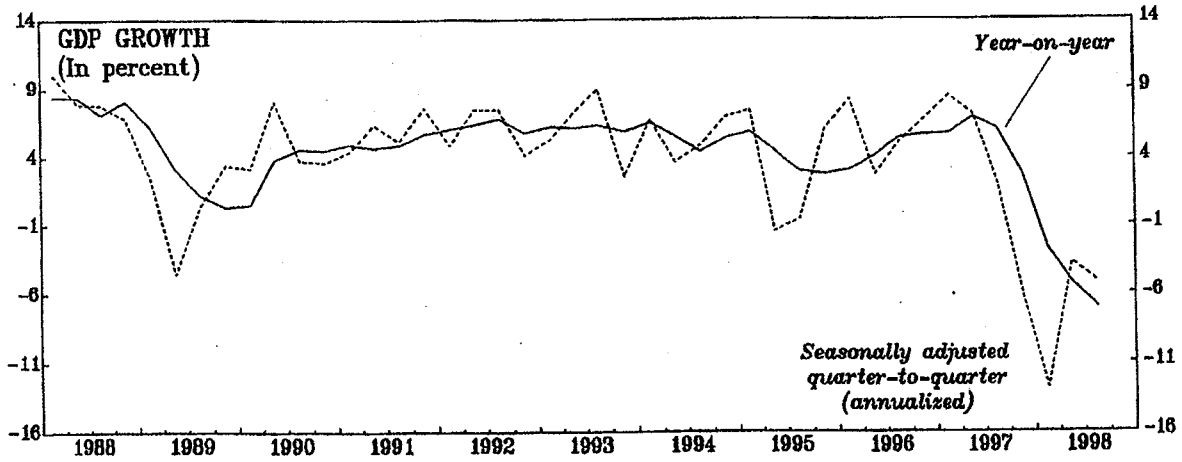
Table 1. Hong Kong SAR: Gross Domestic Product by Expenditure Component
at Constant (1990) Market Prices, 1993-98

	1993	1994	1995	1996	1997	1998 Jan.-June 1/
(In billions of Hong Kong dollars)						
Consumption	469.6	499.6	508.3	531.9	564.9	265.5
Private	415.6	443.6	450.5	471.8	503.3	234.6
Government	53.9	56.1	57.9	60.1	61.6	30.9
Gross fixed capital formation	190.3	220.2	243.8	270.1	313.3	153.6
Private	162.2	187.3	203.7	223.2	268.6	130.6
Government	28.1	32.9	40.1	47.0	44.7	23.0
Final domestic demand	659.8	719.8	752.1	802.1	878.2	419.1
Private	577.8	630.9	654.2	695.0	771.9	365.2
Government	82.0	88.9	97.9	107.1	106.3	53.9
Change in stocks	2.2	20.1	40.1	9.6	3.7	-4.9
Total domestic demand	662.0	739.9	792.2	811.7	881.9	414.3
Net exports of goods, nonfactor services	28.2	-12.4	-36.4	-21.3	-49.6	-32.5
Gross domestic product	690.2	727.5	755.8	790.4	832.3	381.8
(Percentage change)						
Consumption	6.9	6.4	1.7	4.6	6.2	-3.5
Private	7.5	6.7	1.6	4.7	6.7	-3.8
Government	2.2	3.9	3.2	4.0	2.4	-1.5
Gross fixed capital formation	3.7	15.7	10.7	10.8	16.0	0.3
Private	-0.7	15.5	8.8	9.6	20.2	0.6
Government	39.3	17.1	22.0	17.1	-4.2	-1.5
Final domestic demand	5.9	9.1	4.5	6.6	9.5	-2.2
Private	5.1	9.2	3.7	6.2	11.0	-2.3
Government	12.4	8.4	10.2	9.4	-0.5	-1.5
Total domestic demand	4.9	11.8	7.1	2.5	8.7	-4.6
Exports of goods and nonfactor services	12.7	9.8	11.0	5.3	5.2	-0.8
Export of goods	13.5	10.4	12.0	4.8	6.1	0.4
Domestic exports	-4.5	-2.3	2.0	-8.4	2.1	-2.5
Reexports	19.6	13.8	14.3	7.5	6.8	0.9
Exports of nonfactor services	8.0	6.5	4.8	8.5	-0.6	-8.0
Imports of goods and nonfactor services	12.0	13.5	12.7	4.2	6.9	-1.3
Import of goods	12.7	14.0	13.8	4.3	7.2	-1.7
Import of nonfactor services	5.8	8.8	2.1	2.5	4.1	3.7
Gross domestic product	6.1	5.4	3.9	4.6	5.3	-4.0
Memorandum items:						
Contribution to growth:						
From total domestic demand	4.7	11.3	7.2	2.6	8.9	-5.0
Of which: From change in stocks	-1.0	2.6	2.8	-4.0	-0.7	-2.6
From net exports of goods and nonfactor services	1.4	-5.9	-3.3	2.0	-3.6	1.0

Sources: Census and Statistics Department, Quarterly Report of GDP Estimates, Second Quarter 1998.

1/ Percentage changes calculated over January-June 1997.

CHART 1
HONG KONG SAR
REAL GDP GROWTH, 1988-98



Sources: Quarterly Report of GDP estimates; and staff estimations.

1/ Potential output estimated by applying Hodrick-Prescott filter.

B. Domestic Demand

6. The boom in domestic demand in 1997—which followed a prolonged period of negative real interest rates and was fueled by rapidly escalating asset prices—collapsed in 1998. The contribution of domestic demand to real GDP growth fell from 9 percentage points in 1997 to -5 percentage points in the first half of 1998, with consumption and investment growth both moderating rapidly.

Private consumption

7. The loss in wealth associated with the collapse in asset prices—estimated at well over 100 percent of GDP—weakened consumer sentiment and, together with the rise in unemployment and higher real interest rates, caused **private consumption** to fall. Private consumer spending, which accounts for around 60 percent of GDP, declined by 3¾ percent in real terms in the first half of 1998, in relation to the first half of 1997. In the third quarter, the volume of retail sales plummeted by around 20 percent over a year earlier. Sales of durables and nondurables other than food fell particularly sharply, while sales of food items declined modestly and sales of services were flat.²

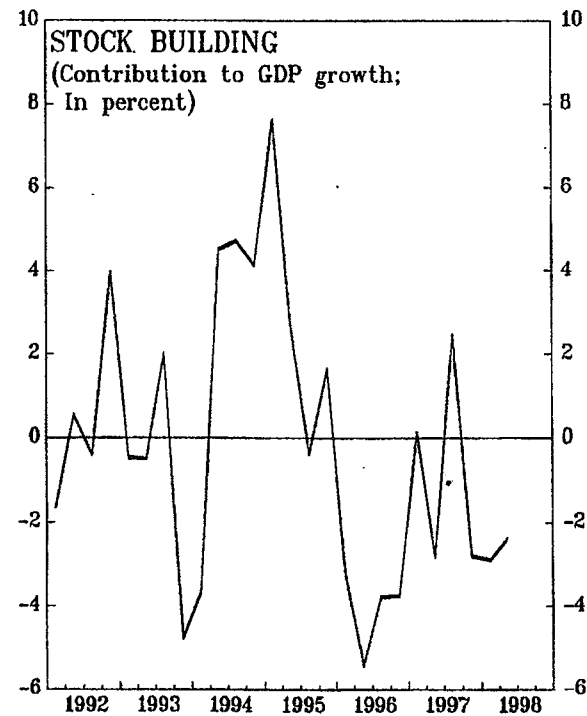
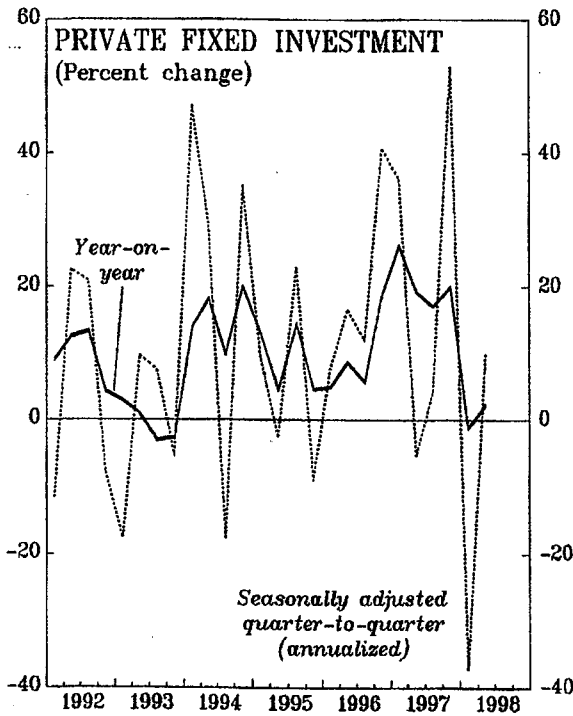
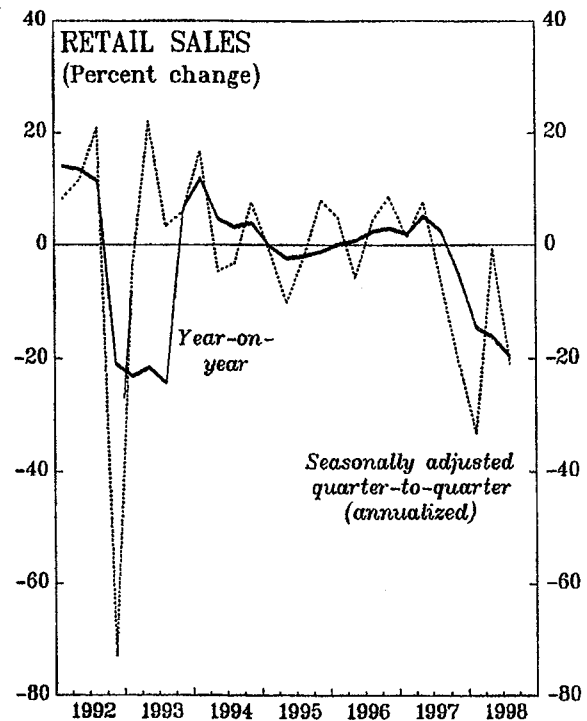
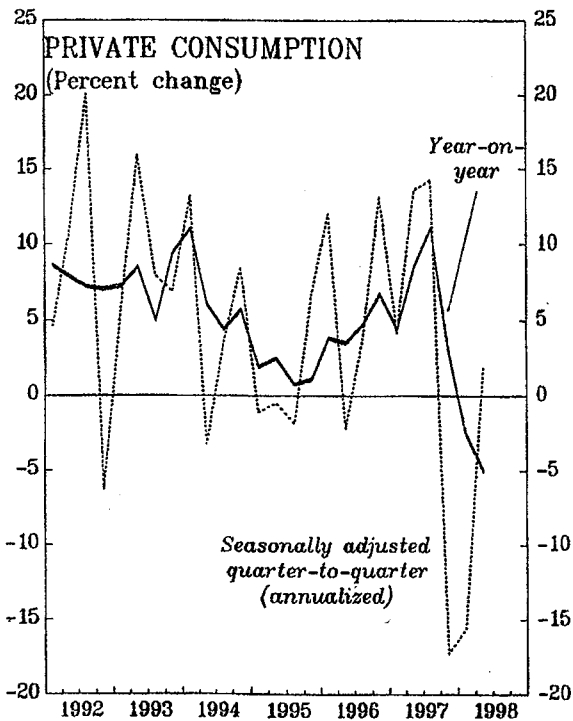
8. The close relation between asset prices and interest rates on the one hand, and private consumer spending on the other, was highlighted by developments during the past year (Chart 2). In seasonally adjusted terms, private consumption and retail sales plunged in the last quarter of 1997 and the first quarter of 1998, following the sharp correction in stock and residential property prices and the steep rise in interest rates. By the second quarter of 1998, as asset prices stabilized and interest rates eased, consumer spending started to recover. However, with the onset of renewed financial market turbulence in July–August, the volume of retail sales fell back in the third quarter.

Private investment

9. The growth of **gross fixed investment by the private sector**, which had averaged around 20 percent in real terms in 1997, fell to almost zero in the first half of 1998 in response to higher interest rates and weaker economic conditions. The weakening in the property market led to a steady deceleration in private construction activity, following the expansion of construction spending of 20 percent during the boom in 1997 (Appendix Table 12). Investment spending on transportation equipment fell, notwithstanding increased imports of transport equipment in the first quarter of 1998.

²The sharp decline in retail sales also reflects declining tourism, and substitution of domestic consumer spending in favor of increased spending abroad to take advantage of price differentials that had emerged following the depreciation of regional currencies. The number of outbound tourists increased sharply in 1998.

HONG KONG SAR
DOMESTIC DEMAND DEVELOPMENTS, 1992-98



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

10. Swings in **inventory accumulation** have had a sizable impact on measured GDP growth in recent years. The contribution of stock building to GDP growth, after recovering steadily in 1997 as increased imports helped replenish inventories, fell in the first half of 1998, reflecting the sharp decline in retained imports. For the half year, inventory decumulation accounted for 3 percentage points of the contraction in GDP.

Public consumption and investment

11. **Public investment**, after contracting by 5½ percent in 1997 as the airport project neared completion, fell by a further 1½ percent (year-on-year basis) during the first half of the year, notwithstanding the flurry of activity in the second quarter to complete the airport in advance of its opening in early July. **Government consumption**, measured on a national accounts basis, also fell by 1½ percent in the first half of 1998.

C. External Demand

12. After widening to 12¼ percent of GDP in 1997 with the upswing in domestic demand, the merchandise trade deficit narrowed to 11 percent of GDP in the first half of 1998. Notwithstanding the deterioration in export performance, the contribution of net exports to GDP growth rose from -3½ percentage points last year to 1 percentage point in the first half of this year. Despite weaker net exports of services, the deficit on goods and nonfactor services trade narrowed in the first half of 1998 (Table 2 and Appendix Table 13).

Exports

13. **Overall export performance** deteriorated steadily in 1998 as import demand in the region weakened (Chart 3). A disruption in air cargo handling services at the new airport also affected exports in July–August,³ as did the severe flooding in central Mainland China, which hampered land delivery of exports to the Mainland. The volume of exports fell by 2¼ percent in the first nine months of 1998, following a 6 percent expansion in 1997 as a whole (Table 3). Export unit values also declined, by close to 3½ percent in the first three quarters of the year.

14. The weak economic conditions in the region were reflected in the sharp decline in exports to many of Hong Kong SAR's trading partners in Asia. Exports to the ASEAN-4 and Korea fell by 38 percent and 24 percent, respectively, in the first half of 1998 (year-on-year basis), while exports to Japan and Singapore also shrank markedly. However, exports to Mainland China—Hong Kong SAR's most important trading partner—and Taiwan Province of China were flat, while exports to the United States and the European Union rose.

³Market analysts estimate that the disruption in air cargo service at the new airport reduced real GDP growth by around ¼ percentage point in 1998.

Table 2. Hong Kong SAR: External Balances, 1994-98

	1994	1995	1996	1997	1998		
					Staff Proj.	Jan.- June	July- Oct.
Merchandise trade balance							
In billions of U.S. dollars	-10.9	-19.6	-18.4	-21.1	-14.2	-8.9	-9.6
Net domestic exports 1/	-30.9	-42.7	-44.3	-49.2	-40.1	-21.7	...
Net reexports 2/	20.5	23.7	26.5	28.6	25.9	12.8	...
In percent of GDP	-8.4	-14.1	-11.9	-12.1	-8.3	-11.0	...
Services trade balance							
In billions of U.S. dollars	12.5	13.5	16.2	15.1	13.6	5.4	...
In percent of GDP	9.6	9.7	10.5	8.7	7.9	6.6	...
Balance on goods and nonfactor services trade							
In billions of U.S. dollars	1.6	-6.1	-2.2	-6.0	-0.6	-3.6	...
In percent of GDP	1.2	-4.3	-1.4	-3.5	-0.4	-4.4	...
Net external factor income flows							
In billions of U.S. dollars	0.9	1.9	-1.1	...	...	...	...
Inflows	48.0	50.1	49.7	...	...	...	...
Outflows	47.1	48.2	50.8	...	...	...	...
In percent of GDP	0.7	1.3	-0.7	...	...	...	...
Inflows	36.7	36.0	32.2	...	...	...	...
Outflows	36.0	34.6	33.0	...	...	...	...
Net current transfers (US\$ billion) 3/	-1.0	...	...	...	...	...	...
Current account balance							
In billions of U.S. dollars	1.5	-4.2	-3.3	...	...	...	...
In percent of GDP	7.5	1.1	-2.1	...	...	...	...

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, 1998; Ma and Hawkins (1997); and staff estimates and projections.

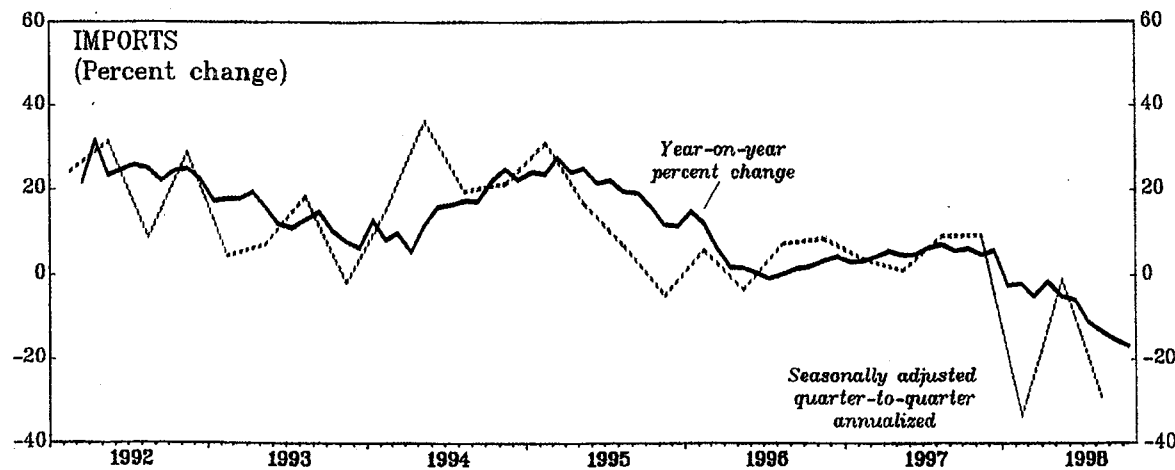
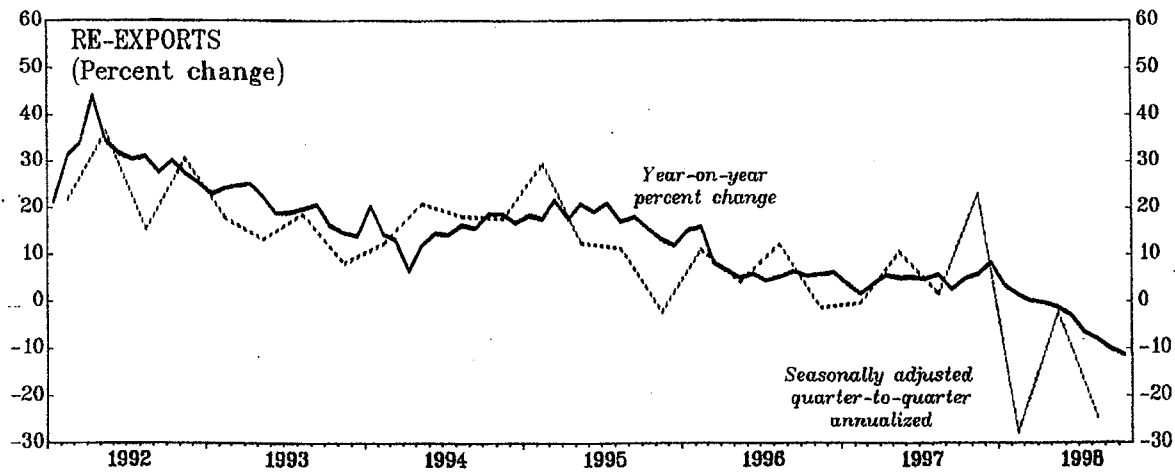
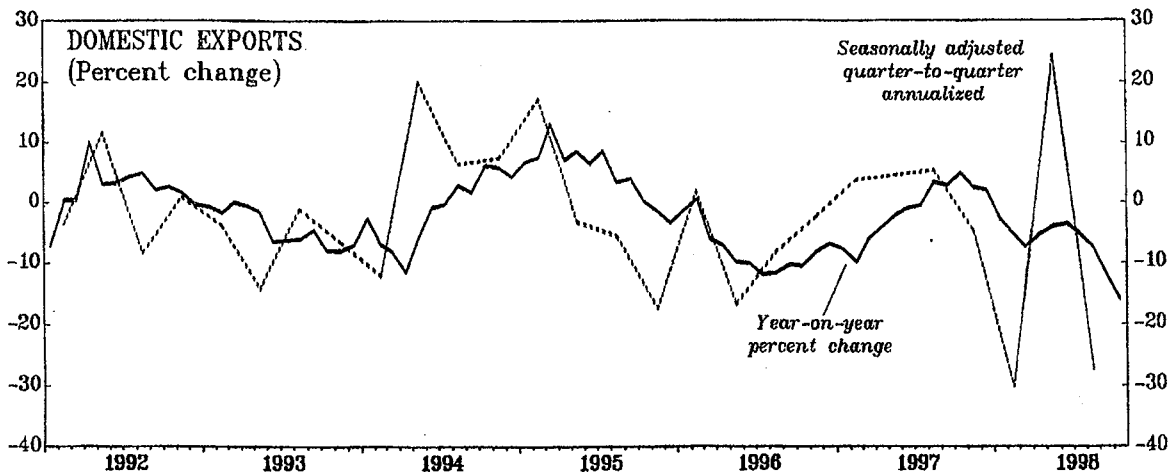
1/ Domestic exports less retained imports.

2/ Reexports less nonretained imports.

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

CHART 3

HONG KONG SAR
EXTERNAL TRADE, 1992-98



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

Table 3. Hong Kong SAR: Foreign Trade Developments, 1993-98

	(Percentage change)					
	1993	1994	1995	1996	1997	1998 Jan.-Sep.1/
Total exports						
Value	13.1	11.8	14.9	4.0	4.2	-5.2
Unit value	-0.4	1.5	3.3	-0.4	-1.6	-3.4
Volume	13.5	10.4	12.0	4.8	6.1	-2.3
Domestic exports						
Value	-4.7	-0.4	4.3	-8.4	-0.4	-7.9
Unit value	0.3	1.6	2.4	0.3	-2.3	-2.8
Volume	-4.5	-2.3	1.9	-8.4	2.2	-5.0
Re-exports						
Value	19.2	15.1	17.4	6.6	5.0	-4.7
Unit value	-0.6	1.5	3.5	-0.5	-1.5	-3.5
Volume	19.6	13.8	14.3	7.5	6.8	-1.9
Imports						
Value	12.3	16.6	19.2	3.0	5.2	-9.1
Unit value	-0.6	2.8	5.0	-1.3	-2.3	-4.8
Volume	12.8	14.0	13.7	4.3	7.2	-4.8
Terms of trade	0.2	-1.3	-1.6	1.0	0.7	1.5
Exports of nonfactor services 2/						
Value	13.8	11.6	10.4	10.2	0.2	-13.3
Unit Value	5.4	4.8	5.4	1.6	0.8	-5.8
Volume	8.0	6.5	4.8	8.5	-0.6	-8.0
Imports of nonfactor services 2/						
Value	7.7	17.1	11.7	4.3	5.3	1.6
Unit Value	1.8	7.6	9.4	1.6	1.2	-2.1
Volume	5.8	8.8	2.1	2.5	4.1	3.7

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics, and Quarterly Report of GDP Estimates, Second Quarter 1998; and Financial Services Bureau, Third Quarter Economic Report 1998.

1/ Average of 12-month percentage changes.

2/ Data for 1998 are for the first half of 1998 over first half of 1997.

Hong Kong SAR: Direction of Exports, 1996-98

	1996	1997	1998H1
Exports to:	(Annual percentage change)		
Mainland China	7.1	5.8	-0.7
Taiwan Province of China	-6.7	9.7	-0.1
United States	1.4	6.7	5.5
European Union	3.5	-1.4	2.8
Japan	11.6	-3.5	-18.3
Korea	4.7	-4.7	-37.9
Singapore	0.4	-0.8	-16.4
ASEAN-4	6.9	0.8	-24.4
	(In percent of total exports)		
Mainland China	34.3	34.9	36.1
Taiwan Province of China	2.4	2.5	2.6
United States	21.3	21.8	22.2
European Union	14.9	14.1	14.5
Japan	6.6	6.1	5.3
Korea	1.6	1.5	1.0
Singapore	2.8	2.6	2.3
ASEAN-4	3.7	3.6	3.0

Source: International Monetary Fund, *Direction of Trade Statistics*.

15. Hong Kong SAR's **reexport trade**, which had decelerated markedly in 1996-97, shrank in 1998. For the first nine months of the year, reexports were 4¾ percent lower than in the corresponding period of 1997, with the volume of reexports falling by almost 2 percent and unit values by 3½ percent. While the Mainland remained the most important trading partner for reexports—accounting for 59 percent of reexports by source and 35 percent of reexports by destination—reexports to the ASEAN-4, Korea, Japan, and Singapore fell sharply, reflecting the weak demand for imports in the region. By category of goods, reexports of consumer goods fell relatively sharply, while there was a more moderate decline in reexports of raw materials and intermediate goods and an increase in reexports of capital goods.

16. **Domestic exports** suffered an even steeper decline than reexports. In the first nine months of 1998, domestic exports fell by 8 percent, with most of the decline due to a reduction in export volume. Exports to all major markets except the United States—which accounts for close to 30 percent of Hong Kong SAR's total domestic exports—shrank. Domestic exports to the ASEAN-4, Korea, Japan, and Singapore declined particularly sharply.

Imports

17. **Overall imports** shrank by 9 percent in value and 4¾ percent in volume in the first three quarters of 1998 (year-on-year) as domestic demand and reexport activity fell. The decline was even more marked for **retained imports**, which plummeted by 11 percent in real terms. By category, retained imports of consumer goods fell by almost a quarter in real terms, on account of the slackening in consumer demand, the precipitous decline in wealth, and rising unemployment. Imports of raw materials and intermediate goods declined by 15 percent, curbed by weaker export activity, and imports of food by decreased almost 10 percent. Imports of capital goods were flat. By contrast, fuel imports rose by almost 50 percent, due to increased stocking to take advantage of the marked decline in world oil prices.

Services

18. The deterioration in external demand was also reflected in the net surplus on nonfactor services, which narrowed from 8¾ percent of GDP in 1997 to 6½ percent of GDP in the first half of 1998. Nonfactor services exports fell by 8 percent in real terms (year-on-year), with the number of tourists visiting Hong Kong SAR falling by over 20 percent. Exports of trade-related and other business services—particularly financial services—also weakened as a result of weaker activity and financial market turbulence in the region. However, this was partly offset by a deceleration in services import growth, which moderated from 4 percent in 1997 to 3¾ percent in the first half of 1998. While outward tourism by Hong Kong SAR residents increased in response to the depreciation of regional currencies against the Hong Kong dollar,⁴ overall services import growth moderated.

D. Inflation and External Competitiveness

19. With the value of the Hong Kong dollar against the U.S. dollar fixed by the exchange rate link, adjustment to the shocks over the past year has taken place through price deflation to restore external competitiveness. By the last quarter of 1998, asset prices were sharply lower than a year earlier, consumer price inflation was negative, and—while firm data on recent developments are not yet available—anecdotal evidence suggests that wages and bonuses are being cut back.

⁴The number of Hong Kong SAR residents traveling abroad rose by 16 percent in the first half of the year. The largest increase was in travelers to Northeast Asia, followed by the Mainland and Southeast Asia.

Inflation

20. Inflationary pressures eased as domestic demand and economic activity weakened, aided by the strength of the Hong Kong dollar and the softening of world commodity prices. Consumer price inflation, which had averaged 5¾ percent in 1997, moderated steadily in 1998 (Chart 4 and Appendix Table 14). By midyear, the seasonally-adjusted consumer price index (CPI) started to decline, and inflation turned negative on a year-on-year basis by October.⁵

21. Within the components of the index, food prices exhibited a strong downward trend during the course of the year, while durables price inflation also edged lower. The rate of increase of the housing component of the index, while moderating markedly during the first three quarters, remained relatively high as adjustment of rentals in many cases could only be undertaken once existing leases expired. However, by October–November, a full year after the deflation of residential property prices had commenced, housing price inflation fell sharply.

Competitiveness

22. The persistence of higher consumer price inflation than in trading partners over the past 15 years has led to a steady and sizable real appreciation of the Hong Kong dollar, 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 as Hong Kong SAR transformed from a manufacturing-based economy to a services-based international financial center.

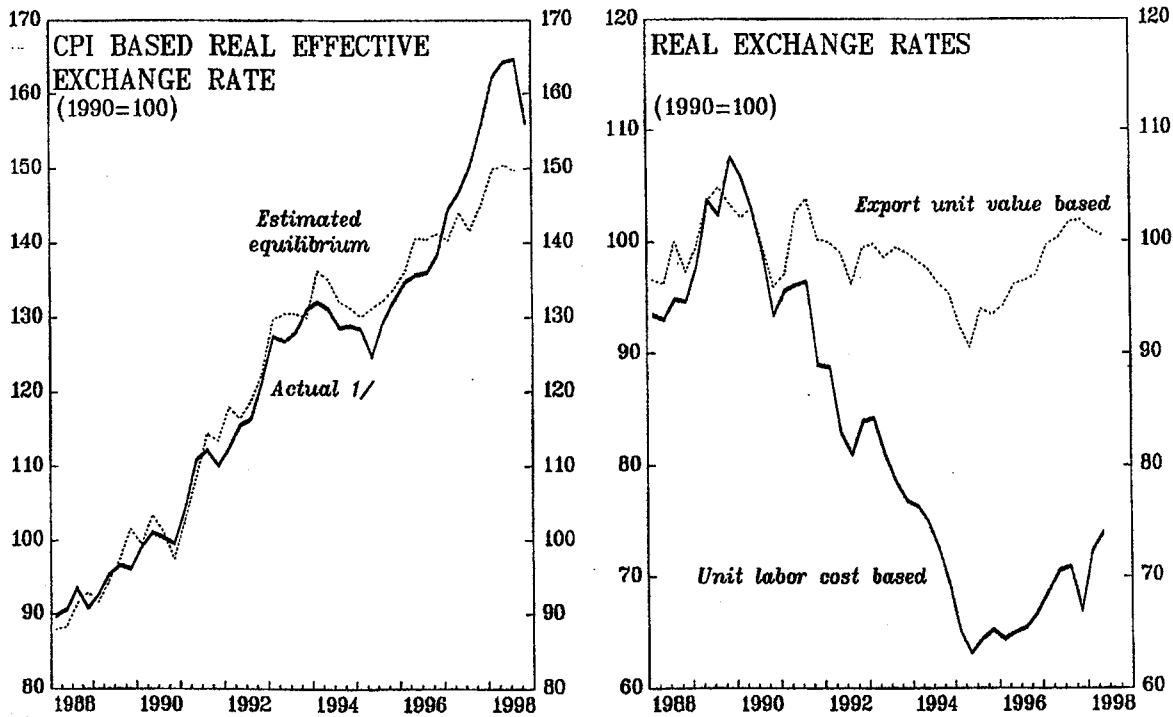
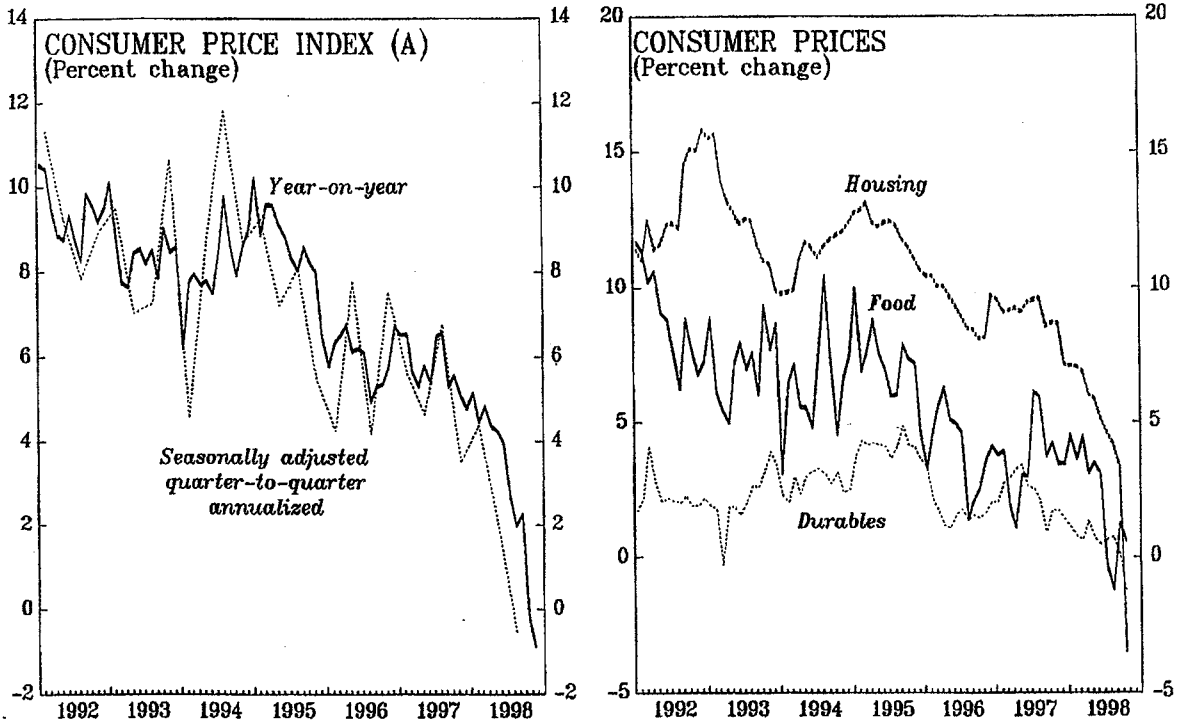
23. Econometric estimates indicate that the equilibrium REER has appreciated in line with the actual REER, with the structural shift of the economy accounting for roughly 90 percent of the appreciation between 1982 and mid-1997. Developments in Hong Kong SAR's terms of trade and fiscal policy, as well as world inflation, have also affected the equilibrium REER. The estimates indicate that deviations between the actual and equilibrium REERs have generally been small and short-lived, suggesting that goods and factor prices in Hong Kong SAR are relatively flexible.⁶

⁵Special factors also played a role in the decline in the CPI, including the freezing of government fees and charges and the rates (a property-related tax) rebate in the fourth quarter.

⁶The estimates and econometric methodology are described in Chapter VI of *People's Republic of China—Hong Kong Special Administrative Region—Recent Economic Developments* (SM/98/12; January 12, 1998).

CHART 4
HONG KONG SAR

INFLATION AND EXTERNAL COMPETITIVENESS, 1988-98



Sources: Consumer Price Index Report: Census and Statistics Department, IMF: INS, Census and Statistics Department; and staff estimates.

1/ Data for 1998 Q4 refer to October 1998.

24. The sharp depreciation of regional currencies, including the yen, over the past year opened up a sizable gap between the actual and estimated equilibrium REERs of the Hong Kong dollar. By August 1998, with deteriorating market sentiment in the region placing downward pressure on partner currencies, the Hong Kong dollar became overvalued by around 10 percent in relation to its estimated equilibrium level. However, following the subsequent appreciation of the yen and other regional currencies, together with moderating consumer price inflation in Hong Kong SAR, this gap narrowed. By October, the deviation between the actual and estimated equilibrium REERs was less than 5 percent.

25. It should be noted that different indices of the REER yield sharply different conclusions about the extent, and even the direction, of real exchange rate changes in Hong Kong SAR. For example, the index based on export unit values, rather than the CPI, has remained broadly stable in recent years, implying that any real appreciation has been confined to the nontradables sector. By contrast, the manufacturing unit labor cost-based index indicates that the Hong Kong dollar has depreciated in real effective terms and, despite the appreciation since 1995, remains well below the level in the early 1990s.

E. Labor Market Developments and Policies

26. The adjustment of the economy to the shock over the past year has entailed a substantial cost in terms of rising unemployment. Measures taken by the authorities in response have aimed at mitigating this cost while maintaining labor market flexibility.

Developments

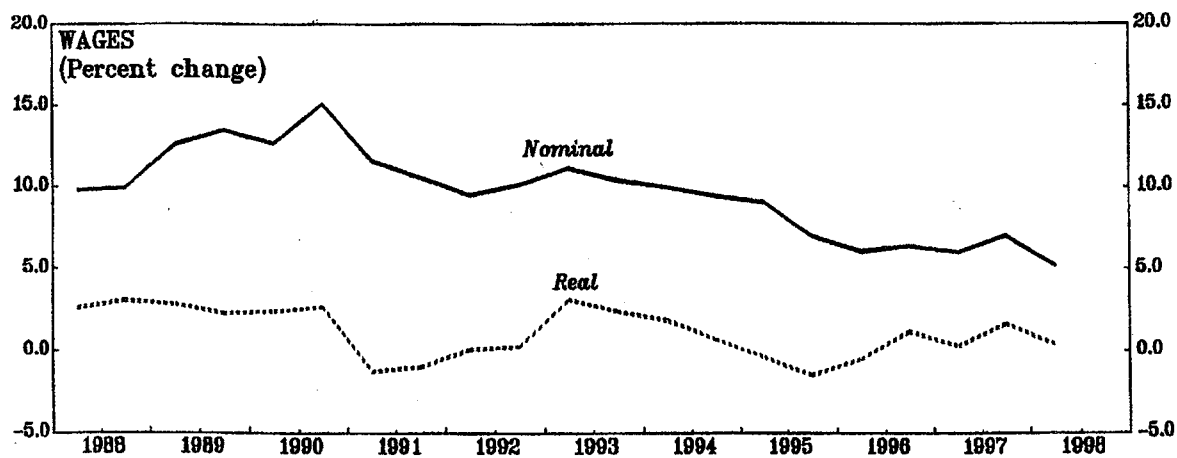
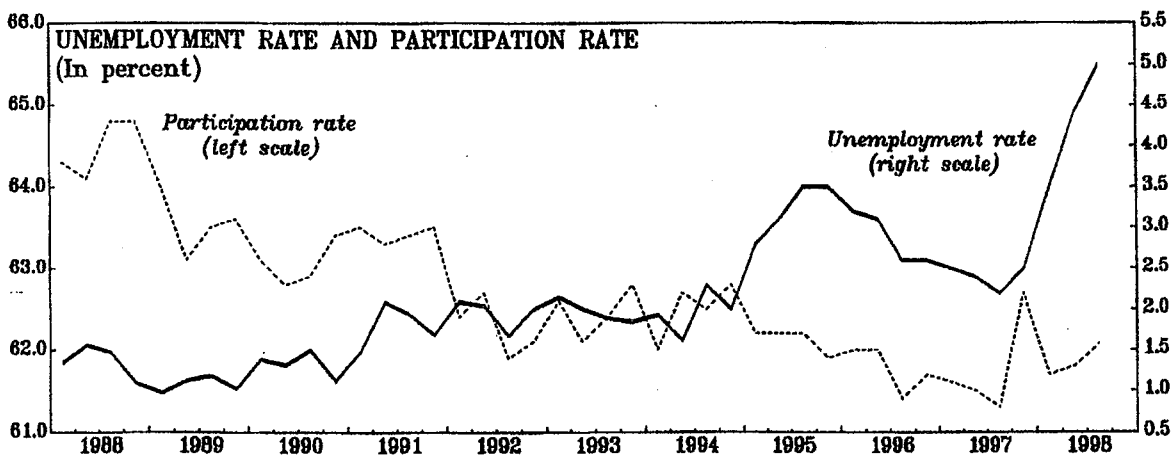
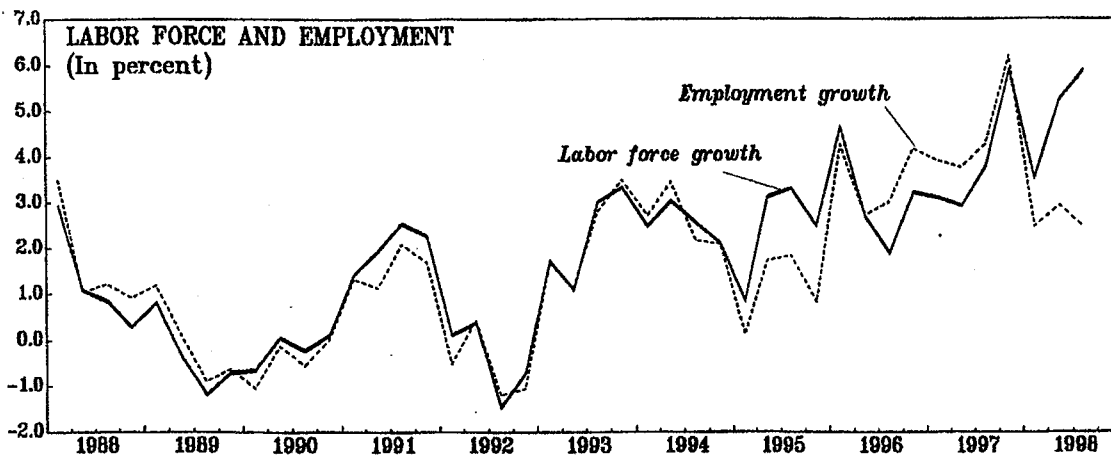
27. The unemployment rate, after trending downward to 2¼ percent in late 1997, rose sharply to 5¼ percent in the third quarter of 1998 (Chart 5 and Appendix Table 15). While unemployment rose for all occupations, the increase was relatively high among unskilled and semi-skilled workers. Unemployment rates in the third quarter were highest for craft and related workers, and for those in service and shop sales.

28. Contributing to rising unemployment was the steady increase in labor force growth, which reached 6 percent in the third quarter (year-on-year basis). This growth was underpinned by continued strong return immigration of Hong Kong SAR residents that had previously emigrated, as well as by the influx of 150 migrants per day from the Mainland.⁷ The labor participation rate edged up, mainly on account of higher participation among middle-aged women, many of whom entered the workforce as uncertainty regarding their spouses' employment rose.

⁷The migrants from the Mainland are mainly children and spouses of Hong Kong SAR residents. Many of the spouses do not immediately join the workforce.

CHART 5

HONG KONG SAR
LABOR MARKET DEVELOPMENTS, 1992-98



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

29. Employment growth slowed sharply to around 2½ percent in 1998, from 4½ percent in 1997. Data from the Quarterly Survey of Employment and Vacancies, which do not exactly match those from the General Household Survey (on which unemployment figures are based), indicate that employment in the construction sector contracted particularly sharply, partly due to the completion of the airport project.⁸

30. Press reports in recent months indicate increased layoffs, wage freezes, and sharp cuts in bonuses. Wage data, which are available only through March 1998 on a semiannual basis, indicated that both nominal and real wage growth has moderated since late 1997 (Appendix Table 16). Nominal wages have decelerated most sharply in the trade and tourism sectors, while wage growth in the financial services sector, while moderating markedly in comparison with previous years, remained relatively high through the first quarter of 1998. In real terms, wages in the manufacturing and trade and tourism sectors declined in the first quarter, while real wage growth in the financial services sector slowed.

Labor policies

31. The principal focus of recent labor policy initiatives has been to improve the existing employee retraining and vocational training programs, with the objective of helping the unemployed rejoin the workforce as soon as possible, and to ensure that their employability is sustained in the longer term. In the face of rising unemployment, the government set up in April 1998 a Task Force on Employment, led by the Financial Secretary and comprising representatives of employers, employees, academics, and government officials to study the unemployment problem. The Task Force has so far announced a series of measures, which can broadly be divided into the following categories:

- **Measures to create jobs.** The government is pressing ahead with a number of infrastructure and public works projects, and 25 projects have been advanced. The authorities estimate that, outside the civil service, 89,000 new jobs will be created between mid-1998 and end-1999 as a result of the policy initiatives;⁹
- **Strengthening employment services.** A strengthened Job Matching Program has been put into effect;

⁸The data from the Quarterly Survey of Employment and Vacancies, which do not cover certain industries due to difficulties in data collection, indicate that total employment shrank by 4 percent in the first half of 1998, after declining by 3½ percent in 1997.

⁹However, only 22,000 of these jobs are permanent. The remaining jobs are interim ones with an average duration of 25 months. Also, the 89,000 figure is not adjusted for anticipated job losses.

- **Enhancing vocational training and employee retraining.** Additional resources have been directed toward providing extra training programs and related services for both the unemployed and school leavers.¹⁰ The government will provide another capital grant of HK\$500 million to the Employees Retraining Board (ERB) to ensure adequate funding for an expansion of training capacity and quality. Among the additional training programs being offered is a Certificate of Skills Training (Service Industries) Course for 1,000 unemployed persons; the Construction Industry Training Authority will also provide extra training places;
- **Promoting further education** by increasing the number of places in government evening schools, increasing enrollment at universities, and raising the availability of student loans; and
- **Tightening measures to combat illegal employment**, particularly with regard to imported labor.

32. In addition, the 1998 Policy Address outlined a number of medium-term initiatives to enhance the overall vocational education and training system in Hong Kong SAR. These include integrating the Vocational Training Council's (VTC) existing two technical colleges and seven technical institutes into a single structure by FY 2001/02 to enhance the VTC's cost effectiveness and responsiveness; and launching a HK\$176 million upgrade of the VTC's information technology infrastructure and services over a period of three years.

III. THE PROPERTY MARKET, LAND POLICY, AND HOUSING POLICY

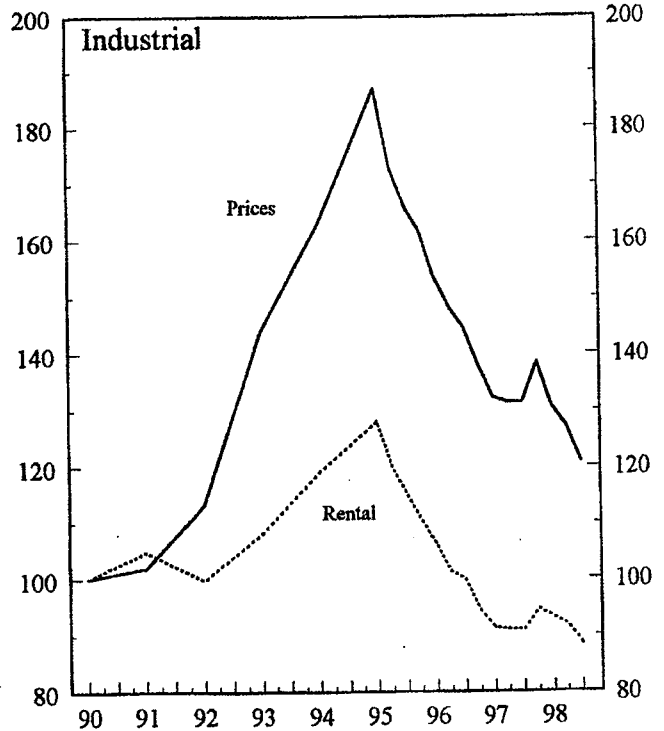
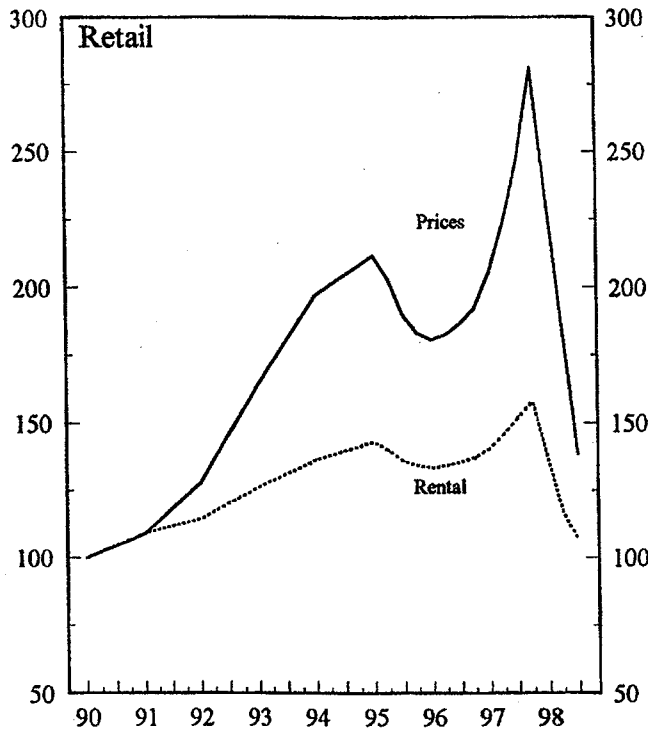
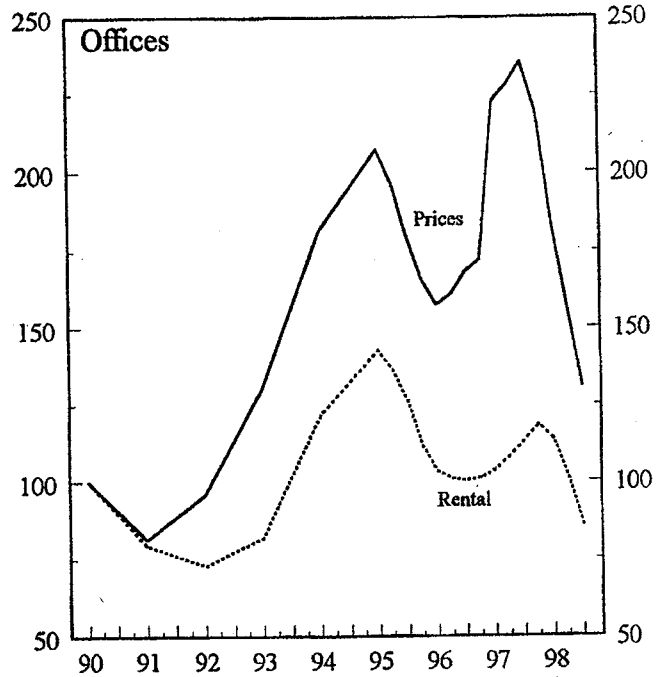
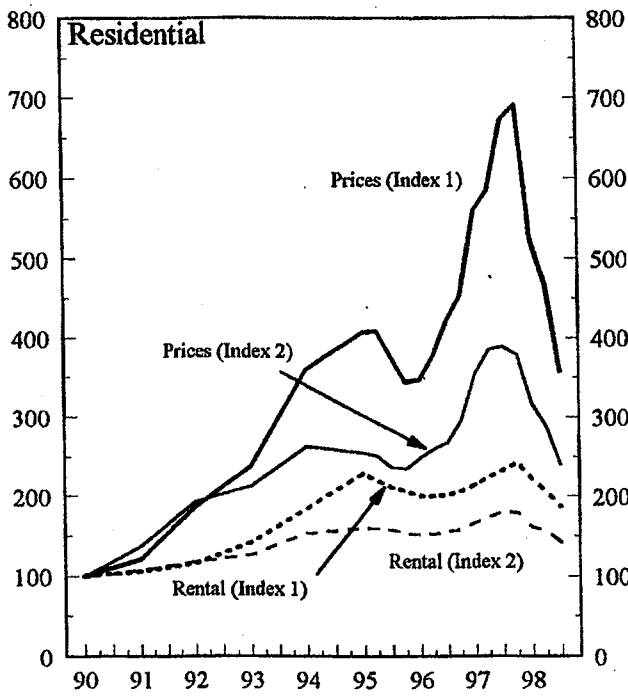
A. Developments in the Property Market

33. Following a downturn in 1994–95, **residential property prices** staged a strong rebound beginning in early 1996 and continuing through mid-1997, rising by over 60 percent trough-to-peak (see Chart 6 and Appendix Table 17). The rebound reflected a shift in market sentiment in early 1996, when the outlook for the labor market brightened and Hong Kong SAR banks reduced their lending rates. The turnaround was underpinned by rapid population growth owing to the return of emigrants, a sustained increase in household income together with a steady decline in unemployment, and negative real interest rates. The demand/supply

¹⁰Employee retraining and vocational training programs are currently provided through two organizations—the Employees Retraining Board (ERB) and the Vocational Training Council (VTC). The ERB, which has provided training to 250,000 people since FY 1992/93, aims to assist workers with lower secondary education. The VTC, which provides about 110,000 training places a year, assists younger and better educated workers in meeting changing industry needs.

CHART 6
HONG KONG SAR
THE PROPERTY MARKET, 1990-1998

(1990=100)



Source: Jones Lang Wootton, Research and Consultancy: JLW Property Index, Hong Kong, and Monthly Digest of Statistics.

1/ Index 1: Jones Lang Wootton data; index 2: Rating and Valuation Department data.

imbalance that emerged was exacerbated by the reduction in housing supply during 1995–97, reflecting the earlier slowdown in housing starts during the cyclical downturn in 1994–95.

34. While fundamentals in part were responsible for the rapid increase in prices, there were clear signs of an asset price bubble.¹¹ Indeed, prompted by concerns that the price gains were being driven by speculative activities, especially for luxury properties, the government took measures in March 1997 to curb speculation. In particular, the government announced that it would further restrict activity in the forward market for apartments. Prices stabilized briefly following the announcement, but rose again in the run up to the handover. In July 1997, the government announced that it would implement a rolling five-year land disposal program aimed at providing sufficient land for housing development and a clear picture on land supply over a five-year horizon.

35. The Asian financial crisis hit confidence hard in Hong Kong SAR, with consequent severe downward adjustments in asset prices as interest rates rose following repeated speculative attacks on the Hong Kong dollar. Residential property prices declined by about 40 percent from their peak in the third quarter of 1997, while rents—which typically adjust more slowly than prices owing to the prevalence of 2–3-year lease contracts—fell by about 20 percent.¹² This reflected the combination of the bursting of the asset price bubble and the price adjustment required to restore competitiveness under the linked exchange rate system. Other contributing factors included increasing supply; declining affordability, due to a combination of high prices, rising interest rates, and slowing wage growth; weakening consumer confidence, owing in part to rising unemployment; and a tightening in banks' provision of liquidity.

36. With successive and substantial price cuts, intensive sales promotion packages, and flexible mortgage arrangements offered by developers failing to rejuvenate the market, the government announced, in May and June 1998, two packages of measures to stabilize the property market, which included, *inter alia*, the suspension of most of the anti-speculation measures previously imposed on the sales of pre-completion flats, the imposition of a moratorium on all government land sales by auction and public tender until March 31, 1999, and an increase in the allocation of concessionary loans to eligible home buyers for the purchase of flats.

¹¹Preliminary empirical work by the staff supports this observation.

¹²There is some variation between estimated residential property price changes suggested by official statistics (from the Rating and Valuation Department), which suggest a decline in prices of around 40 percent, and Hong Kong SAR property analysts, who suggest a decline on the order of 50 percent. The discrepancy reflects lags in the official data and differences in coverage.

37. These measures seem to have helped stabilize market sentiment in the months following the announcement of the packages. There have been some signs of a tentative recovery in the residential market, as reflected in a pickup in sale and purchase agreements, and anecdotal evidence that prices have begun to stabilize amidst a rise in primary market activity. The improvement in affordability—which measures the ratio of the monthly mortgage repayment of flat buyers to average household income—augurs well for a near-term recovery, and an emerging supply shortage beyond 2000 will also help underpin prices. Nevertheless, downside risks remain and a number of market analysts expect further price declines (ranging from 15 percent to 30 percent) in the near term.

38. Other sectors of the property market also suffered significant declines following the onset of the Asian crisis. Since the 1997 second quarter peak, prices in the **office sector** have fallen by nearly 50 percent reflecting excess supply conditions. Rents in the office sector have declined by 16 percent amidst corporate downsizing.¹³ With additional office space coming on stream over the next few years, exacerbating the supply/demand imbalance, the downward adjustment process is likely to continue for some time.

39. Property prices in the **retail sector** have fallen by about 40 percent since the third quarter 1997 peak, attributable to excess supply conditions. Depressed retail activity combined with a slowdown in inbound tourism have caused rents to fall by 10 percent.

40. Prices in the **industrial sector** have fallen by 27 percent since early 1997, as demand was dampened by the ongoing relocation of production processes to Mainland China and the general slowdown in economic activity. Rentals have also adjusted downwards, though by a lesser amount. Given poor prospects, many proposed industrial projects have been changed to other types of development, resulting in a substantial reduction in completions.

B. Land Policy

41. Land policy has always played a key role in Hong Kong SAR's property market because of limited land supply, difficult terrain, and the locational preferences of the population and businesses. However, the sizable gyrations in property prices in the last two years, combined with the crucial importance of the property market to the Hong Kong SAR economy, has prompted the government to pursue a more activist land policy recently.

¹³What is not captured in the data is the fact that landlords were more flexible in the lease terms and offered longer rent-free periods than before the downturn.

42. A significant change for land policy came when the annual 50-hectare limit on land disposal, which was provided for in the Joint Declaration, was abandoned.¹⁴ Specifically, 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 envisaged a significant increase in the supply of land for housing development (to a total of 690 hectares) between 1997 and 2002. The adoption of this program ensured a steady supply of land for development, which has remained the principal objective of the government's land policy.

43. Subsequently, the severe impact of the Asian crisis on property prices in Hong Kong SAR prompted the government to announce a number of measures aimed at stabilizing the property market:

- On June 22, 1998, the government announced—as part of a broader set of measures—that it would suspend all land sales by auction or public tender for the remainder of FY 1998/99 (i.e., until end-March 1999) and freeze Private Treaty Grants for Sandwich Class Housing.¹⁵ The government said it would decide in early 1999 whether to resume land sales in FY 1999/00. In making its announcement, the government noted that while moderation in an overheated property market was in Hong Kong SAR's long-term interest, the drastic reduction in prices that had occurred recently negatively affected many sectors of the economy;
- The quotas for the Home Starter Loan Scheme and the Home Purchase Loan Scheme were expanded, thus allowing families in the low- and middle-income groups to take advantage of current market conditions as flats have become more affordable;
- In addition, the government announced on May 29, 1998 and September 12, 1998 the relaxation of some anti-speculation measures, as speculation was deemed to no longer be a problem;¹⁶

¹⁴Note that the actual amount of land disposed of in each of the years since the entry into force of the Joint Declaration well exceeded the limit.

¹⁵Sandwich Class Housing refers to housing for those whose income is too high to be eligible for public housing but too low to afford private housing.

¹⁶This included the relaxation of the resale restriction on uncompleted flats before assignment; the suspension of the restriction limiting companies to the last 15 percent of flats sold; the suspension of the requirement for developers to put up flats for sale within six months after consent to pre-sale has been given; the suspension of the requirement for

(continued...)

- Furthermore, the Hong Kong Monetary Authority announced on July 28, 1998 that its 40 percent guideline on the property exposure of authorized institutions was withdrawn with immediate effect.
44. Moreover, on December 3, 1998, the Hong Kong Mortgage Corporation (HKMC)—established in 1997 to catalyze the development of a secondary mortgage market—announced a scheme under which the HKMC will provide a guarantee at a fee to lending banks for an amount up to 15 percent of the value of the property. The scheme will enable home buyers to secure mortgages with up to 85 percent loan-to-value ratios (compared with 70 percent previously).

C. Housing Policy

45. The Hong Kong SAR government operates an extensive public housing program, which covers almost half of the population.¹⁷ The broad aim of housing policy is to help all households gain access to adequate and affordable housing and to encourage home ownership in the community. In line with this objective, the White Paper on Long Term Housing Strategy, published in February 1998, set out the government's housing targets, the most important of which are:¹⁸

- To produce 85,000 flats a year in the public and private sectors, starting from 1999/2000, as a long-term target to meet the future housing needs of the population. Of this total, 35,000 flats are to be supplied by the private sector. In the 1998 Policy Address, Chief Executive Tung Chee-Hwa noted the significant change in property market conditions that had occurred since the announcement of the target, including a reduction in the demand for private sector residential property. Against the background of these developments, he stressed the long-term nature of the target;

¹⁶(...continued)

developers to put up not less than 20 percent of the total number of flats in each batch of sale; lowering the amount of deposit required from purchasers; and the relaxation of the quota for private sale.

¹⁷For details on housing policy, see Chapter III of *People's Republic of China—Hong Kong Special Administrative Region—Recent Economic Developments* (SM/98/12; January 12, 1998).

¹⁸These targets were first announced by Chief Executive Tung Chee-Hwa in the 1997 Policy Address.

- To achieve a home ownership rate of 70 percent by 2007 (from 52 percent in 1997); and
 - To reduce the average waiting time for public rental housing to three years by 2005.
46. To achieve the above targets, the government will continue to provide housing loans to encourage home ownership and supply sufficient flats for allocation to applicants waiting for public rental housing.

IV. PUBLIC FINANCE

A. Overview

47. Fiscal policy in Hong Kong SAR has traditionally followed a noninterventionist approach, aimed at maintaining a small and efficient government and supporting private sector activity. 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. Government spending as a share of public expenditure has also been kept low, largely reflecting the absence of high spending on social welfare and defense. Thus, over the period FY 1984–97, Hong Kong SAR established an outstanding record of fiscal prudence, achieving an average annual budget surplus of about 2 percent of GDP.

48. Following the transfer of sovereignty in July 1997, fiscal policy in Hong Kong SAR has been guided by the Basic Law. 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.” While the outcome in FY 1997 was considerably stronger than had been expected, the outlook for the current fiscal year looks decidedly less rosy, as the slowdown in the real economy owing to the Asian financial crisis negatively affects revenues.¹⁹

¹⁹The fiscal year runs from April 1 to March 31. The Budget comprises 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 revenue heads, and, on the expenditure side, all current operational expenses of government departments. The CAF 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. Chapter III in *United Kingdom—Hong Kong—Recent Economic Developments* (SM/97/42, Revision 1; May 21, 1997) provides a more detailed description of the budgetary process.

B. Recent Budgetary Developments

49. Budgetary performance in FY 1997 was, as in the previous fiscal year, considerably stronger than expected, mainly reflecting better-than-expected revenues. The fiscal surplus was HK\$86.8 billion (6½ percent of GDP), compared with the HK\$31.7 billion surplus projected in the FY 1997 Budget (Chart 7, Table 4, and Appendix Tables 18, 19, and 20).²⁰ Expenditures reached HK\$194.4 billion (14½ percent of GDP), roughly HK\$9 billion below the budget projection; the underspending reflected lower outlays on public works projects by the Capital Works Reserve Fund and across the board underspending on recurrent expenditure from the GRA. Revenues rose sharply to HK\$275.2 billion (20½ percent of GDP),²¹ over HK\$40 billion higher than the budget projection. The stronger-than-expected revenue performance was due to a surge in stamp duty receipts from the buoyant stock and property markets, strong receipts from land transactions, and higher-than-anticipated revenues from the earnings and profits tax.

50. The **FY 1998 Budget**, tabled in February 1998, envisaged a sharp decline in the fiscal surplus to HK\$10.7 billion (¾ percent of GDP). Relative to FY 1997, **revenues** were projected to fall by 10 percent, mainly owing to the introduction of new tax concessions amounting to about 1 percent of GDP, including: a reduction in the corporate profit rate to 16 percent from 16½ percent, with the standard profit rate for unincorporated businesses unchanged at 15 percent; a trimming of the stamp duty on stock transactions to 0.25 percent from 0.3 percent; while the salaries tax would remain unchanged, tax bands would change and allowances would be raised; the introduction of a salaries tax deduction (with a maximum of HK\$100,000 per year per property) for home mortgage interest payments; and several changes related to depreciation allowances.

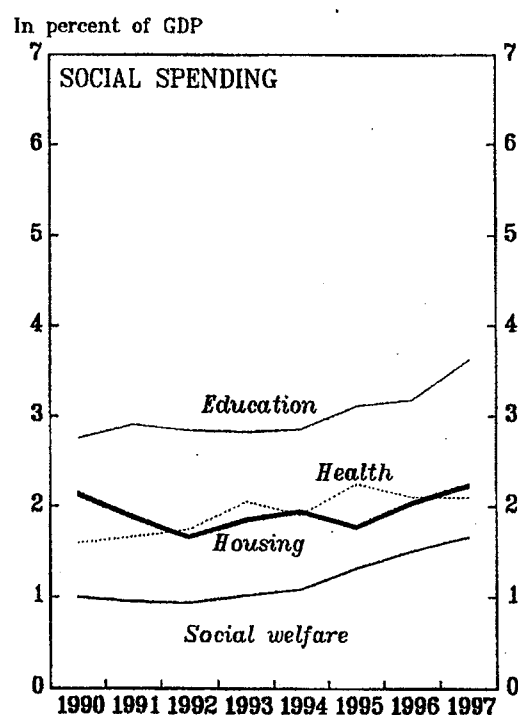
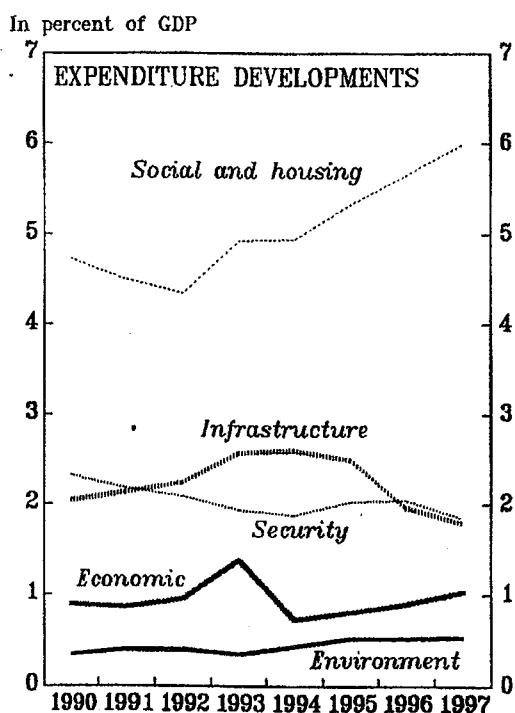
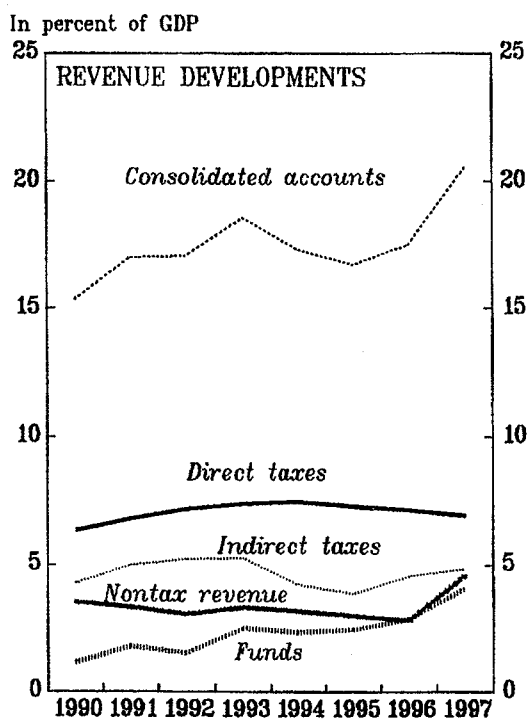
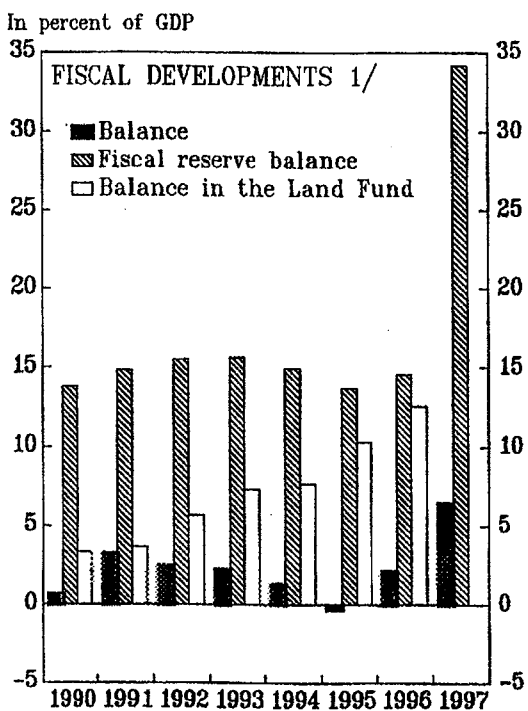
51. **Expenditures** were projected to increase by about 28 percent over FY 1997, with current expenditures remaining constant as a share of GDP but capital expenditures projected to increase by 1¾ percent of GDP. This increase would reflect the commencement of HK\$63 billion worth of major capital projects, including school and hospital construction and improvement programs, and infrastructure projects. The budget envisaged an increase of 11¼ percent (in real terms) in total public expenditures.²² Thus, in line with the target of achieving a 70 percent home ownership rate in 10 years, the budget proposed total public housing expenditure of HK\$49 billion (3¼ percent of GDP) in FY 1998. The budget also

²⁰Note that the surplus for FY 1997 includes the change in the net worth of the Land Fund, equivalent to HK\$6 billion.

²¹Not including the change in the net worth of the Land Fund.

²²Public expenditure includes spending by several self-financing public sector bodies, including the Hong Kong Housing Authority.

CHART 7
HONG KONG SAR
FISCAL DEVELOPMENTS, FY 1990 - FY 1997



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

1/ Fiscal reserves at the end of FY 1997 include the balance in the Land Fund (HK\$ 197 billion as of July 1, 1997), which reverted to the Hong Kong SAR on July 1, 1997.

Table 4. Hong Kong SAR: Consolidated Government Account, FY 1994-FY 1998 1/

	1994/95	1995/96	1996/97	1997/98		1998/99	
				Budget	Actual	Budget	Staff proj.
(In billions of Hong Kong dollars)							
General Revenue Account							
Revenue 2/	151.1	153.2	173.9	177.9	220.2	181.0	165.0
Expenditure	108.2	123.3	138.5	159.4	162.5	182.5	183.1
Current	106.0	120.3	134.7	154.4	149.4	171.7	169.6
Capital	2.2	3.0	3.8	5.0	13.1	10.8	13.5
Surplus (+)/deficit (-) before transfers	42.9	29.9	35.4	18.5	57.7	-1.5	-18.2
Transfers from (+)/to(-) funds	-39.1	-32.5	-13.4	-4.3	5.8	12.0	...
Balance after transfers	3.8	-2.6	22.0	14.2	63.5	10.5	...
Consolidated Account Funds 3/							
Revenue 2/	23.9	26.8	34.5	56.9	55.0	66.3	36.3
Capital expenditure 4/	53.6	59.8	44.2	43.7	31.9	65.8	60.6
Surplus before transfers	-29.7	-33.0	-9.7	13.2	23.1	0.5	-24.3
Transfers from General							
Revenue Account	39.1	32.5	13.4	4.3	-5.8	-12.0	...
Balance after transfers	9.4	-0.5	3.7	17.5	17.3	-11.5	...
Total Consolidated Account							
Revenue	175.0	180.0	208.4	234.8	275.2	247.3	201.3
Expenditure	161.8	183.1	182.7	203.1	194.4	248.3	243.8
Current	106.0	120.3	134.7	154.4	149.4	171.7	169.6
Capital	55.8	62.8	48.0	48.7	45.0	76.6	74.1
Changes in net worth of Land Fund	...	...	...	...	6.0	11.7	5.9
Surplus (+)/Deficit (-)	13.2	-3.1	25.7	31.7	86.8	10.7	-36.6
Fiscal reserves balance, end of fiscal year 5/	151.0	147.9	173.6	194.7	457.5	468.2	420.9
(In percent of GDP)							
Total Consolidated Account							
Revenue 6/	17.3	16.7	17.5	17.3	21.0	17.3	15.6
Expenditure	16.0	17.0	15.3	15.0	14.5	16.6	18.3
Current	10.5	11.2	11.3	11.4	11.2	11.5	12.7
Capital	5.5	5.8	4.0	3.6	3.4	5.1	5.6
Surplus (+)/deficit (-)	1.3	-0.3	2.2	2.3	6.5	0.7	-2.7
Fiscal reserves balance, end of fiscal year 5/	14.9	13.7	14.6	14.4	34.2	31.3	31.6
(Percentage change)							
Total Consolidated Account							
Revenue	5.0	2.9	15.8	12.7	32.1	-10.1	-26.9
Expenditure	10.6	13.2	-0.2	11.2	6.4	27.7	25.4
Current	13.7	13.5	12.0	14.6	10.9	14.9	13.6
Capital	5.3	12.5	-23.6	1.5	-6.3	70.2	64.7
Fiscal reserves balance, end of fiscal year 5/	7.7	-2.1	17.4	12.2	163.5	2.3	-10.1

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

1/ The fiscal year begins April 1.

2/ Revenue from land sales is credited to the Capital Works Reserve Fund. The only exception is for the period from July 1, 1997 to December 31, 1997 when land revenue was credited to General Revenue Account pending amendment of the Capital Works Reserve Fund resolution.

3/ 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.

4/ Excludes repayment of government bond but includes direct financing of airport-related projects as well as government equity injections into the Airport Authority, the Kowloon-Canton Railway Corporation, and the Mass Transit Railway Corporation.

5/ For FY 1997/98, includes net worth of HK\$197.1 billion received from the trustee of the former SARG Land Fund on July 1, 1997.

6/ Revenue ratios are calculated using revenues plus changes in net worth of Land Fund. Also, note that ratios for Budgets 1997/98 and 1998/99 are based on the authorities' projections of nominal GDP at the time the budgets were tabled.

envisaged an increase of 15 percent in current expenditures over FY 1997—though remaining broadly steady in terms of GDP, at 11½ percent—with personal emoluments and subventions, the two largest categories of current expenditures, projected to rise by 13¾ percent and 14½ percent, respectively.

52. In the face of a rapidly weakening economy, owing mainly to the regional financial crisis and plummeting asset prices, the Hong Kong SAR authorities announced a **major package of measures** on June 22, 1998 to strengthen confidence and revive economic activity. The main elements of the package were the following:

- Moratorium on government land sales for nine months until March 1999;
- The exemption of interest income on onshore deposits from corporate taxes in order to encourage repatriation of offshore funds and improve liquidity conditions in the onshore market; and
- Several more minor measures, including a once-off rebate of property taxes for the first quarter of 1998, to provide a temporary boost to consumer disposable income of about 0.3 percent of GDP.

53. The budgetary cost of the package was about 2½ percent of GDP, and the projection for the fiscal balance was revised to a deficit of 1½ percent of GDP, compared to a budgeted surplus of ¾ percent of GDP. Since then, the outlook for FY 1998 has weakened further as the sharper-than-expected economic downturn is resulting in across the board revenue shortfalls, particularly in relation to stamp duties and profits tax. In the fiscal year to October 31, 1998, the deficit amounted to HK\$50.2 billion (3¾ percent of GDP).²³ However, when assessing the implications for the full fiscal year, it should be borne in mind that the bulk of tax collections is normally received in the latter part of the financial year. It is also important to note that, under Hong Kong SAR's provisional tax system, corporate and household profits/salaries tax collections for a certain financial year are to a significant extent based on the previous year's profits/salaries, so that changes in the level of economic activity have a lagged impact on fiscal revenues. As a result, the full impact of the current downturn on revenues will not be felt until FY 1999/2000.

54. **The Hong Kong SAR government has built up considerable fiscal reserves**, in part as a contingency for unexpected domestic or external events. As was reported in last year's Recent Economic Developments, 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. With this addition, as well as the full proceeds of land sales, fiscal reserves more than doubled to HK\$457.5 billion (34 percent of GDP) at March 31, 1998. Since then, fiscal

²³Excluding the changes to date in the net worth of the Land Fund.

reserves have declined somewhat reflecting the accumulated deficit during the first seven months of the financial year.

55. In the FY 1998 Budget, the Financial Secretary outlined **guidelines for the level and use of fiscal reserves**, which would be used for three purposes: (i) to meet the operational needs of the government; (ii) to offset the effects of an economic downturn or to cope with unforeseen world events; and (iii) to ensure proper functioning of Hong Kong SAR's exchange rate arrangement. The benchmark level of reserves for these uses would be equal to one year of government expenditures²⁴ plus the Hong Kong dollar money supply M1 as backing for the exchange rate link to the U.S. dollar. At March 31, 1998 the lower and upper boundaries of the allowable range stood at about HK\$300 billion and HK\$500 billion, and the actual reserves at the time exceeded the lower boundary by about HK\$160 billion.

C. Social Expenditures²⁵

56. While Hong Kong SAR has traditionally maintained a noninterventionist stance, eschewing welfare schemes for fear of creating welfare dependence, **social spending**, comprising health, education, and social welfare, has been the fastest growing component of government spending. To some extent, this increase has been a response to the shift to a services economy, requiring the workforce to obtain new skills, and demographic changes, such as immigration and the aging of the population. In FY 1997, social spending accounted for 41 percent of total public spending and almost 7½ percent of GDP. While social spending is still low in comparison with OECD countries, the government operates an extensive public housing program covering almost half of the population.²⁶

Education

57. The government continues to attach great importance to education, as reflected in the fact that education has consistently been the largest area of public spending (Chart 7). Total expenditure on education in the FY 1998 Budget is projected at HK\$53 billion, almost 18½ percent of total public expenditure (or 4 percent of GDP). In his October 1997 Policy Address, the Chief Executive announced a number of new measures to improve the quality of education, which would raise recurrent expenditure on education by more than HK\$2 billion in FY 1998, and would raise education-related capital expenditure by about HK\$22 billion

²⁴The amount of reserves considered adequate for operational and contingency needs were three and nine months of expenditure, respectively.

²⁵Social policies are described in detail in Chapter IV of *United Kingdom—Hong Kong—Recent Economic Developments* (SM/97/42, Revision 1; May 21, 1997).

²⁶See Section III.C. above for further details on the public housing program.

over five years.²⁷ In the 1998 Policy Address, a number of new initiatives were announced, amounting to an additional HK\$850 million in recurrent expenditure and HK\$3.2 billion in capital expenditure to commence in FY 1999, with recurrent spending rising to HK\$44 billion. These initiatives include: a school-building program, which envisages the construction of 115 new primary schools by September 2007; promoting the further use of information technology by equipping primary and secondary schools with more computers; strengthening language proficiency; improving the professional training and standards of teachers; and relaxing eligibility for full assistance under the student financial assistance schemes.

58. At the tertiary level, universities would be encouraged to build on their existing strengths by developing centers of excellence, and efforts would be made to enhance Hong Kong SAR's status as a regional center for higher education, in part by admitting nonlocal students to higher education programs.

Welfare and health care policies

59. Social welfare in Hong Kong SAR comprises social security and other targeted programs aimed at supporting financially vulnerable groups, such as the sick, elderly, and disabled.²⁸ Expenditure on social welfare has risen rapidly during the 1990s and is projected to reach 9 percent of public expenditure in FY 1998 or 2 percent of GDP.

60. In comparison with the OECD countries, Hong Kong SAR does not have an extensive social security system. Instead, the government seeks to ensure that labor market flexibility, combined with retraining and job matching schemes, enables the unemployed to get back to work quickly, thus preventing welfare dependence. Its social security schemes are largely targeted toward those who are not expected to work, e.g., because of disabilities or old age.

61. The main program that constitutes Hong Kong SAR's social safety net is the Comprehensive Social Security Assistance (CSSA) scheme, which raises income to a minimum level for eligible persons in five categories: the elderly, disabled, children, the sick, and able-bodied adults that are unemployed, are low wage earners, or are single parents. The elderly, disabled, and sick combined account for 70 percent of CSSA cases.

²⁷The Chief Executive also asked the Education Commission (EC) to conduct a thorough review of the education system. The EC set up two working groups in mid 1998 to conduct the review, and preliminary proposals are expected in 1999/2000.

²⁸For a review of welfare programs, see Chapter IV of *United Kingdom—Hong Kong—Recent Economic Developments* (SM/97/42, Revision 1; May 21, 1997)

62. Unemployed able-bodied adults have to register for job placement in order to qualify. Access to CSSA assistance is strictly means-tested and has a Hong Kong SAR residency requirement.²⁹ While the proportion of unemployment cases under the CSSA has been rising in line with increased unemployment, it remains at only about 12 percent. Only about 26,000 (as of September 1998) out of total of about 180,000 unemployed have so far made claims under the CSSA. This appears primarily to reflect the impact of wealth testing, and possibly in some cases a reluctance to draw benefits.

63. Assistance under the CSSA appears to be well-targeted, thus preserving labor market flexibility, critical to the functioning of the exchange rate link. The level of income support varies with the size of the household, with assistance for larger families exceeding the median wage of an industrial worker, a fact that has prompted some concerns that this level of assistance gives rise to work disincentives. In contrast, income support for single member or small households is not overly generous, and appears to be consistent with maintaining work incentives. Nevertheless, in addition to the standard rates paid to recipients to meet their basic needs, there are supplements and special grants that bolster the basic payment received. The long-term supplement is for those having received assistance continuously for 12 months. Single parents with young children are entitled to another supplement. The grants provide assistance to pay for housing, utilities, medications, child care, and school.

64. Prompted by growing public concern about the rapid growth in the CSSA caseload and its expenditure, and the high levels of CSSA benefit for larger families as compared with market wages, an inter-departmental Steering Group has conducted a review of the CSSA scheme. The review's main policy directions for the CSSA scheme are to ensure support of the truly needy, to provide temporary financial assistance for unemployed people but at the same time to encourage and help them rejoin the workforce, and to rid the system of work disincentives. The review proposes the following strategies to meet the policy objectives:

- To implement a package of measures to help promote self-reliance amongst the able-bodied unemployed;
- To improve the existing arrangements to maintain social equity and to ensure that CSSA recipients would not be better off than those who work to support themselves. Proposed measures in this area include a reduction in the standard rate payment to larger families (three or more able-bodied members); to tighten special grants and supplements for able-bodied adults/children; to introduce a different scale of asset limits for cases involving any able-bodied adult; and to include an owner-occupied residential property for the asset test in respect of cases involving any employable

²⁹For a single person household, for example, the total value of capital assets (cash, bank savings, investments, and any assets readily convertible to cash) cannot exceed HK\$37,000 (US\$4,800).

adult aged below 50 and where there is no family member who is old, disabled, or sick. The review emphasizes that any measure to tighten existing arrangements should not affect the elderly, the disabled, and the sick; and

- To strengthen controls to safeguard public expenditure against fraud and abuse.

65. The other major social security program is the Social Security Allowance (SSA) scheme. The SSA scheme provides modest flat rate allowances for elderly and severely disabled persons who are not receiving CSSA. Three smaller, non-means-tested, schemes are available to assist victims of crime, traffic accidents, and natural or other disasters.

66. **Health care** services in Hong Kong SAR are provided by a mix of private and public sector establishments and medical charges in the public sector are low as a result of extensive public subsidies. Public expenditure on health care was budgeted at 11 percent of total public spending in FY 1998 (or nearly 2½ percent of GDP). The Department of Health and the Hospital Authority provide a full range of inpatient, outpatient, ambulatory, and community-based services. Of the 30,000 hospital beds in Hong Kong SAR, 90 percent are in the public sector. Emergency services are provided free of charge to all patients.

67. Given a growing and aging population, advances in medical technology and rising community expectations for quality care, the government expects the cost of health care services to escalate rapidly in the future. As a result, the government is undertaking a review of the health care system and has appointed a consultant to examine the current financing and delivery systems and to recommend options for changes. The report is expected in early 1999.

D. Infrastructure Projects

68. Public sector involvement in infrastructure projects typically comes in the form of liquidity injections into the relevant statutory bodies and corporations. The balance of the project costs is financed off-budget by the relevant corporations from internal sources and commercial borrowings. With the completion of the Airport Core Program, the largest public infrastructure project in Hong Kong SAR, public sector expenditure on building and construction faces a temporary lull in 1998. Indeed, public sector expenditure on building and construction is likely to fall by 11 percent in real terms in 1998.

69. However, a number of major infrastructural projects will commence work shortly. In particular, work on five new railway projects (with a total cost of HK\$120 billion) is progressing smoothly, all for completion by 2004. The Kowloon-Canton Railway Corporation (KCRC) and the Mass Transit Railway Corporation (MTRC), respectively, have commenced construction for West Rail (Phase I) (WRI) and the Tseung Kwan O Extension (TKE). The total costs for the two projects are estimated at HK\$64 billion and HK\$30.5 billion, respectively. Following the legislature's approval of a liquidity injection of

HK\$29 billion into the KCRC for the implementation of the WR project, the government paid the first instalment of HK\$14.5 billion in April 1998. Construction of the WR project started at the end of 1998. The KCRC is also carrying out the study and design work for the Ma On Shan (MOS) to Tai Wai Rail Link, Kowloon-Canton Railway extension to Tsim Sha Tsui (TST) and the Sheung Shui to Lok Ma Chau spur line. The project cost for the MOS/TST project is currently estimated at HK\$18.7 billion and the cost of the spur line is estimated to be HK\$14.6 billion. The government has also commissioned the second Railway Development Study for planning the future expansion of Hong Kong SAR's railway network.

70. The government is also embarking on a significant building program for the provision of government, institutional and community facilities, with an estimated total cost of HK\$25.4 billion.³⁰ In addition, the government is planning to start work on the initial phases of three reclamation projects with a total cost of HK\$29.5 billion. When completed, 791 hectares of land will be available to provide housing, transport, and other community facilities for some 485,000 people.

71. In addition, the construction of several new roads is planned over the medium term at a cost of HK\$50 billion. This includes construction of a road link from Shatin, via Cheung Sha Wan to Tsing Yi (Route 9), which is scheduled for completion in 2008.

V. FINANCIAL AND CORPORATE SECTOR DEVELOPMENTS

A. The Foreign Exchange Market

72. The depreciation of regional currencies and the resulting appreciation of the Hong Kong dollar in real effective terms, together with the deterioration in economic conditions in the region, caused the Hong Kong dollar to come under speculative pressure on several occasions since the onset of the Asian financial crisis. Under the linked exchange rate system, each attack resulted in a tightening of liquidity conditions and a sharp increase in interbank interest rates. On each occasion, this adjustment led to quick reversals in capital flows; consequently, the HKMA's foreign exchange reserves have remained broadly stable over the past year. However, the increase in the risk premium has kept interest rates at elevated levels for much of the past year. In response, the HKMA has taken measures to strengthen the transparency of the linked system and reduce interest rate volatility.

73. In October 1997, the Hong Kong dollar came under attack as regional market turbulence intensified following the floating of the New Taiwan dollar. The HKMA, while intervening in the foreign exchange market, allowed liquidity to tighten in the domestic interbank market. As a result, interbank interest rates rose sharply, with the 1-month HIBOR

³⁰This is over and above expenditures under the Public Housing Program.

peaking at 30 percent on October 23. In an effort to reduce banks' reliance on its Liquidity Adjustment Facility (LAF)³¹—through which banks could obtain overnight funds—the HKMA on October 23 increased the spread between the LAF's bid and offer rates from 2 percent to 3 percentage points, and issued a warning that repeated recourse to the LAF would be subject to penal interest rates.³² Pressure against the Hong Kong dollar subsequently abated, and the HKMA's foreign reserves at end-October were US\$3.2 billion higher than at end-September. However, interest rates adjusted slowly, with the 1-month HIBOR-LIBOR spread returning to pre-attack levels only in December.

74. In January 1998, speculative pressure against the Hong Kong dollar intensified once again as market expectations of a renminbi devaluation mounted and a Hong Kong SAR investment bank failed. HIBOR-LIBOR spreads widened, staying at elevated levels until mid-February, and foreign reserves of the HKMA declined by US\$1.3 billion during the month. The HKMA responded by further measures to enhance the transparency of the link and help banks better manage their liquidity. In June, the HKMA began publishing, on a real-time basis, the implied effect of its foreign exchange transactions on the banking system's aggregate clearing balance.³³ In addition, the HKMA announced that, in order to catalyze the development of the debt repurchase market and thereby boost liquidity in the interbank market, it would begin serving as a counterparty to repurchase transactions involving Exchange Fund paper.

75. Nevertheless, speculative pressure revived in June, as the yen depreciated and market sentiment regarding Mainland China's macroeconomic situation weakened. Hong Kong dollar rates rose sharply, with the 1-month HIBOR peaking at over 20 percent. In this case, however, market conditions stabilized quickly, with the HIBOR-LIBOR spread returning to

³¹Under the LAF, banks were permitted to borrow funds overnight against their holdings of eligible securities, which included Exchange Fund paper and certain corporate securities. Banks could also use the facility to deposit excess funds. The bid and offer interest rates charged on the facility were set with reference to the U.S. Fed Funds target rate. However, penal LAF offer rates different from the standard LAF offer rate could be determined on a case-by-case basis for repeated borrowers at the discretion of the HKMA.

³²The definition of repeated borrowing was subsequently (in November 1997) clarified.

³³Previously, banks that were counterparties to such transactions, which are normally settled on a T+2 basis, could only anticipate the change in Aggregate Balance in respect of the transactions they entered into, but would not be able to anticipate the overall impact on the interbank liquidity since the HKMA might also carry out foreign exchange transactions with other banks. The publication of the implied impact of the transactions in effect made this information available to all banks.

its previous level within a week. No significant change in foreign reserves was observed between end-May and end-June.

76. In August, the link came under renewed pressure as market turbulence intensified internationally, prompting the authorities to intervene directly in the stock market. With speculators taking short positions on the stock and futures markets as well as the Hong Kong dollar, interest rates rose and remained high for several weeks. The authorities responded by purchasing stocks amounting to US\$15 billion (equivalent to over 130 percent of stock market turnover in July),³⁴ part of which was financed by the HKMA's foreign exchange reserves. As a result, reserves decreased by about US\$4.4 billion from end-July to end-August, and by a further US\$4 billion by end-September.

77. The authorities subsequently implemented (in early September) a set of measures to strengthen the transparency of the linked exchange rate system and reduce interest rate volatility (Table 5). These included formalizing the HKMA's convertibility undertaking—under which the HKMA guaranteed the conversion of banks' Hong Kong dollar clearing balances into U.S. dollars at the rate of 7.75 per U.S. dollar—and the establishment of a discount facility to replace the LAF. The discount window allows banks to obtain overnight liquidity by rediscounting their holdings of Exchange Fund paper without limit, and without penalties for repeated use, subject to an upwardly sliding schedule of interest rates.³⁵ In addition, the authorities announced a series of measures to tighten securities market regulations (discussed below).

78. Market conditions have started to stabilize since that time, aided by favorable developments in international markets. HIBOR-LIBOR spreads have fallen to close to zero at the shorter end of the maturity spectrum, and the HKMA's reserves at end-November were US\$0.2 billion higher than at end-September.

³⁴The average market turnover for the period May–November excluding August was US\$15.8 billion.

³⁵The HKMA announced in November a formula for determining the interest rate charged on the facility (the base rate). Under the formula, the base rate is set equal to the average of the overnight (average over the day) and 1-month HIBORs and (HKAB fixing rate) over the previous five days, with a floor of the U.S. Fed Funds rate plus 150 basis points. Banks may rediscount up to 50 percent of the Exchange Fund paper holdings at the base rate, and the remainder at the higher between the base rate plus 5 percentage points and overnight HIBOR of the day. Under the previous arrangement, penal interest rates could be applied on a case-by-case basis for repeated borrowers.

Table 5. Hong Kong SAR: Recent Currency Board Reforms

Measure	Purpose of Effects
(I) Convertibility Undertaking	
1. The HKMA provides a clear undertaking to all licensed banks to convert Hong Kong dollars in their clearing accounts into U.S. dollars at the fixed rate of HK\$7.75 to US\$1 and to move the rate of the convertibility undertaking to HK\$7.80 when market circumstances permit.	To demonstrate the government's commitment to the linked exchange rate system and help instill public confidence in the Hong Kong dollar exchange rate.
(II) Technical adjustments to the operation of the discount window	
2. To remove the bid rate of liquidity adjustment facility (LAF).	As the improved efficiency of the interbank payment has facilitated liquidity management of banks, the need for the LAF deposit facility to facilitate orderly interbank market activities has fallen away.
3. To replace the LAF by a discount window and to determine the base rate (formerly known as the LAF offer rate) such that interest rates are adequately responsive to capital flows while allowing excessive and destabilizing interest rate volatility to be dampened.	When HK dollar is under pressure, banks can make use of their exchange fund papers to acquire temporary liquidity from the exchange fund, thus dampening excessive interest rate volatility.
4. To remove the restriction on repeated borrowing in respect of the use of exchange fund papers for discounting the discount window.	As exchange fund papers are fully backed by foreign reserves, banks should be allowed greater access to discount window through repo transactions using such papers.
5. To issue new exchange fund paper only when there is an inflow of funds.	To ensure that additional exchange fund paper are fully backed by foreign reserves such that repo involving such papers through discount window does not depart from the discipline of currency board system.
6. To introduce a schedule of discount rates for different percentage thresholds of holdings of exchange fund paper by the licensed banks for discount window purpose.	To allow the interest rate automatic adjustment mechanism to kick in to maintain exchange rate stability when the Hong Kong dollar is under significant pressure.
7. To retain the restriction on repeated borrowing in respect of repo transactions involving debt securities other than exchange fund papers and not to accept any further new issues of such paper for discount window purpose.	To prevent significant liquidity to be provided to licensed banks against paper not backed by foreign reserves.

B. Interest Rates

79. The pressure in the foreign exchange market was reflected in an increase in the risk premium on the Hong Kong dollar and, consequently, higher interbank interest rates. While banks have adjusted interest rates on Hong Kong dollar time deposits quickly in response to changes in interbank rates, interest rates on savings deposits, which are set by the Hong Kong Association of Banks (HKAB) and the rate on loans, have adjusted relatively slowly. The interest rate on time deposits rose by 2 percentage points to 9¼ percent between October and January, and moved between 6½–8¾ percent for the remainder of the year. However, interest rates on Hong Kong dollar deposits with maturities of less than one week (which are set by the HKAB) were changed only slightly, and the interest rate on savings deposits was raised by only 1½ percentage point to 5½ percent, and was subsequently lowered to 4¼ percent (by December 1998). This resulted in large spreads between interbank and demand and savings deposit rates (Chart 8). Similarly, banks raised their best lending rate (BLR)—also known as the prime rate—by only 1½ percentage points between September 1997 and February 1998 (to 10¼ percent), and subsequently lowered it to 10 percent at end-March, and to 9 percent in December 1998.

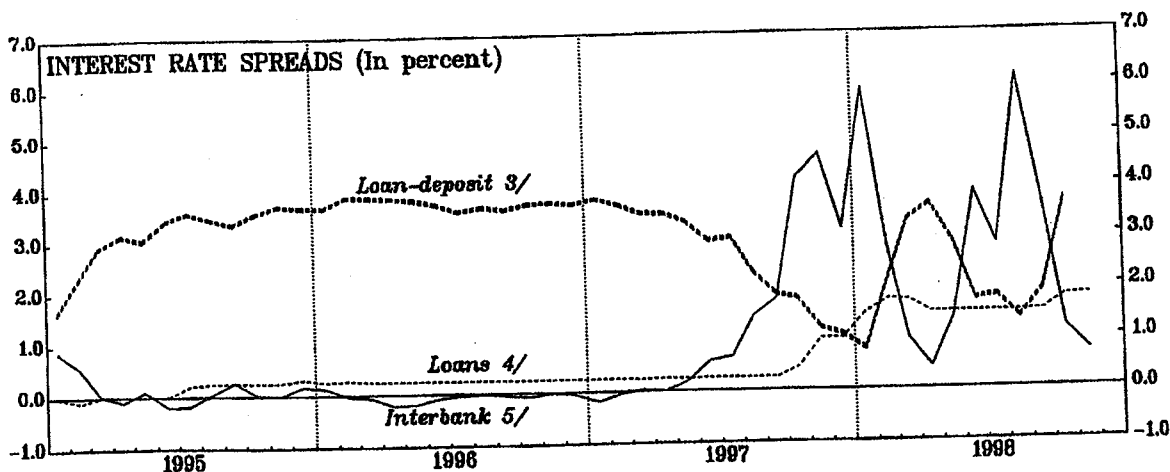
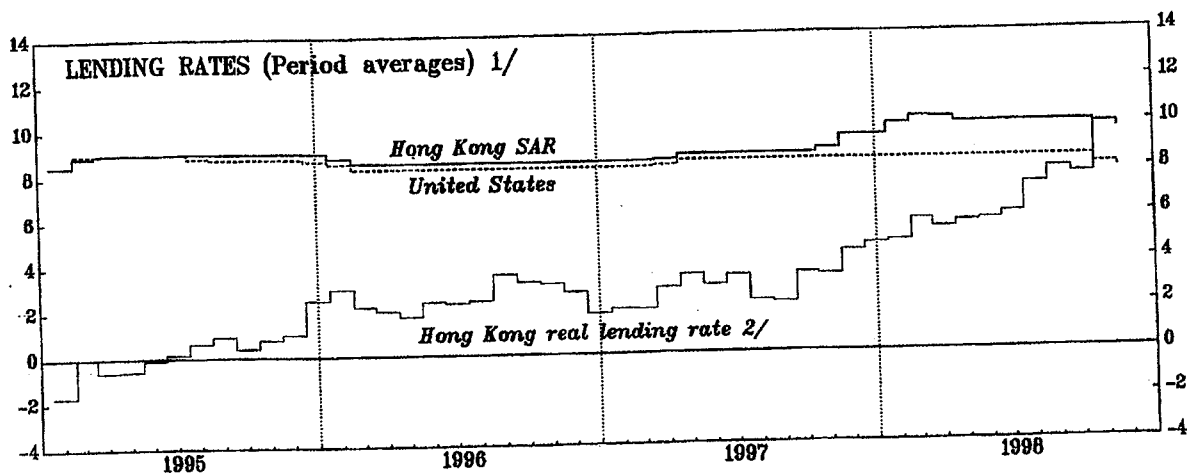
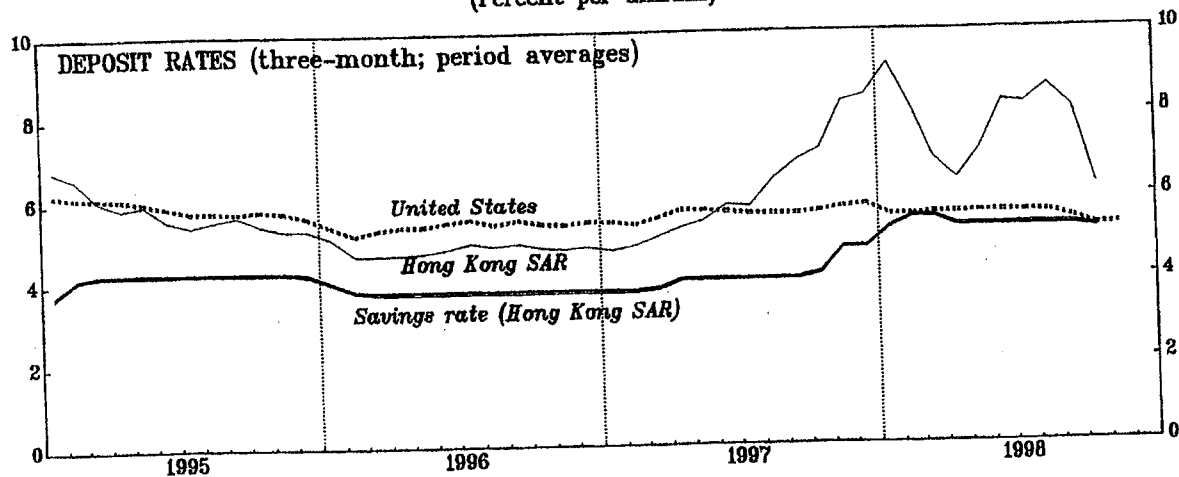
80. The rise in nominal interest rates during the year, together with the moderation in inflation necessitated under the link, resulted in a steady increase in real interest rates. Measured as the nominal interest rate less consumer price inflation over the past year, the three-month time deposit rate and the BLR in real terms were 6 percent and 8 percent, respectively, in September 1998. Moreover—as is usually the case in periods of moderating inflation—real rates measured as nominal rates less anticipated inflation were likely even higher.

C. Money and Credit

81. The institutional framework for monetary policy in Hong Kong SAR—established in the Joint Declaration and the Basic Law—requires that the Hong Kong dollar be fully backed by foreign exchange. The linked exchange rate system operates as a currency board-type arrangement, leaving the HKMA very limited scope to affect monetary conditions. In this context, monetary aggregates are driven mainly by money demand, which in turn reflects income growth, interest rates, and asset market activity.

82. Owing to Hong Kong SAR's role as international financial and banking center and the absence of controls on capital and foreign exchange transactions, its money aggregates have been characterized by the presence of a significant foreign exchange component. On the deposit side, foreign currency denominated deposits traditionally have accounted for about 15–20 percent of demand deposits and 40–50 percent of savings and time deposits. On the loan side, offshore lending in foreign currency has represented around 50 percent of total loans. Onshore lending in foreign currency has been mainly related to trade financing and has

CHART 8
HONG KONG SAR
INTEREST RATE DEVELOPMENTS, 1995-98
(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.

amounted to about 20 percent of loans for use in Hong Kong SAR (which in turn constitute around one half of total loans and advances).

83. In the last quarter of 1997 and the first half of 1998, weak economic activity, the collapse of asset prices, and high interest rates resulted in a sharp slowdown in money and credit growth. Broad money (M3) growth moderated from 13 percent in August 1997 to 7 percent in August 1998. Narrow money (M1) growth also fell, from 13 percent to -16 percent during the same period. The widening of the spread between time and demand deposit interest rates—to almost 3½ percent in August—contributed to the sharp slowdown in M1 growth (Appendix Table 22 and Chart 9).

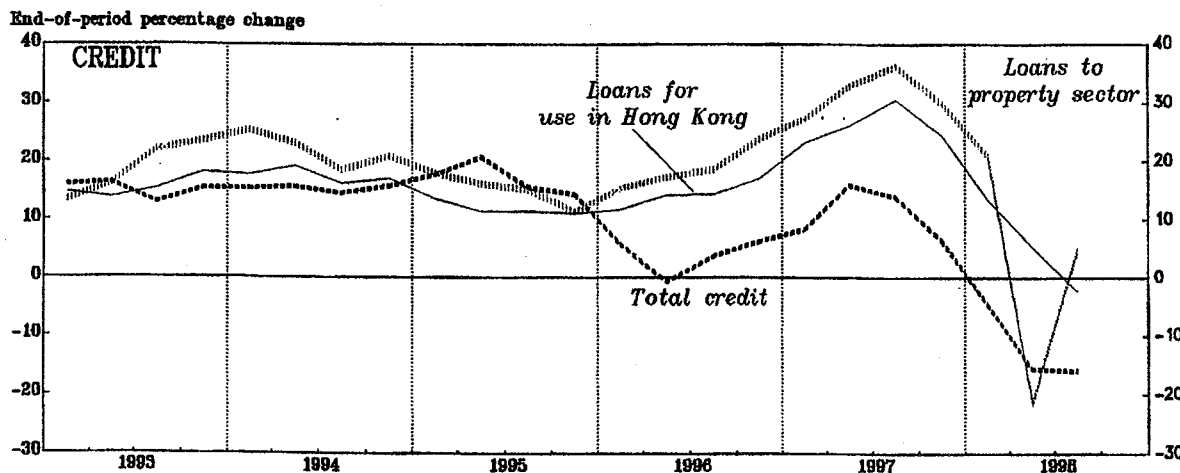
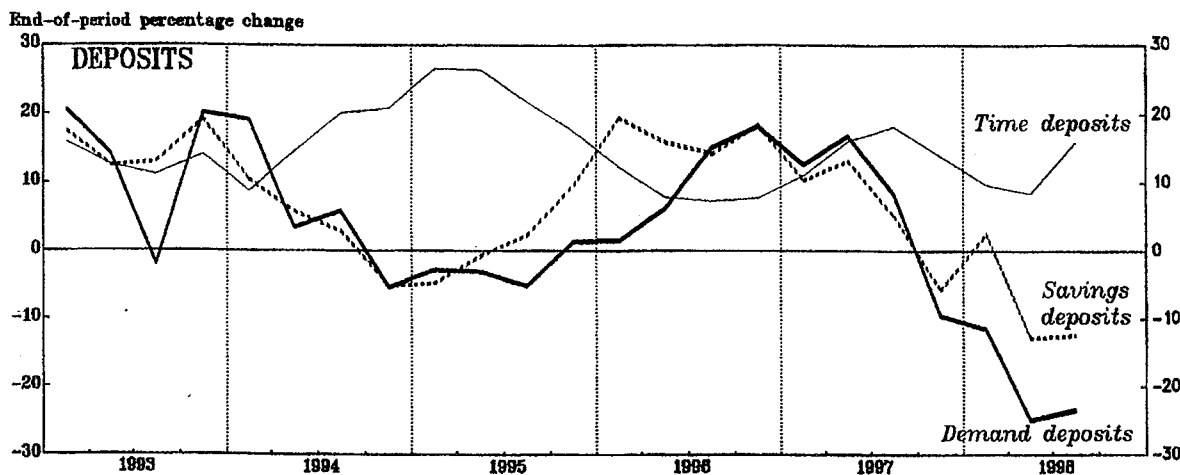
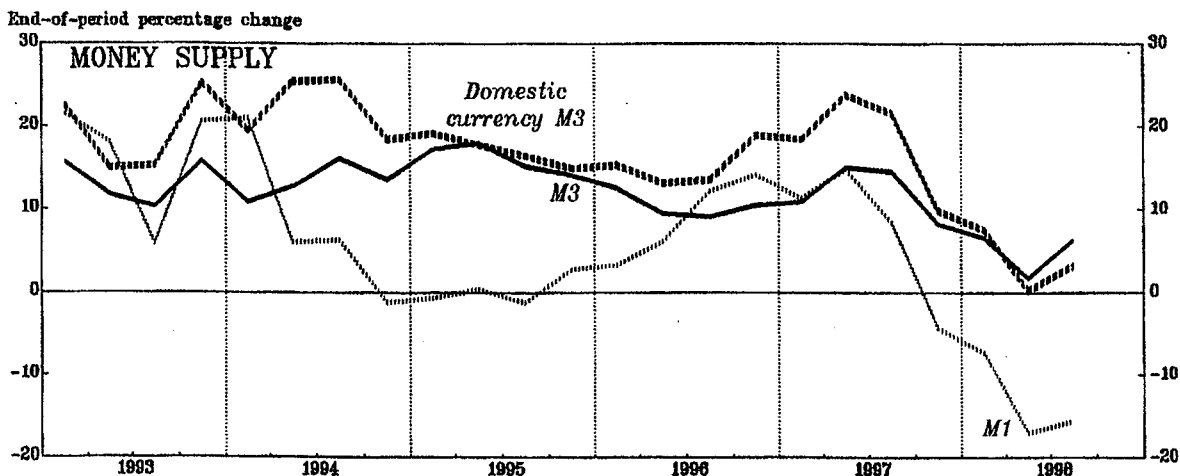
84. The Hong Kong dollar component of the monetary aggregates fell slightly during the year as the widening of the spread between Hong Kong dollar and U.S. dollar deposit interest rates compensated for the weaker demand for Hong Kong dollar deposits. In September 1998, the Hong Kong dollar component of M3 was around 58½ percent, compared to 60 percent a year earlier. Similarly, the Hong Kong dollar component of M1 was 89¾ percent in September, compared to 90½ percent a year earlier.

85. Credit growth fell sharply from mid-1997 (Chart 9), turning negative in the fourth quarter and remaining negative through the first three quarters of 1998. On the supply side, the more uncertain economic environment for Hong Kong SAR banks led them to become more cautious in their lending activity. On the demand side, the weak performance of the Hong Kong SAR economy and the crises in other economies in the region reduced the demand for credit, including trade finance.

86. There was a sharp slowdown in the growth of both Hong Kong dollar and foreign currency denominated loans, although the decline in foreign currency credit was considerably more pronounced. This difference reflected the effect of external factors on offshore lending, which is mainly foreign currency denominated. The weaker demand for loans in other economies in the region, the reduced creditworthiness of many borrowers in these economies, and the reduced activity of foreign banks in Hong Kong SAR resulted in a sharper contraction of offshore relative to onshore lending (Chart 10).³⁶ In September, Hong Kong dollar denominated loans and advances declined by 4¾ percent on a year-on-year basis, while foreign currency denominated loans and advances declined by 33½ percent.

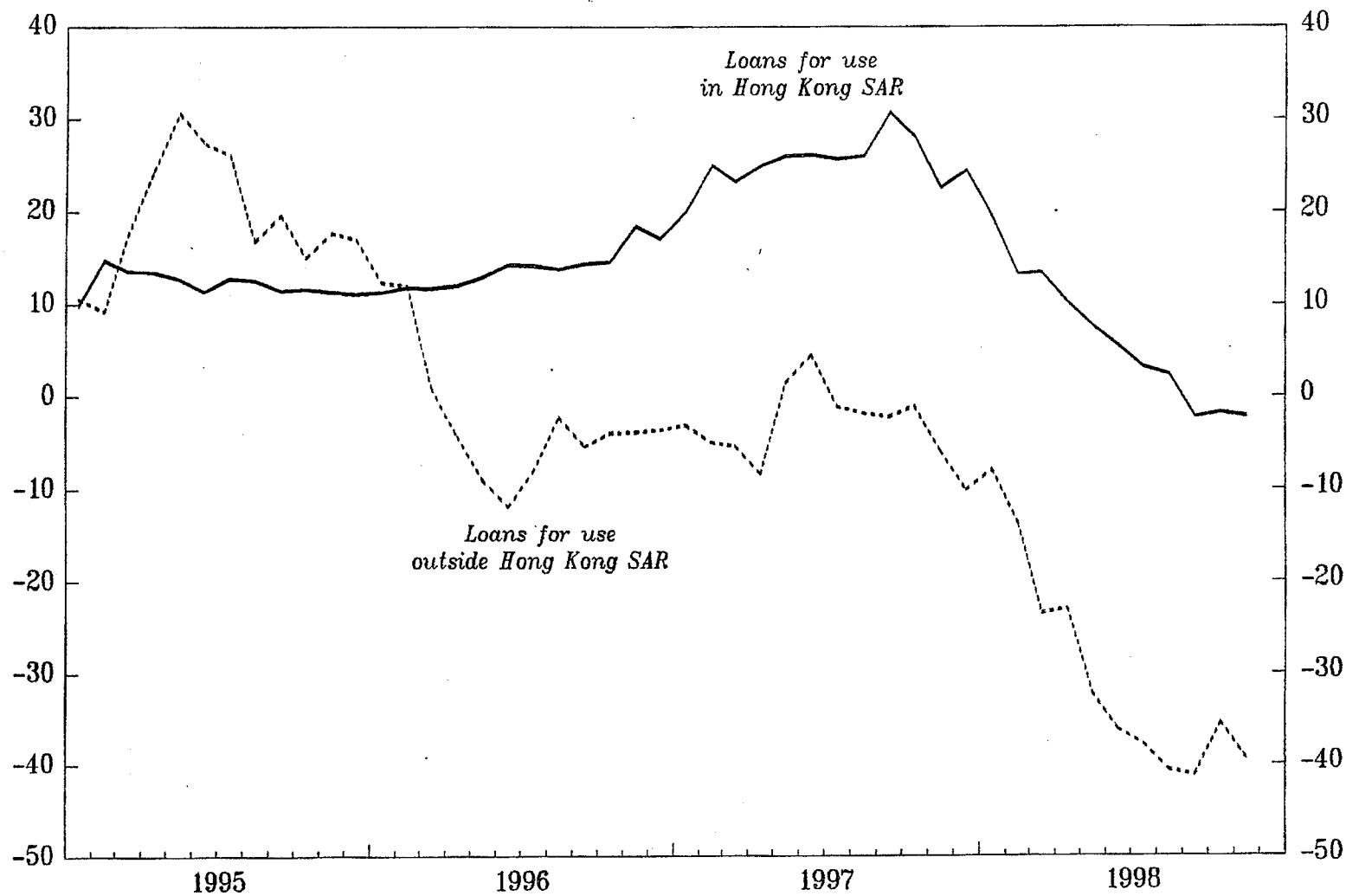
³⁶Particularly important was the offshore activity of Japanese institutions—representing about 90 percent of total offshore lending—and European banks, which fell by 32 percent and 19 percent, respectively, in the first seven months of 1998. By contrast, U.S. banks' offshore lending was broadly stable, while their loans for use in Hong Kong SAR grew by 3½ percent.

CHART 9
HONG KONG SAR
MONETARY DEVELOPMENTS, 1993-98



Source: Hong Kong Monetary Authority, Monthly Statistical Bulletin.

CHART 10
HONG KONG SAR
LOANS AND ADVANCES, 1995-98
(Twelve-month percent change)



Source: Hong Kong Monetary Authority.

87. The deceleration in loans for use in Hong Kong SAR affected all sectors of the economy, but to a varying degree of intensity (Appendix Table 23). While the quarter-to-quarter annualized growth rate of loans for use in Hong Kong SAR moderated from 33 percent in the second quarter of 1997 to $-3/4$ percent in the second quarter of 1998 (Chart 9), the growth of property-related loans slowed from $46\frac{1}{4}$ percent to $7\frac{1}{2}$ percent and the growth rate of loans to the manufacturing sector fell from $13\frac{3}{4}$ percent to $-6\frac{1}{2}$ percent.

88. With their flexibility to respond to the tightening monetary and credit conditions constrained by the linked exchange rate system, the authorities implemented a series of measures aimed at enhancing bank liquidity during the course of the year. In addition to announcing its willingness to serve as a counterparty to Hong Kong dollar repurchase transactions, the HKMA withdrew its 40 percent guideline on the banks' property exposure to boost property lending and stem the decline in property prices.³⁷ In addition, the Hong Kong Mortgage Corporation (HKMC) announced a commitment to purchase an agreed amount of mortgages from banks within a specified period to give banks greater certainty regarding the amount of loans they would be able to sell to the HKMC.³⁸ The authorities also exempted interest income deriving from onshore Hong Kong dollar deposits held by corporates from profits tax—thereby equalizing the tax treatment with that for foreign currency deposits—to help banks mobilize Hong Kong dollar deposits.

89. These measures, together with the pickup in market sentiment, contributed to a rebound in M3 growth in the second half of the year, to an annualized seasonally adjusted rate of 30 percent in August. At the same time, the annualized growth of the foreign currency component of M3 picked up to 45 percent. However, domestic credit remained weak.

D. Stock Market Developments

90. The Stock Exchange of Hong Kong (SEHK) is one of the largest in the world. At the end of 1997, there were 658 listed companies with total market capitalization of around US\$410 billion (239 percent of GDP). The securities market in Hong Kong SAR is self-

³⁷Under the guideline, banks were asked to limit their property exposure to 40 percent of their loans for use in Hong Kong SAR. The guideline was not a binding limit, however, and the average property exposure of the banking system at end-June (prior to the lifting of the guideline) was 43.1 percent.

³⁸The HKMC began operations in late 1997 with the intent to develop a secondary market for mortgages, thereby providing a mechanism for banks to reduce their exposure to the property sector. In September 1998, the HKMC's paid up capital was increased to HK\$2 billion, that with the minimum capital to asset ratio of 5 percent, allowed the HKMC to purchase or commit to purchase up to HK\$40 billion of mortgages.

regulated, but operates under the oversight of the Securities and Futures Commission (SFC), which also supervises the Hong Kong Futures Exchange (HKFE).

91. From the last quarter of 1997, stock prices have been severely affected by the turbulence in regional financial markets, the rise in Hong Kong dollar interest rates, and the deterioration in economic conditions in Hong Kong SAR (Chart 11 and Appendix Table 24). The volatility of stock prices has also increased sharply. Between August 1997 and July 1998, the Hang Seng Index (HSI)—which represents around 66 percent of market capitalization—declined by around 45 percent. Following an intensification in market turbulence internationally, the HSI sank by a further 23 percent to mid-August 1998, with the index bottoming at around 40 percent of its August 1997 peak level.

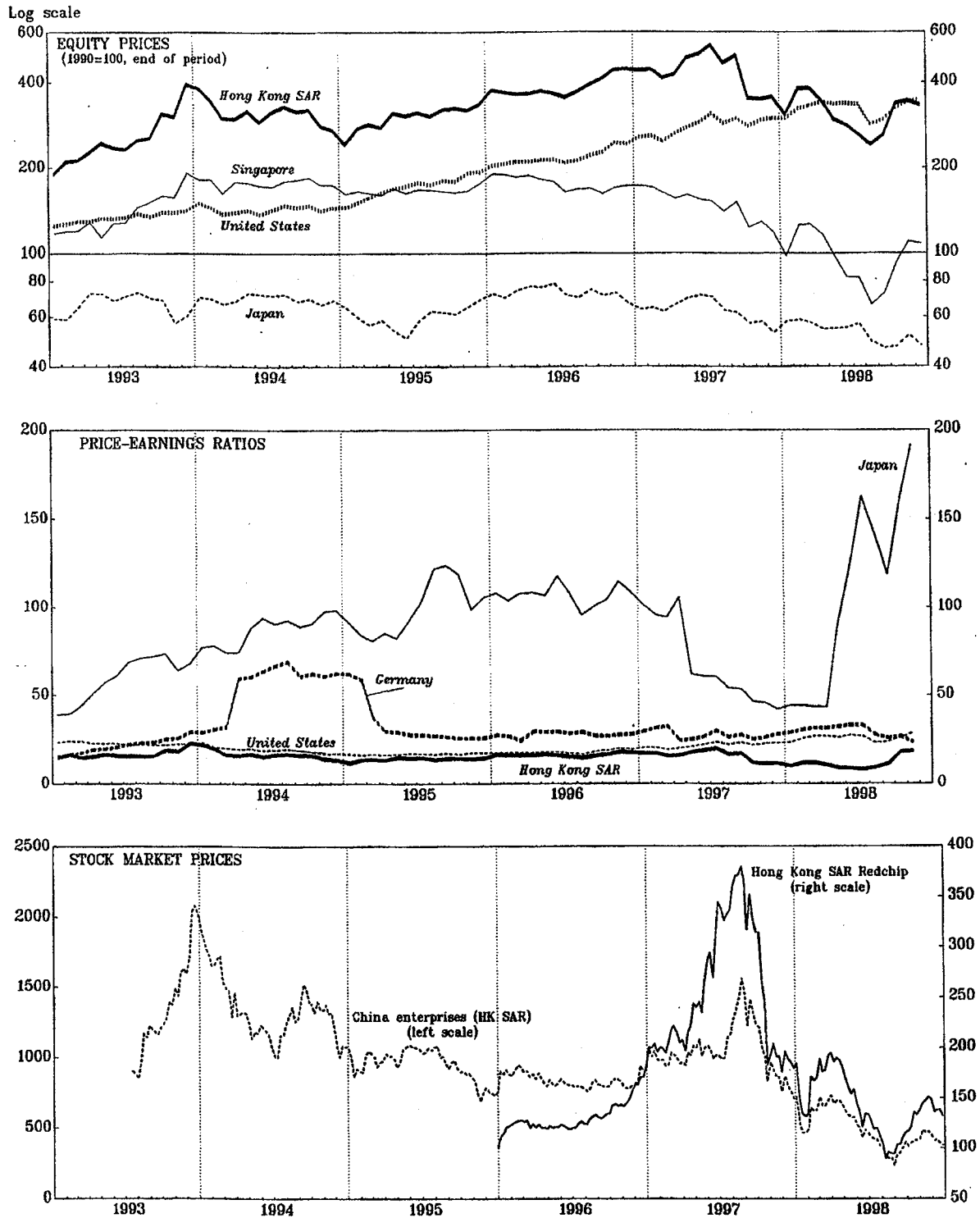
92. The authorities, concerned that markets were being manipulated and that confidence could be undermined, intervened directly in the market during the second half of August 1998. The intervention was limited to the 33 companies of the HSI, with the authorities purchasing between 2½–12¼ percent of the outstanding shares of these firms.³⁹ Subsequently, an independent company, the Exchange Fund Investment Ltd. (EFIL), was established and entrusted with the management of the government's stock holdings, with the principal objective of disposing the shares in an orderly manner. The EFIL has disclosed its stock holdings and the average price paid by the government to purchase each stock.

93. Following the intervention, the authorities announced a set of measures to tighten securities market regulations and increase the cost of speculative activity. The measures, outlined in a “30-point” program (Appendix Table 25), were aimed at improving the transparency of short-selling activity and enhancing the enforcement of settlement rules. In particular, the strict enforcement of the T+2 settlement rule, with a compulsory buy-in on T+3, sought to reduce differential treatment amongst market participants and improve settlement efficiency. It also had the effect of making short-selling activity more expensive, as the shorter settlement period made it more difficult for market participants to complete all the technical steps involved with short-selling. Also related to short-selling was the reintroduction of a “tick” rule aimed at reducing selling pressure in a falling market.⁴⁰ On the futures market, prior to the introduction of the 30-point program, the Hong Kong Futures Exchange had already taken the initiatives to impose a special margin rate of 150 percent on open position of 10,000 contracts (the margin rate was HK\$80,000 at that time but was later reduced to HK\$63,000 on November 30, 1998) and lower the threshold for reporting of large open positions to the SFC from 500 to 250 contracts. These measures were introduced to

³⁹As a result of the intervention, the government now owns over 10 percent of three of the companies.

⁴⁰This rule stipulates that short sales of securities can only be executed at prices not below the best current ask price.

CHART 11
HONG KONG SAR
STOCK MARKET DEVELOPMENTS, 1993-98



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

address the concern or rapid buildup of speculative positions in the preceding months. Under the 30-point program, to further improve the market order and cross-market information flows, it had been suggested that the threshold for triggering the special margin rate should be reduced to 5,000 contracts and a cross-market early warning system that would be triggered whenever the futures market activity exceeded the cash market activity by a predetermined amount. These measures have, however, not yet been implemented. Moreover, a decision was taken to develop a cross-market early warning system that would be triggered whenever the futures market activity exceeded the cash market activity by a predetermined amount.

94. Market conditions have improved since the intervention and the subsequent measures, aided by favorable external developments. By mid-December, the HSI was around 50 percent higher than in mid-August, and only around 7 percent lower than at end-1997. However, stocks of Mainland China-related companies—generally considered more risky—were still around 45 percent below their end-1997 levels.

E. Banking Sector

95. The Hong Kong SAR banking system is characterized by a strong presence of foreign and foreign-owned banks. In 1997, the vast majority of financial institutions operating in Hong Kong SAR were incorporated abroad, or were subsidiaries of foreign banks. Moreover, only 16 of the 180 licensed banks, and 17 of the 181 restricted license banks and deposit-taking companies were domestically owned. Foreign and foreign-owned (excluding Mainland China) banks' share of total loans for use in Hong Kong was around 40 percent. In addition, foreign and foreign-owned banks represented around 95 percent of offshore lending (Appendix Tables 26 and 27 report selected statistics for the banking system).

96. Notwithstanding the financial turbulence and the weak macroeconomic situation, Hong Kong SAR's banks remain well capitalized. As of mid-1998, all the banks chartered in Hong Kong SAR had consolidated a capital adequacy ratio over 13 percent, well above the 8 percent recommended by the Basle Committee on Banking Supervision. The average ratio for locally incorporated authorized institutions was 18.2, up 0.7 percentage points from end-1997.

97. With interbank and time deposit interest rates rising by more than lending rates over the past year, banks' interest margins and profits have been compressed (Table 6). For local banks as a whole, the net interest rate margin declined to 2.31 percent of interest bearing assets in the first half of 1998, from 2.43 percent in 1997.⁴¹ This decline was likely to be more pronounced for smaller banks that had to rely more on funds the costs of which were

⁴¹The higher return on the interest-free capital represented a mitigating factor that contributed to sustain banks' profitability.

Table 6. Hong Kong SAR: Banking Sector Indicators 1/

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

	1992	1993	1994	1995	1996	1997	1998 June
Net interest margin	2.27	2.32	2.32	2.49	2.58	2.43	2.31
After-tax profits (in percent of average total assets)	1.85	1.94	1.85	1.82	1.79	1.65	1.13
Nonperforming assets (in percent of total credit exposure)2/	...	...	...	2.38	2.31	1.71	3.24
Default rate 3/ (in percent)	0.17	0.12	0.06	0.08	0.18	0.15	0.39
Capital adequacy ratio 4/ (in percent)	16.0	17.0	17.4	17.5	17.8	17.5	18.2

Sources: Data provided by the Hong Kong SAR authorities; and HKMA.

1/ Data cover locally incorporated banks only.

2/ Loans classified as "substandard," "doubtful," or "loss."

3/ Bad debt charge as percent of average total assets.

4/ Consolidated ratio for all locally incorporated institutions.

related to HIBOR. Profit margins—defined as the ratio of profits to total interest bearing assets—fell by 30 percent in the first half of 1998 (year-on-year basis).

98. The contraction in economic activity, together with the deterioration in economic and financial conditions in the region, inevitably weakened asset quality, although the level of nonperforming loans remained low. In mid-1998, classified exposures of local banks amounted to 3.24 percent of total credit exposure, compared to 1.71 percent at end-1997. The volatile interest rate environment and increased perceived credit risk induced banks to lower their overall credit exposure and adopt a more cautious lending policy. As a result, the loan-to-deposit ratio for all authorized institutions in mid-1998 was 22 percentage points below its end-1997 level.

99. The share of banks' property related lending rose further in 1998, as lending for commercial use fell sharply in response to the contraction in economic activity. In mid-1998, the share of property related lending to total lending for use in Hong Kong by authorized institutions (which excludes trade financing) was 45.4 percent, against 44.3 percent in 1997. The share of residential mortgages (excluding the Home Ownership Scheme and the Private Sector Participation Scheme) rose by 1.1 percentage points to 24.7 percent (Table 7).

100. While banks' property exposure is high and rising,⁴² the concentration risk associated with this exposure is mitigated by banks' observance of the HKMA's recommended maximum loan-to-value ratio of 70 percent for residential mortgages as well as the low gearing ratio of property developers and the practice of pre-selling a large number of units. As a result, the default rate for mortgages remains low (0.29 percent in mid-1998). The average gearing ratio (computed as total debts over equity) for listed property companies was at 30 percent in 1997, and, while the situation at the individual firm level was quite heterogenous, even the maximum ratio was only 68 percent.

101. The exposure of the Hong Kong SAR banking system to the Asian crisis countries is limited, with only 7.5 percent of total external claims to the ASEAN-4 and Korea, representing 4 percent of total assets of the banking system as of mid-1998. Direct claims on banks and nonbanks in Mainland China were at 9.3 percent of total external claims, although

⁴²The total exposure to the property sector is significantly lower if banks' offshore activities are taken into account. In mid-1998, the share of property related lending to total lending was at 21.9 percent.

Table 7. Hong Kong SAR: Share of Property-Related Loans in Total Lending, 1993–98

(In percent)

	1993	1994	1995	1996	1997	1998 1/
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	20.7	20.7
As a share of total loans and advances	6.0	7.1	6.6	8.1	10.2	11.7
Residential mortgages 3/						
As a share of loans for use in Hong Kong SAR 2/	21.7	20.5	21.5	22.6	23.6	24.7
As a share of total loans and advances	8.2	7.9	8.0	9.4	11.7	13.9
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	44.3	45.4
As a share of total loans and advances	14.1	15.1	14.6	17.5	21.9	25.6

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

1/ As of end-June 1998.

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.

indirect exposure—through lending to Mainland-related firms in Hong Kong SAR—is likely much higher.⁴³

102. The Hong Kong prudential supervision framework, already strong by international standards, has been strengthened further over the past year with the introduction of tighter accounting standards, the market risk capital adequacy regime, and measures to improve the transparency of the banking system. The market risk based capital requirement was put into effect at end-1997, in line with the Basle Committee's recommendations. In May 1998, guidelines on the recognition of interest were issued with the purpose of achieving more standardized accounting policies. These standards are to be adopted by all authorized institutions in their reports to the HKMA, and for local banks the standards also apply to their published financial statements. Since end-1997, all banks were required to disclose in their interim reports the breakdown by industry of advances to customers; while since June 1998, listed local banks were also required to disclose problem loans by the length of overdue period, and the total amount of rescheduled loans. Finally, from end-1998, all local banks will be required to have a risk-weighted capital adequacy ratio of not less than 10 percent (the Basle standard is 8 percent).

F. Corporate Sector

103. The Hong Kong SAR corporate sector is characterized by a relatively low gearing ratio which, together with the sector's moderately high profitability, has resulted in comfortable interest coverage for the average firm (Table 8).⁴⁴ There is, however, a significant degree of heterogeneity across sectors and between "blue chip" companies included in the HSI and Mainland-affiliated enterprises listed on the SEHK ("red chips"). There are also significant differences between the financial structure of large and small companies.

104. Data from a sample of 70 listed companies suggests that blue chip companies were less leveraged and had higher profits than red chips in 1997 (Table 9). The average debt/equity ratio was 37 percent for blue chips, compared with 56 percent for red chips. At

⁴³The Hong Kong SAR banking system's direct claims on the China's International Trust and Investment Companies (ITICs) and their subsidiaries amounted to HK\$30 billion (less than 1 percent of total loans) at end-September 1998. In addition, there were HK\$14 billion of contingent liabilities. Around 63 percent of the direct exposure and most of the contingent liabilities concerned the financing of ITICs activities in Hong Kong SAR. The remaining HK\$11 billion were related to loans to the ITICs in Mainland China and were mostly registered with SAFE.

⁴⁴Interest coverage is defined as the ratio of earnings before interest and taxes to interest expenses.

Table 8. Hong Kong SAR: HSI Companies Indicators 1993-97 1/

	1993	1994	1995	1996	1997
Return on Equity (in percent)	14.3 (12.9)	19.0 (14.5)	21.1 (12.0)	20.7 (12.0)	18.8 (10.9)
Pre-Tax Margin (in percent) 2/	40.5 (30.5)	46.3 (28.6)	47.8 (36.3)	48.2 (26.7)	55.3 (48.4)
Gearing Ratio 3/	28.6 (30.5)	33.8 (28.5)	36.1 (28.0)	31.3 (27.8)	36.7 (28.4)
Interest Cover 4/	18.7 (18.6)	50.8 (50.4)	26.3 (26.6)	34.8 (35.0)	56.7 (145.6)
Current Ratio 5/	0.96 (0.94)	1.22 (0.74)	1.20 (0.87)	1.26 (0.88)	1.78 (1.43)

Source: SEHK.

1/ Data relate to the 29 nonfinancial HSI companies and are weighted averages. Data in parentheses are standard deviations.

2/ Defined as pre-tax income over total revenue.

3/ Total debt/company equity.

4/ Earnings before interests and taxes (EBIT)/interest expenses. This ratio indicates the number of times earnings exceed interest payments.

5/ Current assets/current liabilities.

Table 9. Hong Kong SAR: Corporate Sector Selected Indicators for HSI and Red-Chip Companies, 1997

	Gearing Ratio 2/		Pre-tax Margin 3/ (in percent)		Interest Cover 4/		Return on Equity (in percent)		Current Ratio 5/	
	HSI	Red-chips	HSI	Red-chips	HSI	Red-chips	HSI	Red-chips	HSI	Red-chips
Utilities Companies	20	-	42	-	93	-	90	-	182	-
Properties Companies	29	58	80	41	83	6	13	14	188	331
Consolidated Enterprises	59	68	35	22	8	5	14	12	130	129
Industrial Companies	23	44	56	20	8	7	17	20	326	270
Hotel Companies	31	-	23	-	5	-	3	-	90	-
Total	37	56	55	27	57	6	19	15	178	230

Source: SEHK.

1/ Data relate to the 29 nonfinancial HSI companies and 36 red-chips. All figures are weighted averages with weights based on market capitalization.

2/ Total debt/company equity.

3/ Defined as pre-tax income over total revenue.

4/ Earnings before interest and taxes (EBIT)/interest expenses. The ratio indicates the number of times earnings exceed interest payments.

5/ Current assets/current liabilities.

the same time, blue chips' average pre-tax profit margin was 55 percent, versus 27 percent for the average red chip. Similar differences existed at the sectoral level as well. For the three sectors for which comparisons were possible—property companies, consolidated enterprises, and industrial companies—HSI companies tended to have higher pre-tax profit margins and lower gearing ratios than red chip companies. It should be noted, however, that red chips' gearing ratios have declined over time, reflecting their increasing ability to raise equity capital.

105. The data, together with financial statistics from a wider sample of Hong Kong SAR corporates—which include both HSI firms as well as a large number of minor listed firms—suggest that smaller firms are significantly more leveraged than larger firms.⁴⁵ The median gearing ratio of 463 listed firms was 142 percent at end-1996, considerably higher than the weighted average ratio of 31 percent for blue-chip firms. Since the median is skewed toward the large number of small firms, this would seem to imply that the smaller firms were more leveraged, as would be expected since smaller firms' access to direct intermediation via equity issues is considerably more limited than for large firms. Similarly, the median interest cover ratio for the larger sample was 3.6 in 1996, compared with a weighted average ratio of 35 for blue-chip firms. The median return on assets/equity for the larger sample was 4.1 percent, considerably lower than the weighted average of 21 percent for HSI firms.

106. The data also indicate that the financial position of property companies—which are important for the stability of the banking system since 20 percent of banks' onshore lending goes to property development—was strong in 1997. The average gearing ratio of property companies in the HSI was around 30 percent, in line with the average in other sectors, with the ratio ranging from 4 percent to 68 percent for individual firms. However, the weighted average of property companies' profit margins was 80 percent, well above the average of 55 percent across all sectors.⁴⁶ Similarly, property companies' interest cover ratio averaged 83, also well above the average ratio of 57 for firms in all sectors.⁴⁷ The strong financial position of property developers at end-1997 was at least partly due to the rapid runup in property prices for much of the year; the situation at end-1998, following the collapse of the bubble in property prices, will likely be considerably weaker. Nevertheless, data available at this time suggest that the financial position of the property developers—both blue chip and red chip—is relatively strong.

⁴⁵See Claessens, Djankov, and Lang, "East Asian Corporates: Growth, Financing and Risks over the Last Decade," mimeo, The World Bank, September, 1998.

⁴⁶The average was weighted by firms' market capitalization. All reported averages refer to weighted averages.

⁴⁷By way of comparison, red chip property companies' gearing ratios, profit margins, and interest cover ratios averaged 58 percent, 41 percent, and 6, respectively.

107. Among the other sectors, consolidated enterprises—which are diversified across sectors, and in many cases have significant offshore operations—have traditionally had lower pre-tax profit margins. In 1997, these companies were especially hard hit by the Asian financial crisis and, as a result, their profit margins declined by more than in other sectors. Consolidated enterprises have also tended to have higher gearing ratios, as operations outside Hong Kong SAR were often financed with debt to reduce currency risk. In 1997, the average ratio for HSI companies rose to 74 percent, as large long-term investments financed mainly with external debt were initiated by two major consolidated companies. This, together with an average profit margin of 35 percent for the sector, resulted in a decline in the average interest cover ratio to 8 times interest expenses.⁴⁸

108. For industrial companies, overall financial performance in 1997 was close to that of the corporate sector as a whole. HSI industrial firms' pre-tax profit margins averaged 56 percent, while industrial red chips' margins averaged 20 percent. In terms of leverage, both HSI and red chip industrial companies enjoyed relatively low gearing ratios of 23 percent and 44 percent, respectively.

109. The full effect of the Asian financial crisis on Hong Kong SAR corporates can only be gauged once financial data for 1998 become available; the data for 1997 likely only capture the initial impact. Nevertheless, the experience of hotel companies provides an illustrative example of the impact of the regional crisis. The sharp decline in the number of visitors to Hong Kong SAR caused a decline in average profit margins from 41 percent in 1996 to 23 percent in 1997. While average gearing ratios (31 percent) were broadly similar to the average for firms in other sectors, hotel companies' high operating costs, highly competitive environment, and relatively large capital base implied a low return on equity of 3 percent in 1997, compared with 19 percent on average for all Hong Kong SAR firms.

⁴⁸Red chip consolidated enterprises had similarly high leverage—68 percent on average at end-1997—but lower profit margins (averaging 22 percent). As a result, their average interest cover ratio was 5 times interest expenses.

Table 10. Hong Kong SAR: Gross Domestic Product by Expenditure
Component at Current Market Prices, 1993-98

	1993	1994	1995	1996	1997	1998
					Jan.-June	
	(In billions of Hong Kong dollars)					
Consumption	586.9	676.3	748.7	826.5	916.7	444.8
Private	514.2	592.7	654.5	722.1	802.6	385.1
Government	72.6	83.7	94.2	104.4	114.2	59.7
Gross fixed capital formation	245.2	301.1	329.6	372.7	467.9	217.6
Private	212.1	261.1	277.1	308.9	405.2	193.7
Government	33.1	40.0	52.5	63.9	62.7	31.2
Final domestic demand	832.0	977.4	1,078.3	1,199.2	1,384.7	662.3
Change in stocks	2.3	21.3	45.7	9.8	1.9	-4.3
Total domestic demand	834.3	998.7	1,124.0	1,209.0	1,386.5	658.0
Net exports of goods and nonfactor services	63.1	12.2	-46.8	-16.9	-46.8	-27.5
Exports of goods and nonfactor services	1,261.8	1,410.7	1,609.8	1,690.7	1,749.3	786.1
Exports of goods	1,046.3	1,170.0	1,344.1	1,397.9	1,455.9	656.8
Domestic exports	223.0	222.1	231.7	212.2	211.4	90.7
Re-exports	823.2	947.9	1,112.5	1,185.8	1,244.5	566.1
Exports of nonfactor services	215.6	240.7	265.6	292.8	293.4	129.3
Imports of goods and nonfactor services	1,198.7	1,398.5	1,656.6	1,707.6	1,796.2	813.6
Imports of goods	1,075.7	1,254.4	1,495.7	1,539.9	1,619.5	725.9
Of which:						
Retained imports	400.0	461.1	562.2	555.0	589.0	304.8
Imports of nonfactor services	123.0	144.1	160.9	167.8	176.7	87.7
Factor income inflows	316.7	371.3	387.3	384.3	...	...
Factor income outflows	306.4	364.0	372.8	392.5	...	...
Net factor income flows	10.3	7.3	14.5	-8.2	...	...
Gross national product	907.8	1,018.2	1,091.7	1,183.8	...	...
Gross domestic product	897.5	1,010.9	1,077.2	1,192.0	1,339.7	630.5
	(In percent of GDP)					
Memorandum items:						
Consumption	65.4	66.9	69.5	69.3	68.4	70.5
Gross fixed capital formation	27.3	29.8	30.6	31.3	34.9	34.5
Total domestic demand	93.0	98.8	104.3	101.4	103.5	104.4
Net exports of goods and nonfactor services	7.0	1.2	-4.3	-1.4	-3.5	-4.4

Sources: Census and Statistics Department, *Estimates of Gross Domestic Product, 1961 to 1996*; and *Quarterly Report of GDP Estimates, Second Quarter 1998*.

Table 11. Hong Kong SAR: Gross Domestic Product by Sector at Current Prices, 1992-96

	1992	1993	1994	1995	1996
	(In millions of Hong Kong dollars)				
Agriculture and fishing	1,468	1,612	1,596	1,453	1,444
Mining and quarrying	205	197	249	317	311
Manufacturing	99,764	92,582	87,354	84,770	82,769
Electricity, gas, and water	15,637	17,591	22,175	23,578	26,989
Construction	37,337	43,089	46,325	54,761	65,058
Wholesale, retail and export/import trades, restaurants and hotels	190,760	224,462	249,167	270,520	301,277
Transportation, storage, and communications	71,227	78,993	92,109	102,199	111,087
Financing, insurance, real estate, and business services	178,923	214,550	254,346	247,985	284,538
Community, social, and personal services	110,703	130,408	151,293	175,956	198,967
Ownership of premises 1/	80,941	89,862	115,659	134,933	147,546
Adjustment for financial intermediation services 2/	-54,846	-63,177	-70,101	-80,358	-89,356
Gross domestic product at factor cost (production-based estimates)	732,120	830,169	950,172	1,016,115	1,130,630
Indirect taxes	48,777	53,278	56,286	52,974	62,442
Gross domestic product at market prices (production-based estimates) 3/	780,897	883,447	1,006,458	1,069,089	1,193,072
	(In percent of GDP)				
Memorandum items: 4/					
Manufacturing	13.7	11.2	9.2	8.3	7.3
Wholesale, retail and export/import trades, restaurants and hotels	26.1	27.0	26.2	26.6	26.6
Financing, insurance, real estate, and business services	24.4	25.8	26.8	24.4	25.2
Transportation, storage, and communications	9.7	9.5	9.7	10.1	9.8

Source: Census and Statistics Department, *Quarterly Report of Gross Domestic Product Estimates, Second Quarter, 1998*.

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 12. Hong Kong SAR: Gross Fixed Capital Formation, 1993-98

	1993	1994	1995	1996	1997	1998 Jan.-June
(In billions of Hong Kong dollars, at current prices)						
Gross domestic fixed capital formation	245.2	301.1	329.6	372.7	467.9	217.6
Private	212.1	261.1	277.1	308.9	405.2	184.0
Public	33.1	40.0	52.5	63.9	62.7	33.6
Construction	73.2	90.0	101.0	117.7	136.4	73.5
Private	42.9	53.8	54.3	62.2	83.3	45.4
Public	30.3	36.3	46.7	55.5	53.2	28.1
Machinery and equipment	95.3	114.9	156.8	164.5	184.2	86.6
Private	92.5	111.1	151.0	156.1	174.6	81.2
Public	2.7	3.7	5.8	8.4	9.6	5.4
Transfer costs of land and buildings	19.9	21.3	13.9	22.2	37.9	8.3
Real estate developers' margin	56.8	74.9	57.9	68.4	109.4	49.2
(Share in total, in current prices)						
Private capital formation	86.5	86.7	84.1	82.9	86.6	84.6
Public capital formation	13.5	13.3	15.9	17.1	13.4	15.4
Construction	29.9	29.9	30.6	31.6	29.2	33.8
Machinery and equipment	38.9	38.2	47.6	44.1	39.4	39.8
Transfer costs of land and buildings	8.1	7.1	4.2	6.0	8.1	3.8
Real estate developers' margin	23.2	24.9	17.6	18.3	23.4	22.6
(Percentage change, in constant prices)						
Gross domestic fixed capital formation	3.7	15.7	10.7	10.8	16.0	0.3
Private	-0.7	15.5	8.8	9.5	20.4	-1.5
Public	39.3	17.1	22.0	17.1	-4.8	0.6
Private investment in construction	-1.5	20.3	-5.9	5.7	20.0	9.9
Private investment in machinery and equipment	1.9	17.3	24.4	10.0	17.5	-1.3

Sources: Census and Statistics Department, *Annual Digest of Statistics, Estimates of Gross Domestic Product, 1961-96*; and *Quarterly Report of GDP Estimates, Second Quarter 1998*.

Table 13. Hong Kong SAR: Estimates of External Factor Income Flows
by Income Component and by Business Sector, 1993-96

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

Type of income components	1993	1994	1995	1996
Direct investment Income				
Inflow total	80,743	111,562	106,810	117,157
Banking	6,610	6,156	7,558	9,082
Others	74,133	105,405	99,252	108,074
Outflow total	153,550	169,026	177,942	201,267
Banking	59,074	55,890	61,630	59,530
Others	94,475	113,136	113,312	141,737
Portfolio investment income				
Inflow total	68,656	66,482	78,575	84,583
Banking	32,767	19,088	24,300	23,828
Others	35,889	47,394	54,276	60,755
Outflow total	10,838	20,257	24,089	28,333
Banking	2,476	3,587	4,171	5,961
Others	8,362	16,670	19,918	22,372
Other investment income				
Inflow total	167,196	193,120	201,623	182,032
Banking	163,696	187,188	192,710	172,104
Others	3,500	5,932	8,913	9,928
Outflow total	141,863	174,542	170,466	162,385
Banking	137,295	169,064	162,310	150,885
Others	4,567	5,477	8,156	11,500
Compensation of employees				
Inflow total	100	141	270	549
Outflow total	100	141	270	549
Banking	11	10	45	13
Others	89	131	225	536
Total external factor income flows				
Inflow total	316,696	371,305	387,278	384,321
Banking	203,073	212,432	224,568	205,015
Others	113,622	158,872	162,710	179,306
Outflow total	306,350	363,965	372,767	392,534
Banking	198,857	228,551	228,156	216,389
Others	107,494	135,414	144,611	176,145
Net flow total	10,345	7,340	14,511	-8,212
Banking	4,217	-16,118	-3,589	-11,374
Others	6,129	23,458	18,099	3,162

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

Table 14. Hong Kong SAR: Selected Price Indicators, 1993-98

(Percentage changes)

	Weight in the Index (Percent)	1993	1994	1995	1996	1997	1998 1/		
							Q1	Q2	Q3
CPI (A) 2/	100.0	8.5	8.1	8.7	6.0	5.7	4.8	4.2	2.3
Food - overall	37.3	7.2	6.4	7.2	4.0	3.7	4.2	3.3	-0.1
Meals away from home	20.4	8.7	7.8	7.1	4.2	4.3	4.6	3.1	1.8
Excluding meals away from home	16.9	5.6	4.8	7.3	3.7	2.9	3.8	3.3	-2.2
Housing	25.3	12.6	11.2	12.2	9.3	9.0	7.0	5.7	4.1
Fuel and light	3.4	3.9	3.4	7.6	5.2	5.6	0.7	1.7	1.5
Alcohol and tobacco	2.1	10.5	5.6	6.3	5.8	5.7	6.8	6.1	6.5
Clothing and footwear	5.1	7.6	8.8	8.6	9.5	9.1	3.9	3.1	1.8
Durable goods	4.3	2.2	2.8	4.2	1.8	2.3	0.9	0.9	0.5
Miscellaneous goods	6.0	6.8	6.8	6.6	2.5	7.2	4.3	5.7	2.6
Transportation and vehicles	7.2	8.3	9.3	7.5	6.3	3.9	5.4	5.0	4.6
Miscellaneous services	9.3	9.5	11.8	11.4	6.9	4.9	3.8	4.9	5.0
Composite CPI 2/	...	8.8	8.8	9.1	6.3	5.8	5.0	4.4	2.8
Residential price index	...	10.2	23.6	-7.2	9.6	40.9	-10.4	-25.2	...
GDP deflator	...	8.5	6.9	2.5	5.8	7.2	4.2	1.6	...
Domestic demand deflator	...	7.8	7.1	5.1	4.9	6.1	4.4	0.1	...
Export prices 3/									
Goods deflator	...	-0.3	1.3	2.6	-0.8	-1.9	-2.4	-2.6	...
Services deflator	...	5.4	4.8	5.4	1.6	0.8	-5.5	-6.0	...
Import prices 3/									
Goods deflator	...	-0.5	2.3	4.8	-1.3	-1.9	-3.6	-4.5	...
Services deflator	...	1.8	7.6	9.4	1.6	1.2	-1.8	-2.4	...

Sources: Census and Statistics Department, *Consumer Price Index Report, Hong Kong Monthly Digest of Statistics*; and *Quarterly Report of GDP Estimates, Second Quarter 1998*.

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 15. Hong Kong SAR: Labor Force, Employment, and Unemployment, 1993-98

	1993	1994	1995	1996	1997	1998		
						Q1	Q2	Q3
(In thousands)								
Labor force	2,856	2,929	3,001	3,094	3,216	3,273	3,348	3,379
Employed	2,800	2,873	2,905	3,008	3,145	3,167	3,204	3,199
Unemployed	56	56	96	86	71	106	144	181
(In percent)								
Unemployment rate	2.0	1.9	3.2	2.8	2.2	3.5	4.4	5.0
Labor force participation rate	62.3	62.0	62.0	61.8	61.8	61.7	61.8	...
(Percent changes)								
Labor force growth	2.3	2.5	2.4	3.1	3.9	3.5	5.3	5.9
Employment growth	2.3	2.6	1.1	3.5	4.6	2.5	2.9	2.4
(In percent of total employed)								
Employment in selected sectors 1/								
Manufacturing	19.7	16.7	15.0	12.7	11.7	11.6	11.4	...
Financing, insurance, real estate, and business services	13.8	14.6	15.1	15.5	16.6	16.3	16.6	...
Trade and tourism 2/	38.7	40.3	40.6	41.3	40.5	40.4	39.9	...
Building and construction	2.3	2.5	2.7	3.2	3.4	3.6	3.4	...
Community, social, and personal services	11.4	11.8	12.0	12.5	12.8	13.0	13.2	...
Transportation, storage, and communications	6.3	6.5	6.9	7.1	7.2	7.1	7.3	...
Civil service	7.4	7.1	7.2	7.2	7.5	7.7	7.8	...

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

1/ Based on data on persons engaged by industry sector.

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

Table 16. Hong Kong SAR: Wages, Labor Productivity,
and Unit Labor Costs, 1993-98

(Percentage change)

	1993	1994	1995	1996	1997	1998 1/
Nominal wages 2/						
Overall economy	10.4	9.4	7.0	6.4	7.0	5.2
Manufacturing	10.0	8.1	5.6	7.5	5.3	3.4
Trade and tourism 3/	10.3	9.9	7.2	5.0	7.8	4.7
Financial services 4/	12.2	8.9	8.1	8.4	7.4	6.3
Real wages 2/						
Overall economy	2.4	0.7	-1.5	1.2	1.7	0.4
Manufacturing	1.9	-0.3	-3.0	2.2	0.0	-1.4
Trade and tourism 3/	2.2	1.3	-1.4	-0.1	2.3	-0.2
Financial services 4/	4.0	0.3	-0.5	3.0	2.1	1.4
Labor productivity 2/ 5/						
Overall economy	3.5	2.1	1.1	2.3	1.7	-7.9
Manufacturing	12.4	15.9	14.4	12.2	6.4	10.9
Unit labor costs 2/ 5/						
Overall economy	6.7	7.2	5.9	4.0	5.2	10.8
Manufacturing	-2.1	-6.7	-7.6	-4.2	-1.0	-3.4

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

1/ Data on wages are based on March 1998 wage indices; data on productivity are based on data for the first half of 1998; data on unit labor costs are for the first quarter of 1998. Percentage changes are calculated over corresponding year-earlier periods.

2/ Based on 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.

Table 17. Hong Kong SAR: Property Market Developments, 1994-98 1/

	1994	1995	1996	1997	1998		
					Q1	Q2	Q3
(1989 = 100)							
Price indices							
Private domestic premises	293	272	298	420	354	321	267
<i>Of which:</i>							
40 to 70 square meters	306	282	310	435	364	331	272
100 square meters and above	351	314	352	514	415	373	307
Private retail premises	285	277	287	382	339	289	245
Offices	222	188	184	206	159	146	112
Flatted factories	189	166	143	142	122	118	107
(Year-on-year percent change)							
Private domestic premises	23.6	-7.2	9.6	40.9	-10.4	-25.2	-38.3
<i>Of which:</i>							
40 to 70 square meters	25.4	-7.8	9.9	40.3	-11.2	-26.0	-39.1
100 square meters and above	40.4	-10.5	12.1	46.0	-14.6	-29.0	-41.9
Private retail premises	16.8	-2.8	3.6	33.1	-0.3	-23.7	-40.7
Offices	39.6	-15.3	-2.1	12.0	-25.7	-32.7	-44.6
Flatted factories	6.8	-12.2	-13.9	-0.7	-17.0	-18.6	-24.1
(1989 = 100)							
Rental indices							
Private domestic premises	170	174	171	194	178	172	157
Private retail premises	192	192	192	203	198	191	184
Offices	134	132	112	115	113	107	98
Flatted factories	133	131	118	118	114	109	103
(Year-on-year percent change)							
Private domestic premises	21.4	2.4	-1.7	13.5	-3.8	-10.9	-21.5
Private retail premises	15.0	0.0	0.0	5.7	0.5	-5.4	-10.7
Offices	21.8	-1.5	-15.2	2.7	0.0	-7.0	-15.5
Flatted factories	3.1	-1.5	-9.9	0.0	-4.2	-7.6	-12.7

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

1/ Data are period averages.

Table 18. Hong Kong SAR: Revenue (General Revenue Account), 1994/95-1998/99 1/

(In millions of Hong Kong dollars)

	1994/95	1995/96	1996/97	1997/98		1998/99 Budget
				Budget	Actual	
Taxes	118,643	120,545	139,767	135,234	158,256	133,275
Direct taxes	75,754	78,696	85,476	86,328	93,112	83,686
Earnings and profits tax	74,295	77,419	83,966	85,140	91,524	82,456
Estate duty	1,459	1,277	1,510	1,188	1,588	1,230
Indirect taxes	42,889	41,849	54,291	48,906	65,144	49,589
Duties	7,583	7,899	8,450	8,597	8,465	9,229
General rates	5,156	5,806	6,285	6,312	6,258	4,907
Internal revenue	23,202	23,491	34,552	28,639	44,263	30,716
Bets and sweeps tax	9,352	11,051	12,191	13,879	13,453	14,693
Hotel accommodation tax	445	501	580	644	511	369
Stamp duties	12,714	11,215	20,461	12,760	29,097	14,750
Air passengers' departure tax	488	522	1,121	1,187	1,002	701
Cross Harbor Tunnel passage tax	203	202	199	169	200	203
Motor vehicles taxes	4,662	2,880	3,249	3,258	4,246	3,241
Royalties and concessions	1,653	1,773	1,755	1,857	1,889	1,396
Taxi concessions	633	0.0	0.0	243	23	100
Nontax revenue	32,409	32,649	34,090	42,606	61,885	47,707
Fines and penalties	1,520	1,607	1,592	1,691	1,566	1,596
Properties, investments, and interest	8,376	8,735	9,347	14,774	17,323	22,161
Of which: interest	4,942	5,910	5,616	6,350	8,976	11,920
Reimbursements and contributions	4,166	4,811	5,326	8,020	7,118	7,677
Utilities	8,392	7,199	6,608	6,978	6,735	4,625
Fees and charges	9,562	9,879	10,766	10,765	11,279	11,648
Land transactions 2/	393	418	451	378	17,864	...
Total Revenue	151,052	153,194	173,857	177,840	220,141	180,982
Transfer from Capital Works Reserve Fund	...	...	...	...	8,535	35,000
Total including transfers from Capital Works Reserve Fund	151,052	153,194	173,857	177,840	228,676	215,982

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 expired before June 30, 1997. Revenue from other land transactions is credited to the Capital Works Reserve Fund. The only exception is for the period from July 1, 1997 to December 31, 1997 when land revenue was credited to General Revenue Account pending amendment of the Capital Works Reserve Fund resolution.

Table 19. Hong Kong SAR: Government Expenditure Under the General Revenue Account, 1994/95-1998/99 1/

(In millions of Hong Kong dollars)

	1994/95	1995/96	1996/97	1997/98		1998/99 Budget
				Budget	Actual	
Current expenditure	106,022	120,284	134,737	154,411	149,386	171,706
Personal emoluments	32,077	34,832	37,404	42,151	40,114	45,635
Personnel-related expenses	9,835	11,304	12,853	15,232	13,617	14,421
Departmental expenses	5,568	6,199	7,062	8,530	8,067	9,834
Other charges	15,633	17,928	21,147	24,100	24,139	29,118
Subventions	42,909	50,021	56,271	64,398	63,449	72,698
Capital expenditure 2/	41,238	35,573	17,195	9,266	15,794	33,784
Plant, equipment, and works	545	581	616	1,281	852	1,263
Other nonrecurrent	598	1,619	1,116	2,554	11,180	8,419
Subventions	995	838	2,043	1,154	1,065	1,093
Transfers to funds	39,100	32,535	13,420	4,277	2,697	23,009
Capital Works Reserve Fund	15,500	11,500	6,390	0.0	0.0	0.0
Capital Investment Fund	7,500	19,500	3,500	0.0	0.0	9,000
Loan Fund	9,100	1,500	3,500	3,750	2,170	14,000
Disaster Relief Fund	0.0	35	30	27	27	9
Civil Service Pension Reserve Fund	7,000	0.0	0.0	500	500	0.0
Total expenditure	147,260	155,857	151,932	163,677	165,180	205,490

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 20. Hong Kong SAR: Public Expenditure by Function, 1994/95-1998/99 1/

(In millions of Hong Kong dollars)

	1994/95			1995/96			1996/97			1997/98 Revised Estimates			1998/99 Budget		
	Recurrent	Capital	Total	Recurrent	Capital	Total	Recurrent	Capital	Total	Recurrent	Capital	Total	Recurrent	Capital	Total
Economic	6,380	994	7,374	6,734	1,973	8,707	7,812	2,947	10,759	9,302	4,585	13,887	10,190	9,068	19,258
Security	18,137	838	18,975	19,501	2,363	21,864	21,207	3,145	24,352	22,642	2,137	24,779	24,708	2,633	27,341
Internal security	14,661	755	15,416	15,635	2,155	17,790	16,907	2,838	19,745	17,648	1,757	19,405	18,980	2,154	21,134
Immigration	1,455	62	1,517	1,604	115	1,719	1,762	49	1,811	1,893	104	1,997	2,183	36	2,219
Other	2,021	21	2,042	2,262	93	2,355	2,538	258	2,796	3,101	276	3,377	3,545	443	3,988
Social services	27,485	2,785	30,270	33,159	5,273	38,432	39,491	3,613	43,104	46,589	3,851	50,440	53,856	3,863	57,719
Social welfare	10,458	490	10,948	13,196	951	14,147	16,789	1,152	17,941	20,567	1,694	22,261	24,885	1,361	26,246
Health	17,027	2,295	19,322	19,963	4,322	24,285	22,702	2,461	25,163	26,022	2,157	28,179	28,971	2,502	31,473
Education	26,210	2,695	28,905	30,343	3,297	33,640	33,779	4,129	37,908	37,275	11,235	48,510	42,990	10,210	53,200
Environment	1,748	2,653	4,401	2,156	3,470	5,626	2,388	3,851	6,239	2,977	4,121	7,098	3,312	3,116	6,428
Community and external affairs	7,539	1,663	9,202	8,512	2,042	10,554	9,669	3,119	12,788	10,838	3,118	13,956	12,397	3,734	16,131
Recreation, culture, and amenities	6,289	1,635	7,924	7,116	2,004	9,120	8,049	3,001	11,050	8,957	2,877	11,834	10,351	3,617	13,968
District and community relations	872	19	891	973	20	993	1,145	94	1,239	1,329	221	1,550	1,471	96	1,567
Other	378	9	387	423	18	441	475	24	499	552	20	572	575	21	596
Infrastructure	6,972	19,259	26,231	8,075	18,770	26,845	9,054	14,357	23,411	10,181	13,834	24,015	11,411	15,357	26,768
Transportation	1,573	9,108	10,681	1,796	8,408	10,204	2,048	6,991	9,039	2,446	5,127	7,573	2,749	4,004	6,753
Land and buildings	2,261	8,312	10,573	2,568	8,219	10,787	2,872	5,588	8,460	3,195	6,977	10,172	3,629	8,279	11,908
Water supply	3,138	1,839	4,977	3,711	2,143	5,854	4,134	1,778	5,912	4,540	1,730	6,270	5,033	3,074	8,107
Civil service support services	17,635	3,256	20,891	20,244	6,357	26,601	22,217	6,219	28,436	23,844	7,481	31,325	25,701	7,429	33,130
Housing	7,814	11,887	19,701	9,969	9,100	19,069	10,542	13,709	24,251	12,967	16,928	29,895	13,730	35,185	48,915
Total public expenditure	119,920	46,030	165,950	138,693	52,645	191,338	156,159	55,089	211,248	176,615	67,290	243,905	198,295	90,595	288,890

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 21. Hong Kong SAR: Exchange Fund Balance Sheet, 1993-98

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

	1993	1994	1995	1996	1997	1998 June
Assets						
Foreign currency	335,499	381,233	428,547	493,802	588,475	608,923
Hong Kong dollar	12,987	24,617	32,187	40,715	48,215	50,614
Total	348,486	405,850	460,734	534,517	636,690	659,537
Liabilities						
Certificates of indebtedness 1/	68,801	74,301	77,600	82,480	87,015	84,675
Transfers of fiscal reserves 2/	115,683	131,240	125,916	145,898	237,629	245,393
Coins in circulation	2,604	3,372	3,597	4,164	5,399	5,648
Exchange Fund bills	25,157	46,140	53,125	83,509	89,338	87,758
Balance of banking system	7,314	22,815	38,600	45,130	26,802	33,521
Other 3/	1,385	2,208	1,762	474	296	497
Total	220,944	280,076	300,600	361,655	446,479	457,492
Accumulated earnings	127,542	125,774	160,134	172,862	190,211	202,045

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 22. Hong Kong SAR: Monetary Indicators, 1993-98 1/

	1993	1994	1995	1996	1997	1998 2/		
						March	June	Sept.
(Percentage change)								
M1	20.6	-1.2	2.8	14.2	-4.3	-7.3	-17.0	-15.6
M2	16.2	12.9	14.6	10.9	8.3	7.3	2.8	7.4
M3	15.8	13.6	14.2	10.5	8.2	6.6	1.8	6.2
Hong Kong dollars 3/	25.2	18.4	14.9	18.9	9.9	7.5	0.3	3.2
Foreign currency 4/	7.2	8.5	13.2	0.5	5.9	5.4	4.2	10.8
Total credit	15.2	15.9	13.8	6.2	6.4	-4.6	-16.0	-20.3
Hong Kong dollars	20.2	21.5	6.4	19.9	21.6	10.7	0.8	-5.1
Foreign currency	13.0	13.3	17.5	0.0	-2.0	-14.1	-26.5	-30.7
Of which								
Total loans and advances	15.7	14.3	14.5	4.7	5.3	-5.5	-16.1	-21.4
Hong Kong dollars	17.9	16.9	10.5	17.0	20.4	9.5	3.0	-4.8
Foreign currency	14.6	12.9	16.6	-1.4	-3.6	-15.6	-28.5	-33.5
Currency composition	(Percent of total)							
M1								
Hong Kong dollars 3/	89.8	90.6	90.1	91.2	90.4	91.9	90.4	89.5
Foreign currency 4/	10.2	9.4	9.9	8.8	9.6	8.1	9.6	10.5
M3								
Hong Kong dollars 3/	51.5	53.7	54.1	58.2	59.1	58.8	58.9	58.5
Foreign currency 4/	48.5	46.3	45.9	41.8	40.9	41.2	44.1	41.5
Velocity								
M2	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4
M3	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4
Memorandum items:								
Nominal GDP (HK\$ billions) 5/	897.5	1,010.9	1,077.1	1,192.0	1,345.9	1,351.4	1,340.7	1,317.3
Nominal growth of GDP (percent)	15.2	12.6	6.6	10.7	12.9	9.9	5.1	-0.1

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 23. Hong Kong SAR: Loans for Use in Hong Kong SAR, 1993-97

(Twelve-month percentage change)

	1993	1994	1995	1996	1997	1998		
						March	June	Sept.
Loans for use in Hong Kong	18.2	17.1	11.1	17.1	24.4	13.5	5.5	-2.2
<i>Of which:</i>								
Manufacturing	15.7	16.4	16.6	7.4	2.9	-3.4	-8.0	-10.7
Transportation and equipment	8.0	14.5	-3.9	20.1	16.0	20.7	17.7	13.9
Building, construction, and property development	24.8	38.1	5.2	27.1	32.2	18.9	7.2	0.7
Wholesale and retail trade	12.8	38.3	21.0	6.1	16.6	5.7	-2.4	-4.9
Miscellaneous	18.5	7.4	12.1	17.2	26.9	14.8	6.8	-3.3
<i>Of which:</i>								
To purchase flats in the Home Ownership Scheme and private sector participation scheme	61.3	14.5	18.9	6.6	19.3	10.4	14.5	15.4
To purchase other residential property	15.1	10.9	16.7	23.0	29.4	24.3	16.2	7.1
To financial concerns	27.6	2.6	9.6	17.7	25.2	15.9	8.0	-1.8
To stockbrokers	72.1	30.6	32.5	27.3	4.3	-43.0	-64.0	-86.2

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 24. Hong Kong SAR: Equity Price Developments, 1993-98

	1993	1994	1995	1996	1997	1998 1/
(Index of share prices)						
Hang Seng Index						
End of year	11,888.4	8,191.0	10,073.4	13,451.5	10,722.8	7,883.5
Average of end of month	7,696.0	9,453.5	9,098.5	11,646.5	13,294.7	9,245.2
Sector indices						
(Average of end of month)						
Finance	6,282.8	7,988.8	8,381.4	11,411.8	16,039.1	10,190.1
Utilities	8,993.7	10,708.0	10,323.0	10,243.4	11,722.6	11,647.7
Property	12,362.5	16,556.6	15,550.8	21,926.0	22,495.3	8,536.3
Commerce and industry	5,733.2	7,331.1	6,719.8	8,647.5	8,857.6	4,580.8
(Percentage change)						
Hang Seng Index						
End of year	115.7	-31.1	23.0	33.5	-20.3	-27.0
Average of end of month	38.8	22.8	-3.8	28.0	14.2	-30.4
Sector indices						
Finance	53.9	27.2	4.9	36.2	40.5	-36.5
Utilities	35.3	19.1	-3.6	-0.8	14.5	-0.6
Property	34.1	33.9	-6.1	41.0	2.6	-62.0
Commerce and industry	30.9	27.9	-8.3	28.7	2.4	-48.3

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.

Table 25. Hong Kong SAR: Securities and Futures Market Reforms Announced in September 1998

Measure	Purpose of Effects
(I) Short-selling, open positions, and settlement rules	
SFC, SEHK, and HKSCC will take measures to enhance the enforcement of the T+2 settlement rule and short-selling regulations, by increasing disciplinary actions for brokers in default, and by a compulsory buy-in on T+3.	Improve settlement efficiency and reduce differences of treatment in the market.
SEHK reinstated the "tick" rule for short-selling.	Reduce pressure of short-selling on market prices in falling markets.
HKFE reduced the threshold for the 150 percent super margin to open positions of 5,000 contracts.	Increase the cost of holding large open position on the futures market.
(II) Transparency and Cross-market Monitoring	
SEHK will remind all brokers to report short-selling trades.	Improve market transparency and information flows.
HKFE will disclose on a daily basis information of holders of large open positions, to SFC at the individual level, and to the market at a broker level.	Track the identity of holders of large open positions.
HKFE and SFC will establish a cross-market early warning system to provide signals to the market and its participants whenever the futures market activity exceeds cash market activity by a predetermined level.	Facilitate the detection of speculative attacks involving more than one market.
SEHK will remind its members to ascertain the identity of their beneficiary clients and disclose it to the SFC on request.	Improve market transparency.

Table 26. Hong Kong SAR: Loans and Advances by Type, September 1998

	Hong Kong	Foreign	Total	Share of	Share of
	dollar	currency		HK\$ loans	loan type
	(In billions of Hong Kong dollars)			(In percent)	
Loans for use in Hong Kong	1,672	467	2,139	78.17	63.68
Trade-related	58	89	147	39.46	4.38
Other	1,614	378	1,992	81.02	59.30
Loans for use outside Hong Kong	31	1,157	1,188	2.61	35.37
Trade-related	4	13	17	23.53	0.51
Other	27	1144	1,171	2.31	34.86
Loans for which the place of use is not known	4	28	32	12.50	0.95
Total loans	1,707	1,652	3,359	50.82	100

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

Table 27. Hong Kong SAR: Balance Sheet of All Authorized Institutions, September 1998

	Hong Kong dollar (In billions of Hong Kong dollars)	Foreign currency	Total	Share of total assets/ liabilities (In percent)	Share of Hong Kong dollar assets/ liabilities
Liabilities					
Amount due to authorized institutions in Hong Kong	405	229	634	8.7	63.9
Amount due to banks abroad	230	2,599	2829	39.0	8.1
Deposits from customers 1/ Negotiable certificates of deposit (NCDs) outstanding	1,607	1,268	2876	39.6	55.9
Other debt instruments outstanding	166	52	218	3.0	76.1
Capital, reserves and other liabilities	3	60	63	0.9	4.8
	383	259	639	8.8	59.9
Total liabilities	2,794	4,467	7,263	100	38.5
Assets					
Notes and coins	14	1	15	0.2	93.3
Amount due from authorized institutions in Hong Kong	401	236	637	8.8	63.0
Amount due from banks abroad	176	1,994	2170	29.9	8.1
Loans and advances to customers NCDs held	1,708	1,653	3361	46.3	50.8
Negotiable debt instruments held, other than NCDs	105	43	148	2.0	70.9
Investments in shareholdings	193	388	581	8.0	33.2
Interest in land and buildings	16	2	18	0.2	88.9
Other	52	1	53	0.7	98.1
	100	181	281	3.9	35.6
Total assets	2,765	4,499	7,263	100	38.1
Memorandum items:					
Number of reporting institutions	344				
Number of branches	1,586				

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

1/ Unadjusted for foreign currency swap deposits.