



Hong Kong, China

The handover of Hong Kong to the People's Republic of China (PRC) took place smoothly in 1997. While Hong Kong, China, continues to develop as a financial and business services center, the region's economic crisis and high interest rates have slowed economic activity.

RECENT TRENDS AND PROSPECTS

Two events of major importance took place in Hong Kong, China in 1997. The first was the political handover of Hong Kong, China to the PRC in July. At that time Hong Kong, China became a Special Administrative Region of the PRC. (Note that Hong Kong, China and the PRC maintain separate memberships in the Asian Development Bank and are therefore discussed here as separate economies.) The second event was the sharp downturn in stock and property markets that began around the fourth quarter of the year. Whereas the handover took place smoothly against a backdrop of a fairly robust economic environment, the market downturn—which largely reflects the currency and financial crisis engulfing the region—led to a sharp slowdown in economic activity.

During the first three quarters of 1997 consumer and investment spending grew rapidly, influenced by buoyancy in the stock and property markets. As a result GDP rose by 5.2 percent in 1997, an increase over the rate of growth in 1996. Spending on high value consumer goods such as cars and jewelry increased. Retained imports of capital goods showed a large increase, particularly imports of office equipment, industrial machinery for manufacturing, and construction machinery. While the imports of construction machinery were driven largely by a high demand for housing, imports of office equipment and industrial machinery reflected

increased demand for information technology and retooling of existing manufacturing activities to increase the capital intensity of production.

From the fourth quarter, however, high interest rates adversely affected financial and property markets. By the end of 1997, the benchmark Hang Seng Index stood 36 percent below its August peak and property prices had dropped by 14 percent since October. The profitability of both financial and nonfinancial firms came under pressure, and along with the sharp falls in asset markets caused a slowdown in consumer and investor spending.

Poorer than expected exports also affected the economy during 1997. While goods exports grew at a moderate pace, exports of services were weak in the second half of 1997. An anticipated pickup in exports did not fully materialize because of a strengthening US dollar (which implied a strong Hong Kong dollar because of the link between the two currencies) and weak import demand in some major industrial country markets, such as Japan and the United Kingdom.

Travel and tourism, which has accounted for more than a quarter of exports of services in recent years, was expected to be a source of robust growth for 1997, especially with the handover ceremonies scheduled in the end of June. However, the number of incoming visitors during the first six months of 1997 was actually lower than in the last six months of 1996. The situation failed to improve after the handover because the regional economic crisis and

the continued strength of the Hong Kong dollar discouraged tourism.

Imports of goods grew faster in 1997 than in 1996, with retained imports of capital goods largely responsible for the acceleration. Imports of goods were once again larger than exports, but the resulting deficit on the merchandise trade account for 1997 was balanced to some extent by a surplus on the services trade account.

After tightening during the first three quarters of 1997, labor markets began to reflect the slowdown in consumption and investment expenditures. The labor force grew by 3.9 percent during 1997 as a whole, and robust labor demand until the last quarter resulted in an unemployment rate of around 2.5 percent. Most of the unemployed were semi-skilled and unskilled workers from the manufacturing, construction, wholesale and retail sectors. While total employment increased by about 4.6 percent compared to 1996, the trend of declining employment in the manufacturing sector continued with the relocation of labor-intensive production from Hong Kong, China to other economies, particularly the PRC. Whereas manufacturing employment was 46 percent of total employment in 1980, it was down to some 13 percent in September 1997.

Inflation remained under 6 percent. Upward pressures on prices generated by tightening labor

markets and property rentals in the earlier part of 1997 were balanced out by subdued imported inflation. In the last quarter the drop in property prices and slowdown in economic activity further reduced any likelihood of accelerating inflation.

Budgetary deficits are the exception rather than the rule in Hong Kong, China and a surplus of some HK\$77 billion (around \$10 billion) has been estimated for 1997-1998. This will add to Hong Kong, China's healthy official fiscal reserves, which received a major injection of funds when the PRC transferred the almost HK\$200 billion (around \$26 billion) Land Fund to Hong Kong, China in June 1997. (The Land Fund consisted of revenues from land auctions reserved for the Hong Kong Special Administrative Region agreed on under the 1984 Sino-British Joint Declaration.)

Hong Kong, China's economy is clearly feeling the strains of the regional economic crisis. The combination of high interest rates, sharp contractions in share and property prices, and expectations of a protracted economic slump in the region will continue to dampen consumer and investment spending. External demand for Hong Kong, China's goods and services is also likely to remain weak in 1998, both because of weak demand in some export markets and competition. Unemployment is bound to increase as the economy slows down.

Table 2.1 Major Economic Indicators: Hong Kong, China, 1995-1999
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product growth	3.9	5.0	5.2	3.0	3.5
Gross domestic investment/GDP	34.8	32.3	34.5	31.0	32.0
Gross domestic saving/GDP	30.5	30.7	30.6	30.0	32.0
Inflation rate (consumer price index)	8.6	6.0	5.7	4.5	5.0
Money supply (M2) growth	14.6	10.9	8.4	9.4	9.6
Fiscal balance/GDP	-0.3	2.2	5.8	0.3	0.1
Merchandise exports growth	14.8	4.0	4.0	2.2	3.5
Merchandise imports growth	19.1	3.0	5.1	1.0	6.0
Service exports growth	10.3	8.7	0.3	4.1	1.5
Service imports growth	11.6	3.6	6.3	1.4	1.0

Sources: Hong Kong Monetary Authority data and staff estimates.

On a positive note, inflationary pressures will remain weak and some fiscal stimulus should result from the cuts in corporate and income taxes announced in February 1998. Moreover, if expectations of moderate growth in the PRC and a stable renminbi are borne out, then the economy can expect some relief from its close links with the PRC. Over the longer term, as regional growth and investments resume, Hong Kong, China's economy should once again pick up as long as it maintains its competitiveness in providing financial and other business services, not just to the PRC, but to Asia as a whole.

CRITICAL ISSUES IN SHORT-TERM ECONOMIC MANAGEMENT

The economy of Hong Kong, China has come under severe pressure as a result of the regional financial and economic crisis. While business exposure to recession-prone regional economies has contributed to the economic slowdown of this extremely open economy, fears of declining competitiveness of Hong Kong, China's products have also taken their toll. With substantial currency devaluations occurring in such advanced Asian economies as Republic of Korea; Singapore; and Taipei, China, some market participants expect Hong Kong, China to follow suit to remain competitive. The linked exchange rate system under which the Hong Kong dollar is pegged to the US dollar has come under heavy speculative attack on a number of occasions as investors sell Hong Kong dollars and buy US dollars in anticipation of a devaluation of the local currency. However, Hong Kong, China's authorities have ruled out a devaluation, and the PRC supports this decision.

The speculative attacks have led to an increase in interest rates in Hong Kong, China. Interest rates rose because the linked exchange rate system entails not only pegging the local currency to the US dollar, but backing local currency by an equivalent amount of US dollars. Thus a speculative exchange of Hong Kong dollars for US dollars by investors anticipating a devaluation reduces the supply of domestic currency, thereby putting upward pressure on interest rates. The loss of US dollars by note-issuing banks constrains their ability to issue new Hong Kong dollars and counter the rise in interest rates.

The main result of the increase in interest rates has been to choke off funds that were flowing into the share and property markets. The steep declines in asset prices in conjunction with the continued high interest rates—the 3-month interbank loan rate at end-January 1998 was about 6 percentage points higher than a year earlier—have taken a toll on business. In addition, the continuation of the peg has caused concerns in the tourism and manufacturing sectors, because the relatively strong Hong Kong dollar makes local goods and services more expensive.

While it may appear that maintenance of the local currency's peg to the US dollar is making Hong Kong, China uncompetitive, this is not necessarily the case for several reasons. First, flexibility of prices and wages can make up for the lack of nominal exchange rate adjustments. Available evidence suggests that wages in Hong Kong, China are quite downward-flexible, and property prices and rentals, major determinants of Hong Kong, China's cost structure, have already fallen. In addition, and in contrast to those Asian economies that have devalued their currencies, adherence to the peg is keeping "imported" inflation in check.

Finally, Hong Kong, China is essentially a service-oriented economy and does not compete directly with those regional economies such as Indonesia and Thailand that have seen devaluations of 50 percent or more. A more relevant comparator for Hong Kong, China may be Singapore, which has seen its currency devalue by 17 percent in relation to the US dollar (and hence the Hong Kong dollar). While a devaluation of this magnitude is not trivial, the competitiveness of high-end services such as finance, insurance, and other related business services that Hong Kong, China is increasingly providing is not as sensitive to prices as, say, low-technology manufactured goods. However, tourism is somewhat more sensitive to prices than other services. Perhaps more important, Hong Kong, China has a strategic position as the chief provider of services to the PRC. Thus as long as growth in the PRC does not slow down dramatically during the next year, the economy of Hong Kong, China should continue to benefit.

In sum, a devaluation of the Hong Kong dollar would be of no obvious overall benefit to the economy. Its value in increasing competitiveness is questionable, and it might, perversely, only add to

the instability both in Hong Kong, China and in the region. Hong Kong, China's current economic slowdown should be seen not as a result of the decision to maintain the linked exchange rate system, but as the inevitable consequence of an extremely open economy operating during a period of regional slowdown.

POLICY AND DEVELOPMENT ISSUES

Structural changes in Hong Kong, China's economy during the last 15 to 20 years have made it one of the most service-oriented economies in the world, with services now accounting for around 85 percent of GDP. The resulting decline in the importance of manufacturing has caused concern among some observers that too much of the manufacturing base has been lost. Observers are also concerned about the paucity of high-technology industries within the manufacturing sector. As a result, some have called for setting up a high-technology industrial park, introducing tax breaks for multinationals, and establishing a venture capital fund for domestic firms attempting to establish high-technology businesses.

However, the loss of the manufacturing base within Hong Kong, China itself need not be viewed with particular alarm. Since the early 1980s, Hong Kong, China's manufacturing facilities have increasingly been relocated to the PRC as Hong Kong, China companies contract out all or part of their production processes to companies in the PRC to take advantage of the abundant supply of low-cost labor. In parallel with this, offshore trading and exports of professional and other business services that service the relocated manufacturing facilities have grown in importance. Thus while Hong Kong, China's own manufacturing sector has diminished in importance, its service sector is not bereft of a manufacturing base.

The economy has benefited from its increased service orientation and is likely to continue to do so. In the last 15 years the PRC has attracted some \$200 billion as foreign direct investment, of which around 55 percent has flowed through Hong Kong, China. Moreover, the Asian and Pacific region is expected to generate a huge demand for infrastructure upgrading once it is back on a firmer economic footing. This will lead to a rise in the demand for investment funds and professional support services, and Hong Kong, China is in a good position to play

a key role as a provider of financial and business services.

However, two factors may constrain further development of financial and business services, namely, a human resource constraint and a possible deterioration in the business environment.

Currently, aside from those in the finance sector, many of Hong Kong, China's service sector jobs tend simply to be "front office" operations for low-skill-intensive manufacturing firms. Moreover, even within manufacturing, much of the activity takes place under contract production, so firms tend not to be involved in higher end research, design, and market promotion activities. Thus the concern is that Hong Kong, China's workforce is not adequately equipped to make the transition to more skill-intensive manufacturing and to high-end services.

Government efforts to upgrade the human resource base have included providing vocational and retraining programs and encouraging greater enrollment in tertiary education. Some progress is apparent. For example, the percentage of the population aged 17 to 20 enrolled in tertiary education increased from about 5 percent in 1984 to about 18 percent in 1994-1995. In addition, universities and training centers are stressing communication and computer skills, both of which are essential when providing high-end services. Nevertheless, room for improvement still exists. For instance, enrollment in tertiary education remains low by industrial country standards, and recently there have been complaints about declining proficiency in English, a crucial language in international business.

As concerns the business environment, it is currently characterized by openness, low taxes, high standards of corporate disclosure, and generally well-policed capital markets. Moreover, the overall policy stance has been and continues to remain one of positive nonintervention by the state, whose activities are essentially limited to providing prudential regulation and supervision. Hong Kong, China has prospered under this framework, and there is no reason why it should not continue to do so.

Recent events in East and Southeast Asia have demonstrated the importance of maintaining high standards of prudential regulation and supervision and ensuring transparency in economic transactions. While the record of Hong Kong, China on this front is among the best, its close ties with business in the

region suggest that it cannot rest on its laurels. Whereas business in Hong Kong, China has so far been based foremost on clear-cut market considerations, business elsewhere in the region tends to take place in the shadow of government and market. This generates the potential for lack of transparency, corruption, and political interference. While these can

obstruct the efficient working of markets, they can be particularly devastating for financial markets as the regional economic turmoil has revealed. For Hong Kong, China's future competitiveness as an international center for financial and business services, its business environment must not be allowed to deteriorate.