

Hong Kong, China

Economic Assessment

The 9.5% rise in GDP in the first half of 2004—magnified by the low base of the year-earlier period when the economy was hit hard by the SARS outbreak and was still suffering from a prolonged property market slump—was stronger than expected. First-half growth was balanced between total consumption (contributing 5.2 percentage points) and total investment (4.2 percentage points) (Figure 2.2). Private consumption increased by 8.5% over the period. Fixed investment grew by 9.3%, helped by a pickup in machinery and equipment investment, and government spending rose by 2.8%.

Domestically, consumer spending has progressively recovered from the SARS setback. Partly reflecting a strong increase in tourism from the PRC, retail sales volume has remained strong since August 2003. In the first 7 months of 2004, it grew by 11.7%, with particularly buoyant growth in sales of durable goods. Exports of goods and services rose by 17.6% in the first half, helped by the Hong Kong dollar's link to the weakening US dollar as well as by robust inbound tourism and reexports. Faster import growth brought down net export growth to 1.6% in the first 6 months from 43.3% in the same period of 2003 and made no significant contribution to GDP's expansion. In contrast, in 2003 net exports were the main driver of growth.

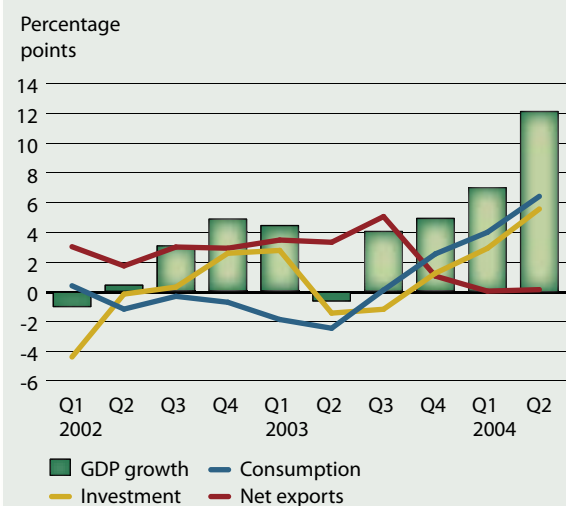
On the production side, services, by far the biggest sector, rebounded strongly from the previous year as tourism, wholesale and retail sales, and financial services all recovered. Labor market conditions also improved, with unemployment falling from 8.7% in May–July 2003 to 6.9% in the same period this year. In addition to the recovery creating new jobs, the unemployment rate was lowered by some people leaving the labor force. Employment expanded in the wholesale trade, hotels, transportation, and cleaning services

subsectors particularly. Nominal wages continued to decline during the first 3 months of 2004, leaving real wages almost unchanged at end-March from 12 months earlier.

The fiscal position has improved since the economy started to recover. The deficit in FY2003 (ended 31 March 2004) was HK\$40.1 billion, or 3.3% of GDP, well below an earlier official estimate of a HK\$49.0 billion budget gap. Expenditures for the first 4 months of FY2004 totaled HK\$78.7 billion and revenues HK\$73.4 billion, resulting in a deficit of HK\$5.3 billion, only 12% of the HK\$43 billion official deficit estimate for FY2004. (The official estimate of the deficit and the revenue for the 4 months includes HK\$20 billion in proceeds from a bond issue and HK\$6 billion from the sale of asset-backed securities.)

Major asset markets have taken different paths in 2004. The property market, mainly apartments, has maintained a rally that started in August 2003,

Figure 2.2 Contribution to GDP Growth by Expenditure Account, Hong Kong, China, Q1 2002–Q2 2004



Source: www.info.gov.hk/censtatd.

Table 2.2 Selected Economic Indicators, Hong Kong, China, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	6.0	7.5	5.0	6.0
Inflation (CPI)	1.1	0.7	1.1	1.1
Current account/GDP	6.8	6.8	8.5	8.5

Source: Staff estimates.

underpinning the general level of consumer and investor confidence. But the benchmark Hang Seng Index of share prices, which rallied by 35% in 2003, turned down in mid-February on expectations of an increase in US interest rates and a tightening in PRC macroeconomic policies. Since May though, share prices have been edging back up.

Broad money (M2) grew by about 9% year on year in the first 6 months, picking up from 8.4% in 2003. Price deflation concerns faded, and the composite CPI was virtually flat over the first half in month-on-month terms. On a year-on-year basis, the index rose by 0.9% in July, the first year-on-year rise since November 1998, lifted by the recoveries in private consumption and property prices. The Hong Kong dollar moved back closer to the linked rate of HK\$7.8 to the US dollar after a sharp appreciation in October 2003, then strengthened again briefly in May along with the rebound in the stock market. The nominal trade-weighted effective exchange rate kept appreciating, though at a slower rate. With inflationary pressures and interbank offered rates low, current ample liquidity should not be a serious concern.

The rebound in inbound tourism picked up pace in the first half of 2004, due in part to a policy change in the PRC that allows residents in selected cities to visit Hong Kong, China individually, as well as in tour groups as previously. PRC visitors now account for more than half of total tourist arrivals, up from about 40% in 2002 and 30% in 2001. Also on the external front, a robust expansion of reexports (showing average annual growth of 16.9% for the first half of 2004) was fueled by outward processing activities in Guangdong province, where many of Hong Kong, China's companies have moved their manufacturing bases and ship the goods to Hong Kong, China for reexport. Due to the

strong growth in reexports, merchandise imports grew by 19.3% on average in the first half of 2004. Retained imports (imports excluding those for reexports), which account for around 28% of merchandise imports, rose by 26.2% as a result of a surge in fuel imports and stronger domestic consumption. Consequently, the merchandise trade deficit averaged HK\$11.5 billion in the first half of 2004, widening from HK\$5.7 billion in the year-earlier period, and the current account surplus fell to 5.0% of GDP, from 11.0%.

Policy Developments

Balancing the budget by FY2008 remains a major goal of the authorities. However, despite the better than expected economic growth, stronger property market, and bond sales this year, the budget has remained in deficit, reflecting the narrow tax base that relies on land-based revenues. The rumbling debate over the tax system continued in 2004, with the authorities still considering a goods and services tax (GST), which would be a broad-based and stable revenue source. The financial secretary has stated that the economic recovery provides a conducive environment to introduce a GST, but has also indicated that the authorities will not make a decision on the tax until 2005. The financial secretary had previously estimated that a GST would raise HK\$6 billion for every percentage point of the tax rate. Implementing the 5% GST under discussion would make a significant contribution toward eliminating deficits. A GST would take some time to introduce, so may not contribute to the balanced budget target of FY2008.

Sales of government assets and asset-backed securities are planned in an effort to improve the fiscal position. In May 2004, the authorities issued a HK\$6 billion bond that securitized future toll revenues from five government-owned tunnels and a bridge. The issuance of government bonds will help promote the domestic bond market, but the impact on the fiscal position may be limited, in part because the authorities pledged to make direct payments to support the asset-backed bonds if regular revenues from the tunnels and bridge fall short of projections.

The Closer Economic Partnership Arrangement (CEPA) between Hong Kong, China and the PRC, signed in the depths of the

SARS crisis in 2003, has been extended to cover more goods and services. The original agreement allowed for 374 products made in Hong Kong, China to have tariff-free access to the PRC market from January 2004, ahead of market-opening deadlines stipulated in the PRC's WTO accession pact. Under CEPA II, signed in August 2004, the PRC will apply zero import tariffs on an additional 713 products from Hong Kong, China, starting in January 2005. The PRC also agreed to grant preferential treatment to Hong Kong, China firms that provide eight types of services, including airport, information technology, and patent agency services.

Outlook for 2004–2005

GDP growth rates in 2004 and 2005 are now forecast at 7.5% and 6.0%, both higher than the 6.0% and 5.0% projections made in *ADO 2004*. The upward revisions stem from the stronger than expected retail sales and the surge in tourism. Overall investment is expected to grow by around 9% in 2004. Investment in machinery, equipment, and computer software has increased, but private construction investment remains weak. In 2005, investment growth will stay at around 9%, supported by planned government infrastructure projects and by private construction, since the authorities resumed land auctions this year after suspending them in late 2002.

For all of 2004, merchandise exports are expected to grow by 7.0%, moderating from 16.5% growth in the first half. The sustained global popularity of digital products will support exports of electronics products. Services exports will be underpinned by tourism, and are being buttressed by trading firms and manufacturers

in Hong Kong, China engaging in transaction services that involve goods made in the PRC and shipped directly from PRC ports to international markets, without passing through Hong Kong, China. This shift from reexporting to direct offshore trade is a result of the growth of PRC production and port capabilities.

Imports will also rise along with stronger consumption and investment. The current account surplus as a share of GDP is therefore expected to decline from 10.2% in 2003 to 6.8% in 2004 and 8.5% in 2005.

The recovery in the services sector will bolster the labor market. A survey of hiring intentions shows that job prospects in finance, insurance, and real estate continue to improve. Employment will grow in wholesale and retail trade, too. Deflation is expected to die out because of the firmer property prices, increases in the costs of some imported items, and the end of certain rebates on charges of utilities and public housing, but the lack of inflation in the first half of 2004 has resulted in a lowering of the full-year forecast to 0.7% (from 1.1%). For 2005, inflation is projected at 1.1%. The forecast for the fiscal deficit stays at 3.0% of GDP for 2004, with tax revenues rising due to higher corporate profits, stamp duties, and land premiums.

This outlook assumes continued economic growth in the PRC and the US and no serious public health scares, such as SARS or avian flu. Hong Kong, China's reliance on oil is fairly low, given the services orientation of the economy. Its retained imports of petroleum are equivalent to about 1% of GDP and fuel accounts for less than 5% of overall business operating costs (excluding labor). Hence, the direct effect of higher oil prices on aggregate demand is relatively limited.