

## Hong Kong

**D**uring 1995, links with the US dollar and US financial markets, and the economic developments in China continued to be the principal influences on the performance of the Hong Kong economy. In addition, increases in interest rates, a slump in the real estate market, and depressed domestic consumption contributed to a further decline in the growth rate. By midyear, however, expectations of lower interest rates, the bottoming out of the real estate market, and improved Sino-British relations restored some investor confidence and led to increased stock market activity. Export growth was higher than in 1994, although a slowdown became apparent toward the end of 1995. The investment climate remained slightly weak because of China's continued tight monetary policy. The strength of the US dollar toward the end of 1995 translated into higher costs for foreign investors intending to invest in Hong Kong.

Being a predominantly service-oriented economy, Hong Kong's future economic performance will depend on continued recovery in the financial and real estate markets as well as on the level and nature of infrastructure investment. Relations with China will be the most relevant factor influencing the future development of Hong Kong (Figure 2.1).

### Recent Trends and Prospects

*Growth, Investment, and Employment.* GDP growth declined to 4.6 percent in 1995, nearly one percentage point less than in the previous year. Increased public investment in infrastructure helped keep construction activity

robust, although private sector construction declined because of lowered private investor confidence. Closer economic ties with China and strong growth of the Chinese economy continued to benefit tourism. The number of visitors from China increased by over 20 percent during the year. Tourism was also helped in early 1995 by the weakening of the US dollar.

Increased tourist spending offset some of the decline in domestic consumption expenditure, which was instrumental in keeping the growth rate below 5 percent in 1995. The main factor leading to the decline in consumption expenditure was the sharp decrease in property prices, which fell by over 30 percent from their peak levels in 1994. As a result, private saving increased over the year. Public sector investment, mainly because of spending on infrastructure projects, also increased, as did private investment other than for property development. Gross domestic saving increased to 34.5 percent of GDP compared with 33.9 percent in 1994, while gross domestic investment increased to over 33 percent of GDP in 1995 compared with 31.8 percent in the previous year. The domestic resource surplus thus decreased to 1.4 percent of GDP in 1995 from 2.1 percent in 1994.

Employment during 1995 registered a sharp increase of 4.1 percent over that in the previous year; however, this was more than offset by a rapid increase in immigration. Also as a result of immigration, the shortages in the labor market experienced in recent years disappeared. Unemployment increased to a ten-year high during 1995 and underemployment in manufacturing, and particularly the construction sector, also increased.

**Table 2.1 Major Economic Indicators: Hong Kong**

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	6.4	5.4	4.6	4.5	4.5
Gross Domestic Investment	% of GDP	27.7	31.8	33.1	31.1	31.0
Gross Domestic Saving	% of GDP	34.6	33.9	34.5	33.7	33.5
Inflation Rate	% change in CPI	8.5	8.1	8.7	7.5	6.1
Money Supply Growth	% change	16.0	13.2	15.1	14.2	13.6
Merchandise Exports	\$ billion	135.2	151.4	176.7	204.3	235.5
	% change	13.1	12.0	16.7	15.6	15.3
Merchandise Imports	\$ billion	139.0	162.3	191.2	219.6	254.0
	% change	12.6	16.8	17.8	14.8	15.7
Trade Balance	\$ billion	-3.8	-10.9	-14.5	-15.3	-18.5

Sources: Data collected from the Census and Statistics Department of Hong Kong by EDRC for the Asian Development Bank *Annual Report 1995*; Hong Kong Monetary Authority, *Monthly Statistical Bulletin* (Hong Kong, November 1995); Census and Statistics Department, *Quarterly Estimates of Gross Domestic Product* (Hong Kong, November 1995) and *Hong Kong Monthly Digest of Statistics* (Hong Kong, September 1995); and staff estimates.

Paradoxically, the construction sector also attracted most of the migrant workers. In terms of sectoral employment, the services sector continued to increase its share, while that of manufacturing declined. Employment in wholesale trade and import/export services rose; however, the fall in domestic consumption expenditure led to a decline in employment in retail trade, restaurants, and hotels.

Economic growth in Hong Kong is expected to weaken slightly to 4.5 percent annually in 1996 and 1997. Property prices are not expected to rise noticeably in the near future and consumption expenditure is likely to remain weak as consumer uncertainty persists. Although investment in infrastructure is likely to remain strong, gross domestic investment is expected to decline slightly to about 31 percent of GDP in both 1996 and 1997. The savings rate in 1996 is projected to be slightly lower than in 1995 at 33.7 percent of GDP. With lower saving, the surplus available for overseas investment is also likely to decline.

In late 1995, the Government revised the labor importation scheme and reduced the quotas allowed. While this will lessen the official inflow of workers, the need to import certain categories of workers, which are in short supply, will not diminish over the next two years. The new scheme allows for some degree of flexibility although both labor unions and employers are skeptical of its success in

bringing down the unemployment rate. Despite higher unemployment, the inflow of workers outside the labor importation scheme is also likely to continue, thus exacerbating pressure on the labor market.

*Budget, Money, and Prices.* Government expenditure during 1995 was slightly lower than initially estimated for several reasons. Prolonged negotiations over the financing package for the new airport project led to delays in funding for the Provisional Airport Authority. There were also delays in funding for the Mass Transit Railway and, in general, many infrastructure projects were behind schedule. Despite this, however, government expenditure increased to 16.7 percent of GDP during 1995. Government revenues over the year were 16.4 percent of GDP compared with 17.1 percent in 1994 mainly because of lower tax rates and increased exemptions. Thus, the overall balance turned into a small deficit of 0.2 percent of GDP from a surplus of 1 percent of GDP in 1994.

Under the linked exchange rate system with the US dollar, there is little scope for an independent monetary policy in Hong Kong. The money supply is endogenously determined and, with the inflation rate at a high level, broad money (M2) has been growing at a steady rate of around 14–15 percent per annum. During the early part of 1995, the money

supply grew rapidly as a result of conversion of other assets into deposits because of uncertainties in the financial markets and the slump in property values. However, as activity in the equity market improved in the latter part of the year, the rate of growth of the money supply slowed down. By end-1995, M2 had grown by a little over 15 percent, higher than in the previous year.

Hong Kong's inflation rate during 1995 rose to 8.7 percent from 8.1 percent in 1994. Inflationary pressures resulted from higher commodity prices and increased import prices due to the strengthening of the US dollar in the latter half of 1995. Some of the moderation provided by lower property prices disappeared as the real estate market bottomed out. With the unemployment rate increasing over the year, upward pressure on wages declined because unemployed workers were willing to accept lower wages. On the other hand, civil servants' wages increased by 10 percent over the year.

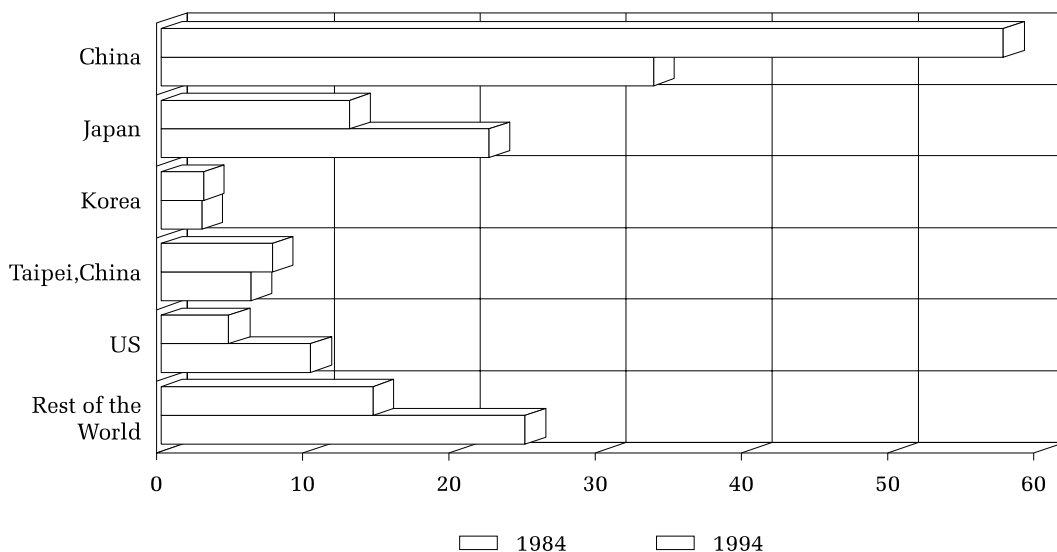
Public expenditure, which includes that by the Housing Authority and the urban and regional councils, exceeded government

expenditure, and is expected to increase over the next couple of years as public sector infrastructure projects continue to absorb the bulk of spending. Apart from the new airport and associated projects, there are major road construction and railway projects in the pipeline. The Government is also committed to some expensive environmental projects and to the construction of additional homes for the elderly. With reductions in business profits, lower land prices, and fewer property transactions, government revenue is expected to decline, leading to small deficits over the next two years.

Growth in the money supply is forecast to be slightly lower over the next two years at 14.2 percent in 1996 and 13.6 percent in 1997. Inflation is expected to be lower at about 7.5 percent in 1996, declining further to around 6 percent in 1997. Lower inflation expectations throughout the world insofar as they lead to lower import costs will help to moderate inflation in Hong Kong.

*External Trade and Payments.* A feature of Hong Kong's external trade performance in

Figure 2.1 Share of Reexports by Origin, 1984 and 1994: Hong Kong (percent)



Sources: Census and Statistics Department, *Annual Digest of Statistics* (Hong Kong, 1993); and Census and Statistics Department, *Hong Kong Monthly Digest of Statistics* (Hong Kong, September 1995).

1995 was a reversal in the decline of domestic exports that has occurred over recent years as a result of the relocation of production into China. However, this changed in 1995 as domestic exports grew by 5 percent in real terms. With reexports increasing by 19 percent, total merchandise exports rose by 16.7 percent in 1995, sharply higher than the 12 percent growth recorded in 1994.

The growth in exports was helped in the early part of 1995 by the weaker US dollar and increased demand for Hong Kong products in its overseas markets. Export growth slowed down during the latter part of 1995 as the US dollar appreciated. Economic recovery of Hong Kong's principal trading partners – the US and Japan – slowed, and fiscal tightening in China continued. Merchandise imports also grew by nearly 18 percent during 1995. The strong growth reflected increased imports of machinery and capital equipment for the manufacturing sector and for the vigorous infrastructure development program under way. Imports of office equipment also increased dramatically – an indication of the economic restructuring taking place. Overall, capital goods imports rose by over 29 percent in real terms. With imports rising more rapidly than exports, the trade deficit widened to \$14.5 billion in 1995 compared with \$10.9 billion in 1994.

Prospects for external trade over the next two years will be influenced primarily by China's economic performance. With economic growth projected to slow down in China, the rate of growth of Hong Kong's reexports to the mainland will not be as high as it was in 1995. Also, overseas demand for Hong Kong products is likely to be sluggish. One effect of the slowdown will be declining capital goods imports because investment in the manufacturing sector will be curtailed. However, infrastructure investment is expected to continue at much the same pace over the next couple of years, and imports of construction machinery will increase further. The trade deficit is expected to continue rising; it will be over \$15 billion during 1996 and higher at \$18.5 billion the following year.

The prospects for foreign investment in Hong Kong are fairly positive. Foreign investors have been attracted by the island's geographic proximity and links to China, as well as by its low tax rates and open trading environment. Recent declines in rents and property prices have also been positive for foreign direct investment. At the same time, any strengthening of the US dollar will dampen foreign investment by reducing Hong Kong's competitiveness, and competition from Singapore in recent years has also tended to divert some FDI away from Hong Kong. Investors' perceptions of policy stability and transparency after 1997 are also important. The net effect of these factors is unclear; however, it is generally expected that foreign investment will remain fairly robust in the near future and Hong Kong's role as an entrepôt center for China will continue.

### **Policy and Development Issues**

The most important policy issue facing Hong Kong is its role and function after its reunification with China in 1997. To maintain its attractiveness to foreign investors, not only will Hong Kong's trade and investment links with China need to be maintained and strengthened, but efforts must also be made to ensure that rising costs do not deter potential investors.

An important factor influencing the investment climate in Hong Kong is the policy of linking its exchange rate to the US dollar. This policy will clearly need to be reviewed in the context of Hong Kong's future relations with China, and any changes are likely to have important impacts on investment, prices, and trade prospects.

The growth and development of services, with the continued restructuring of the economy toward high technology activities is of crucial importance to the maintenance of Hong Kong's competitiveness. It is precisely these features that need to be emphasized to ensure the dynamism of Hong Kong's economy as its status vis-à-vis China changes in a little over a year's time.