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## Hong Kong, China

*The economy of Hong Kong, China has begun to recover from its severest recession in recent decades. It must now focus on meeting new challenges, including stimulating investment, cleaning up the environment, and shifting resources into the information technology industry.*

### RECENT TRENDS AND PROSPECTS

**A**fter contracting by 5.1 percent in 1998, the Hong Kong, China economy grew at 2.9 percent in real terms in 1999. Increased private consumption, higher government spending, and increased exports contributed to this growth. Domestic investment, however, was even weaker than in 1998, a result of high real interest rates and an uncertain business outlook. Prices continued to fall and the composite consumer price index registered a decline of 4 percent in 1999. Fierce price competition, flat rental prices, and a freeze in government fees and most public utility charges contributed to the sustained fall in the consumer price index. Other contributors were weak world commodity prices (except for fuel), a strong US dollar, and deflation in the People's Republic of China (PRC), all of which kept imported inflation at bay.

Hong Kong, China's economic recovery started in the second quarter of 1999, after six consecutive quarters of decline. Increased private consumption and an improved trade balance contributed to the turnaround. The recovery was reinforced by clear signs of

economic revival in neighboring economies, which also contributed to a recovery in local asset markets. Total stock market capitalization increased by 77.6 percent during 1999 and the Hang Seng Index reached a postcrisis peak level of around 17,000 in late December 1999, almost 2.5 times the level just before the government's stock market intervention in August 1998.

Recovery in the property market was mainly reflected in the increased volume of spending during the first half of the year. This can be attributed to the announcement of favorable fiscal measures; resumption of land auctions with good results; and relaxation of banks' mortgage policies, including decreased interest rates. The surge, however, was partly reversed by the rise in nominal interest rates in August, following a rise in US rates. Property prices themselves ended up about 50 percent lower than their peak levels before the 1997 crisis.

In external accounts, the merchandise trade deficit continued to narrow and the services surplus continued to expand. Total merchandise exports declined marginally by 0.1 percent in US dollar terms,

while total merchandise imports declined by 2.7 percent in 1999, and the trade deficit fell to HK\$46.5 billion (US\$6 billion) from HK\$84.8 billion (US\$10.9 billion) in 1998. Estimates indicate that in 1999 the services surplus in current prices was around HK\$100.7 billion (US\$13 billion), an increase of HK\$9.8 billion (US\$1.3 billion) over the previous year. The major impetus for the rebound in export performance was re-exports to other Asian countries, especially Indonesia, Japan, Korea, and Singapore, where import demand strengthened as the region's economies revived. However, domestic exports remained sluggish in the face of stiff price competition.

Following the increase in export growth in the PRC in the third quarter, re-exports rose 7 percent and 12 percent, respectively, in the third and final quarters of 1999. The export of services, which suffered severely in 1998, rebounded by 2.6 percent in US dollar terms in 1999. Tourism rebounded, with 11.5 percent more arrivals. Visitors from the PRC and Taipei, China continued to be the most important sources of tourism growth, accounting for almost 50 percent of arrivals. The number of visitors from other Asian countries also increased, especially from South-east Asia, including Japan, whose tourist numbers had

decreased sharply in 1998 because of the financial crisis. However, despite the increased volume of business, total receipts suffered a mild decline as a result of the fall in prices.

Stronger deflationary pressures partly reversed some of the stimulating effects of nominal interest rate cuts, which returned to precrisis levels. Domestic investment, particularly in the private sector, contracted more sharply in 1999 than in 1998, and investment in plants and machinery declined more than investment in building and construction. Completion of some major public projects also contributed to the lack of a compensating rise in public sector investment.

With an uncertain business outlook and high real interest rates, total loan demand continued to be weak. Moreover, the banking sector experienced problem loans, partly because of exposure to some troubled PRC enterprises, such as Guangdong International Trust and Investment Corporation. Largely reflecting a decline in total loans, the ratio of classified loans to total loans rose to 10 percent. This prompted some banks to increase provisions for bad loans, which affected profitability, and to adopt a more cautious lending stance. Nevertheless, banks' asset quality stabilized in the third quarter of 1999 and the sector's capital

**Table 2.1 Major Economic Indicators, Hong Kong, China, 1997-2001**  
(percent)

Item	1997	1998	1999	2000	2001
Gross domestic product growth	5.0	-5.1	2.9	5.0	5.5
Gross domestic investment/GDP	34.6	29.7	25.4	27.3	34.0
Gross domestic savings/GDP	31.1	30.2	29.8	30.7	32.0
Inflation rate	5.8	2.8	-4.0	-1.0	3.1
Central government budget	6.6	-1.8	-0.1	-0.5	1.0
Money supply (M2) growth	8.3	11.8	8.1	12.0	15.0
Merchandise exports growth	4.0	-7.5	-0.1	9.1	10.0
Merchandise imports growth	5.1	-11.6	-2.7	10.7	11.0
Service exports growth	0.6	-10.4	2.6	9.1	9.7
Service imports growth	5.4	-2.1	-1.6	6.0	8.1

Sources: Government of Hong Kong Special Administrative Region; staff estimates.

adequacy ratio remained at a healthy level, averaging 20.1 percent.

Reducing unemployment is another challenge for policymakers. Although the unemployment rate stabilized around 6 percent, it was high compared with a precrisis level of 3 percent, and was exacerbated by the continued strong growth of the labor force. For 1999, total employment increased 1.8 percent. However, the labor force rose 3.5 percent because of strong immigration, particularly from the PRC, and an increase in the number of women in the labor force.

Nevertheless, the prospects for employment should improve as economic recovery broadens in 2000. GDP growth is forecast to rise to 5 percent in 2000 and 5.5 percent in 2001. The external sector should continue to improve along with the region's economies. This will be aided, to some extent, by additional tourist revenue from a planned Disney theme park. With more infrastructure projects planned, domestic fixed capital formation will start to increase in the next two years. The conventional measures of real interest rates are expected to peak in mid-2000, with the easing of deflationary pressures. Imports will increase as well, with the visible trade deficit worsening in the coming years.

The prospects of Hong Kong, China as an entrepot for the PRC may wane as the PRC develops its own container and port facilities. However, the projected entry of the PRC into the World Trade Organization in the near future is expected to present new opportunities, including stronger re-exports from the PRC as well as closer trade linkages.

### **ISSUES IN ECONOMIC MANAGEMENT**

A severely contracting economy combined with measures aimed at stimulating spending led to fiscal deficits of 1.8 percent and 0.1 percent of GDP in 1998 and 1999, respectively. A deficit is also expected for 2000. Authorities maintain that the budget will be cyclically balanced, with a surplus expected in 2001. A number of infrastructure projects with total outlay of more than HK\$65 billion (US\$8.4 billion) are scheduled to start in 2000. Therefore, whether the government can return its budget to a surplus will depend on its success in finding new ways to raise revenues, aside from the natural increase as the economy recovers.

The government has accumulated huge fiscal reserves over the years. Even with the deficits recorded in the last two years, these reserves stood at HK\$390 billion (US\$50.3 billion) at the end of 1999, and give authorities some latitude in fiscal matters.

High real interest rates have been of greater concern. While nominal interest rates declined for much of 1999 and were well below the peaks reached in 1998, observers have blamed falling prices for pushing real interest rates to their highest levels in more than a decade. Moreover, because the linked exchange rate system forces nominal interest rates to follow closely those in the United States, an anticipated tightening of the US Federal Reserve's monetary policy may keep private investment at its currently subdued levels and hamper the pace of economic recovery.

To some extent, the concern regarding high real interest rates results from how they are typically computed, by adjusting nominal interest rates using actual rates of inflation, rather than the conceptually superior expected rate of inflation. However, the process of deflation is not a downward spiral of prices and production, but rather part of an adjustment process required to make an economy that uses a fixed exchange rate more competitive. Therefore true real interest rates are probably not as high as conventional measures suggest. While prices have been falling, they should cease to do so during the first half of 2000, and investors will take this into account.

Moreover, with the region registering a sustained recovery, business confidence is likely to return to more robust levels. How robust a recovery the economy can stage, however, will depend on how well it can restructure itself to enhance competitiveness as a financial and business center to the PRC, and to the region as a whole.

To facilitate this restructuring, the government has focused its policies not just on macroeconomic management, but also on microeconomic reforms. In particular, the government has taken steps to remove existing barriers to entry and price controls in the telecommunications and banking sectors. Liberalizing the international calls market in January 1999 and implementing mobile phone number portability in March 1999 saw an increased number of suppliers and fierce competition for market shares through better or cheaper services.

Following the completion of the Banking Sector Consultancy Study in December 1998 and considering the views expressed during a public consultation in early 1999, the Hong Kong Monetary Authority developed a coherent package of policy initiatives to reform and further develop the banking sector. Reforms involve deregulating the remaining interest rate rules, relaxing the one-branch policy, implementing a formalized risk-based supervisory approach, simplifying the three-tier licensing system, conducting a full study on deposit protection, and evaluating the feasibility of a credit register for commercial enterprises. The July 1999 announcement allowed foreign banks licensed after 1978 to open as many as three branches. The first phase of interest rate deregulation is scheduled for July 2000, while the review of local bank licensing requirements will be undertaken toward the second half of 2001. Consolidation, in the form of mergers and acquisitions, is also being encouraged to enhance efficiency through exploiting economies of scale, eliminating redundancies, and using joint funding for investments in new technology.

With the advent of the digital age and the rapid global expansion of the Internet, electronic banking offers new products and services, such as multipurpose stored-value cards and banking services via mobile phone or the Internet. However, while these electronic commercial channels offer more convenience, they also pose new risks, such as theft, fraud, or alteration of information by unauthorized access via digital means. Law enforcement is particularly difficult in cases involving cross-border activities. Existing legislation must be amended quickly to provide a prudential supervisory framework for these new financial activities.

In view of the overdependence on the local equity market and banking sector for long-term funding, the Hong Kong Monetary Authority also stepped up its efforts to enhance capital market development. These include developing mortgage-backed securities since 1997 and listing Exchange Fund Notes on the local stock exchange in August 1999. In addition, the merger of the Hong Kong Stock and Futures exchanges and the implementation of the Mandatory Provident Fund will occur in 2000. Thus, the financial sector is expected to expand in 2000-2001, after almost three years of consolidation. Successfully implementing

these financial sector reforms will be critical in maintaining Hong Kong, China as a major regional financial center, especially as reforms are also under way in other Asian cities such as Singapore and Shanghai.

## **POLICY AND DEVELOPMENT ISSUES**

The continued relocation of manufacturing industries to the PRC and the slowdown in major service sectors because of the Asian financial turmoil prompted the government to take more initiatives to develop high-value-added and high-tech industries. A string of projects and research funding have emerged. Besides the Science Park currently under construction, other ambitious projects include a HK\$13 billion Cyberport and the HK\$9.3 billion Silicon Harbor, both to be jointly developed with private sector initiative and involvement. The government's assistance will involve providing research funding and housing subsidies for overseas staff, and granting land at a subsidized rate.

While in the past high-tech industries were considered unduly risky due to their high overhead costs, uncertain demand, and long gestation periods, emphasis on the information technology (IT) industry is being embraced more widely. This is because the IT industry could complement traditional areas of strength, such as finance and trade services. Consequently, banks, property developers, real estate agents, and trading companies are among the first to endorse an IT-based industrial policy.

Development of the IT industry is also being embraced more readily because telecommunications, the basic infrastructure for IT, is well developed and among the best in the world. For example, in terms of telephone lines per household, mobile phones per person, and Internet penetration rates, Hong Kong, China is among the most advanced in the region.

The establishment of the Growth Enterprise Market (GEM) is in line with such industrial development. The strong performance of Internet stocks in the United States, especially on the NASDAQ, provided the incentive for technology ventures to attempt to list in Hong Kong, China. Technology companies dominated the first listings on the GEM in November. Most of these startups were small and medium-size enterprises that lacked the good track record or

substantial assets necessary to obtain funds from banks or list on the main board of the stock market. The government set up the Special Finance Scheme for these enterprises in August, and had committed around HK\$4.8 billion.

However, the GEM is a more attractive source of funding as it provides a bigger investor base and stronger growth potential. The smaller size of these GEM stock issues, however, will imply higher risk of price fluctuations, and hence of speculation. The announcement that some big US technology stocks may be listed on the GEM in 2000 has further boosted local confidence in this new second board. In addition, some larger local enterprises are setting up subsidiaries to capture this rising wave of positive sentiment. Although the results are not yet clear, the availability of such channels for funding and expansion is a strong incentive for developing companies with strong IT connections.

With hardware manufacturing centered in the PRC, Hong Kong, China's IT industries will need to focus on the design, marketing, and application of the latest technological tools for the production, distribution, and consumption of information. To succeed, a steady supply of highly skilled workers will need to be ensured. This can be achieved through improving and extending tertiary education facilities. While appropriate investment in education is critical, keeping Hong Kong, China attractive for professionals from the PRC and elsewhere will also be important.

To this end, Hong Kong, China needs to improve the overall living environment, which will necessitate a more comprehensive and effective environmental policy. Not only will this help attract the best professionals from around the world, but it is also of vital interest to the local populace. The worsening of various forms of pollution in recent years has generated increasing concern regarding health risks. This has far-reaching implications for rising public health costs as well as lower productivity. The negative impact on tourism serves as a good warning. With the global trend

toward greater demand for better environmental standards, it is critical to incorporate environmental issues into any long-term development strategy.

The first significant environmental policy was formed in 1989 with a ten-year plan to fight air, water, noise, and waste pollution. In 1998, the Environmental Impact Assessment Ordinance was implemented to give more legislative power to the Environmental Protection Department. In addition, separate ordinances govern air and water pollution control, noise control, and waste disposal. The authorities have undertaken various forms of control, including requiring licenses and permits for industrial pollution. In 1990, the Hong Kong-Guangdong Environmental Protection Liaison Group was established to facilitate regional pollution control. A joint study of air pollution in the Pearl River Delta was undertaken with the Guangdong authorities and will be completed in 2000. However, most of the problem lies in enforcement, which is hindered by low penalty rates for offenders.

The launching of an air pollution index in 1995 improved public awareness of air pollution levels, and high levels of this index prompted the government to require all diesel-powered taxis to change to liquid petroleum gas by 2005. Improper waste disposal also has worsened as the dumping of household garbage and construction waste has increased, resulting in rising collection and disposal costs for the government. The recycling industry has seen limited success because of high land costs, low profit margins, and the lack of community cooperation.

Eventually the private sector will develop the IT industry, and market forces will shape it. But because of the substantial long-term benefits of an effective environmental protection policy, it is critical that the government spend more resources in enforcement and education to maintain competitiveness as a regional commercial hub and an international city.