

Hong Kong, China

An acceleration in net exports led rapid economic growth in 2005, with support from domestic demand. Consumer price deflation—which has persisted since the Asian financial crisis—ended, while labor market conditions improved following several years of weakness. Economic conditions were buoyed by strong growth in the People’s Republic of China and by generally favorable conditions in the global economy. In 2006 and 2007, growth is expected to edge down, in line with moderation on the mainland and rising domestic interest rates.

Economic performance

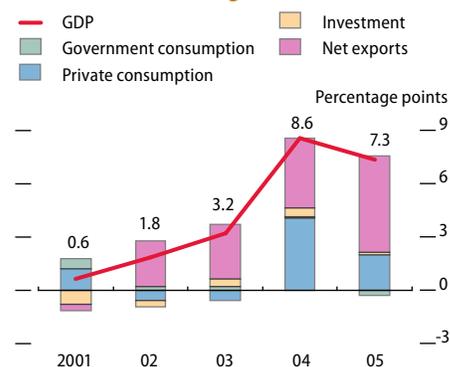
Gross domestic product (GDP) grew by 7.3% in 2005 and consumer prices, on a downward trajectory since 1998, rose by 1.1% in response to the broad-based economic pickup. In 2004, GDP had surged 8.6%, boosted by a low-base effect caused by the outbreak of severe acute respiratory syndrome (SARS) the year before.

The external sector was again a key driver of growth in 2005. Merchandise exports rose by 11.2% in nominal United States (US) dollar terms, while imports grew by 10.2%. Strong merchandise trade growth reflects, in part, the importance of Hong Kong, China as an exit point for exports from the People’s Republic of China (PRC). These exports surged by just over 28% in 2005. Services exports, which are particularly important for Hong Kong, China, grew by 11.8% in nominal terms, outstripping 4.2% growth in services imports. As usually happens, the surplus on services trade (16.4% of GDP) exceeded the merchandise trade deficit (4.3% of GDP). The improvement in the overall trade balance is in line with a trend that has seen the trade balance turn from a deficit of 3.4% of GDP in 1997 to a surplus of 12.1% of GDP in 2005. Net exports contributed 5.5 percentage points to the 7.3% GDP growth rate in 2005 (Figure 2.9.1).

Export-driven growth was supported by a long-awaited and broad-based recovery of domestic demand. Private consumption grew by 3.7% (contributing 2.0 percentage points to growth) and fixed capital formation rose by 3.9% (contributing 0.9 percentage points), picking up strongly toward the end of the year. Capital investment was focused largely on machinery and software, rather than on buildings. However, reflecting a conservative fiscal stance, government consumption fell by 3.0%.

On the production side, services, which constitute 87% of real GDP, grew by 8.0% in 2005 (Figure 2.9.2). Among services activities, the key drivers of growth were import and export trade (which accounts for about 23% of real GDP); financial services and insurance (14%); transportation and storage (8%); and business services (4%), each of which grew by 7.5–14.3%. Both the rising shares of these activities, and changes in the shares of its trading partners (Figure 2.9.3), show that the economy is

2.9.1 Contributions to growth (demand)



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/hong_kong_statistics/statistical_tables/index.jsp?charsetID=1&subjectID=12&tableID=032, downloaded 22 February 2006.

2.9.2 Contributions to growth (supply)



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/hong_kong_statistics/statistical_tables/index.jsp?charsetID=1&subjectID=12&tableID=037, downloaded 27 March 2006.

increasingly oriented to the provision of financial, commercial, and logistics services to PRC companies, especially exporters. Increased trading on the Hong Kong stock exchange also points to the expanding role of Hong Kong, China in raising finance for mainland companies (Figure 2.9.4).

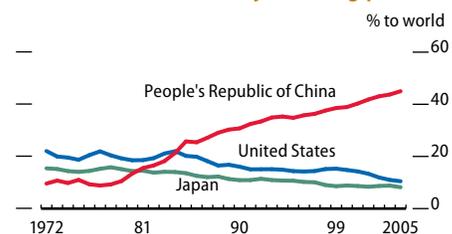
Tourism remains important to the services sector, and arrivals rose by 7.1% to 23 million in 2005. An increase in arrivals in the past 2 years marks, among other things, a rebound from the SARS outbreak in 2003 and the liberalization of PRC travel restrictions on visits to Hong Kong, China. Rising prosperity in the PRC has also contributed to rising tourist numbers, while growth in the number of non-PRC tourists remains robust as well.

In the earlier part of the year, expectations for appreciation of the yuan fueled capital inflows into Hong Kong, China and the mainland. Under the linked exchange rate system, these capital inflows led to an expansion of the monetary base and hence lower domestic interest rates. In order to anchor market expectations on the strong side of the exchange rate link, the Hong Kong Monetary Authority introduced three refinements to the system in May. It introduced an undertaking to sell Hong Kong dollars for US dollars at HK\$7.75/US\$, while the undertaking to buy Hong Kong dollars was shifted from the rate of HK\$7.8/US\$ to HK\$7.85/US\$, creating a convertibility zone defined by the two undertakings. These refinements are conducive to currency stability, and experience since the introduction suggests that they are effective in ensuring that domestic interest rates track US rates more closely. Local rates rose following their introduction. Over 2005, the prime lending rate rose from 5.00% to 7.75%, reflecting rising US interest rates and the Hong Kong dollar's link to the US dollar.

Property prices, which bottomed out in the second half of 2003, rebounded in 2004 and continued to climb through the first half of 2005, before softening a bit later in the year in response to rising interest rates. Purchase prices for residential property rose by 5.8% in December from a year earlier, while corresponding rental rates grew by 12%. Rents for retail space rose modestly, in contrast to falling purchase prices. Commercial property prices appreciated, as rents for "grade A" office space rose by 39% year-on-year to December, clearly reflecting a tightening market. Concurrently, the construction sector contracted by 4.4%. This sector's share in output has been on a downward trend since the Asian financial crisis of 1997–98. There is a wide array of views on the causes of the property price movements and the slump in construction. Some analysts view the recent price increases as a shift toward a sustainable equilibrium in the property market, others as evidence of a growing problem. Accordingly, there is significant uncertainty regarding the future pace of construction activity and forward path of property prices.

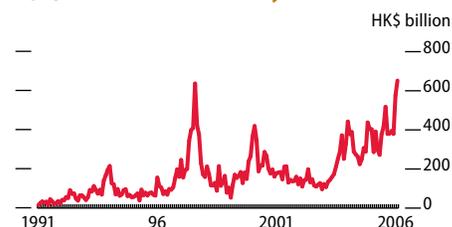
On the back of strong economic growth, unemployment fell from 6.6% in the last quarter of 2004 to 5.3% a year later. Real hourly earnings in most sectors have declined since 2003, though 2005 saw some signs of stabilization (Figure 2.9.5). The decline in real hourly earnings is more pronounced among wage earners, rather than salaried workers. (A depiction of the payroll index, which includes increasingly widespread bonuses, would however show a moderate increase in real earnings.)

2.9.3 Total trade with major trading partners



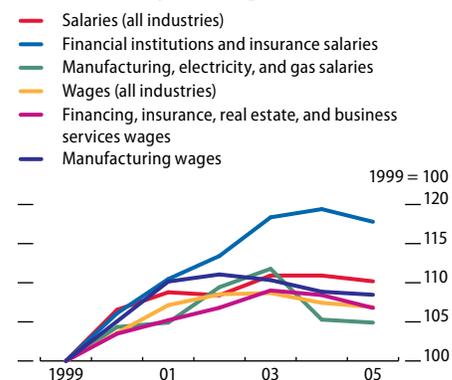
Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/hong_kong_statistics/statistical_tables/index.jsp?charsetID=1&subjectID=3&tableID=060, downloaded 10 March 2006.

2.9.4 Stock market monthly turnover



Source: CEIC Data Company, Ltd., downloaded 15 March 2006.

2.9.5 Real salary and wage indexes



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/hong_kong_statistics/statistics_by_subject/index.jsp, downloaded 22 February 2006.

No matter which payroll index is used, real earnings showed signs of stabilizing, or improving, in 2005. Unemployment also continues to be of greater concern in blue-collar occupations (Figure 2.9.6). These trends reflect increasing pressure from low-skill labor and abundant infrastructure to support manufacturing in the PRC, and the consequent shift of the local economy into higher-skill services.

The Closer Economic Partnership Arrangement (CEPA) between the two economies, implemented in January 2004, was expanded in 2005 and again in 2006. Under the latest version, all Hong Kong, China merchandise that meets CEPA rules of origin enjoys tariff-free access to the mainland market. Even though the PRC is to reduce tariffs on imports from other sources so as to meet its World Trade Organization (WTO) commitments, Hong Kong, China firms can benefit both from a first mover advantage in the PRC, and from below-WTO tariff levels in some product categories under CEPA.

Banks have increased offerings of yuan-denominated personal banking, currency exchange, and credit-card services. The authorities are in discussion with those on the mainland regarding proposals for settlement of cross-border trade in yuan and issuance of yuan bonds in Hong Kong, China. Meanwhile, the revenue mix of banks has continued to shift in favor of services rather than interest earnings. Local capital markets saw a record HK\$165.7 billion raised through initial public offerings in 2005, mainly by mainland companies. An aging local population, and the rapidly growing wealth of clients in the PRC with easier access to Hong Kong, China, have led to an upsurge in wealth-management services.

The authorities expect fiscal surpluses in FY2006 (ended 31 March 2006) in both the operating and consolidated accounts for the first time in 8 years. Cuts in the public payroll together with higher than forecast tax revenues, supported by rapid economic growth and land and property appreciation, underpin the expected surplus. Land sales and stamp duties account for about one fifth of revenues.

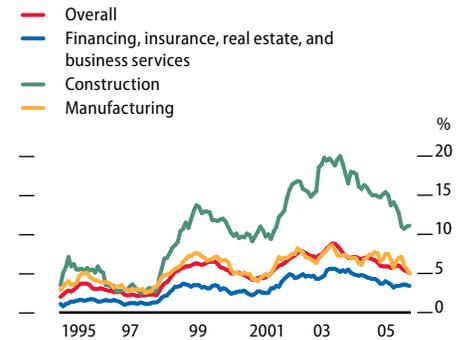
Economic outlook

In addition to the baseline assumptions for the world economy outlined in Part 1, the forecasts assume that the PRC economy will continue its robust growth in 2006 and 2007 and that its merchandise trade volumes will continue to expand at close to 20% (see the chapter on the PRC in Part 2). Further interest rate increases in the US in the first half of 2006 are expected to put upward pressure on domestic lending rates.

Prospects for 2006 and 2007

An end to consumer price deflation, rising incomes, and the tightening labor market all point to support for private consumption spending in the next 2 years, though growth of domestic investment may be tempered by higher real interest rates and other cost factors. Government consumption spending is unlikely to show significant growth. Overall, domestic demand will provide a firm foundation for demand growth, and domestic spending is forecast to grow by 3.5% in 2006 and by 3.3% in 2007. External demand, particularly for services, will continue to drive growth, as the

2.9.6 Unemployment rate by previous industry, 3-month moving average



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/hong_kong_statistics/statistical_tables/index.jsp?charsetID=1&subjectID=2&tableID=009, downloaded 17 February 2006.

2.9.1 Selected economic indicators

	2006	2007
GDP growth	5.5	5.0
Inflation	2.5	2.5
Current account balance (% of GDP)	11.0	10.0

Source: Staff estimates.

economy continues to enjoy the advantages of being a financial and commercial portal for the PRC. This year is expected to be another good year for listings by mainland companies, and the steady stream of multinational and PRC companies establishing corporate offices in Hong Kong, China is likely to be sustained. Trade flows will once again be fortified by reexports to and from the PRC. On the strength of solid trade and income surpluses, the current account surplus is forecast at 11.0% of GDP in 2006 and 10.0% in 2007 (Figure 2.9.7).

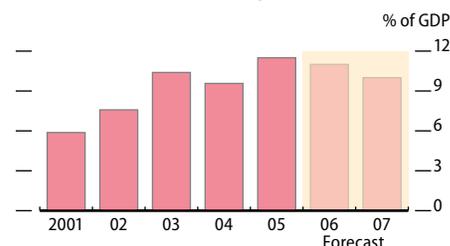
The Government should be able to meet its goal of keeping the fiscal account balanced in 2006 and 2007, as tightened spending and economic growth will at least partially offset cuts in tax rates. The authorities also propose launching a public consultation on the introduction of a goods and services tax. The levy would shift the tax burden away from income, land, and profits, and would widen the tax base.

In these generally favorable conditions, GDP growth is forecast to soften to 5.5% in 2006 and to about 5.0% in 2007, a level roughly equal to the economy's medium-term growth potential (Figure 2.9.8). For the most part, the easing of growth reflects the maturing recovery domestically, a gradual slowing of trade and income growth in the PRC, and the effects of higher interest rates in the US. Consumer price inflation of 2.5% is expected for the next 2 years as a result of tightening labor and land markets, and rising energy prices (Figure 2.9.9).

These projections are subject to various risks. Clearly, if there were to be an unexpected downturn in global growth and trade, the economy would be particularly susceptible as an international trade and financial hub. Higher than anticipated interest-rate rises in the US, which might occur if inflationary threats flare up in the US or a US dollar depreciation raises long-term interest rates, are another risk. And, while local companies are generally in good financial shape, a significant softening of external demand would hit earnings and the increased tightness in the market for office space would be more likely to have adverse effects.

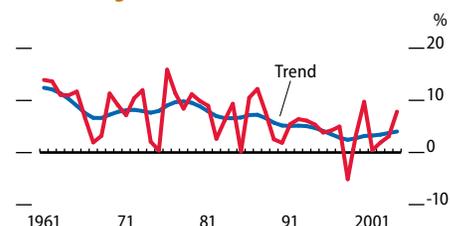
If avian flu becomes easily transmissible from human to human, the high population density could lead to a particularly high infection rate. Also, as seen in the 2003 SARS epidemic, the dominance of the services sector and tourism, both activities that rely on person-to-person contact, would likely mean that the economy would suffer disproportionately. According to ADB estimates, the Hong Kong, China economy suffered an output loss of approximately 2.9% of GDP due to the SARS epidemic, much of which can be attributed to its defensive and psychological effects on economic behavior.

2.9.7 Current account surplus



Sources: Census and Statistics Department, available: http://www.censtatd.gov.hk/hong_kong_statistics/statistics_by_subject/index.jsp, downloaded 28 March 2006; staff estimates.

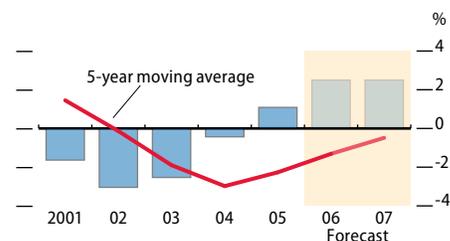
2.9.8 GDP growth



Notes: Growth rates are logarithmic. Trend growth rates are calculated using a Hodrick-Prescott filter.

Sources: World Bank, *World Development Indicators* database; staff estimates.

2.9.9 Inflation



Sources: Census and Statistics Department, available: http://www.censtatd.gov.hk/hong_kong_statistics/statistics_by_subject/index.jsp, downloaded 22 February 2006; staff estimates.