

Hong Kong, China

Above-trend growth was recorded for a third year in a row, supported by domestic and external demand. GDP growth will be trimmed this year and next by the slowing in the economies of the United States (US) and People's Republic of China (PRC), although budget concessions will underpin domestic demand. Medium- to long-term challenges include broadening the tax base, preparing to meet the needs of an aging population, and maintaining high standards of financial infrastructure and regulation as the high-end services sector expands on the strength of closer ties with the PRC.

Economic performance

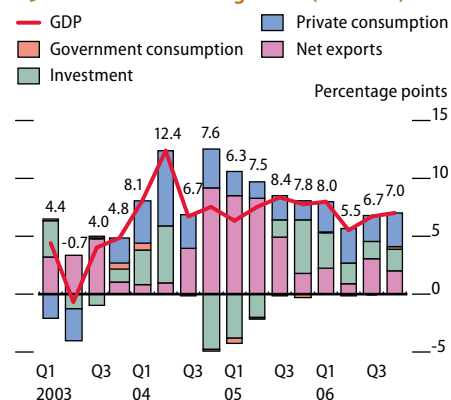
The economy grew robustly by 6.8% in 2006, a third successive year of above-trend growth, on strong support from domestic and external demand. Private consumption (accounting for 52% of GDP) grew by 5.1%, fixed capital investment (23%) grew by 7.9% on the strength of business optimism, and net exports (17.5%) expanded by 12.6%. Government consumption (7.5%) remained restrained.

The generally good year was punctuated by a brief deceleration in the second quarter (April–June; Figure 2.9.1) as trade slowed. Growth bounced back in the third quarter, pulled up by a recovery of exports just ahead of a fourth quarter recovery in the US. Declining oil prices contributed to the recovery of trade, as did booming PRC exports and the falling US dollar. Given that the US and Hong Kong dollars are linked, US dollar depreciation tends to reduce the international price of Hong Kong, China's exports. Corporate investment continued apace, as the economy consolidated its position as a popular entry point for companies doing business in the PRC. Private consumption also was robust in the third quarter. Consumption spending has strengthened over the past 3 years as unemployment has fallen, wages have risen (Figure 2.9.2), and tourism has continued to grow.

The balance of payments surplus grew during the first 3 quarters of 2006, even with a sharp concurrent rise (81.0%) in the merchandise trade deficit (Figure 2.9.3). This spike in the goods trade deficit mostly reflected the slowdown of exports in the second quarter. However, this deficit was small (7.8% of GDP over three quarters) compared with merchandise exports, which amounted to 167% of GDP over the same period.

This reflects the key role of goods reexport in Hong Kong, China, especially from the PRC. In value terms, 90% of exports are reexports. This includes an estimated margin of 17.5% added to goods reexported. The merchandise trade deficit arises because, given the economy's specialization in services (agriculture and industry together accounted for less than 10% of GDP in 2005), it consistently imports more merchandise for domestic consumption than it produces for export. However, net services exports more than compensated for the widening merchandise trade gap, growing by 23.4% and restoring the current account surplus to 9.7% of GDP.

2.9.1 Contributions to growth (demand)



Source: Census and Statistics Department, available: <http://www.censtatd.gov.hk>, downloaded 1 March 2007.

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2.9.2 Unemployment and growth in wages



Note: Average pay includes wages, all bonuses, and overtime payments.

Source: Census and Statistics Department, available: <http://www.censtatd.gov.hk>, downloaded 9 March 2007.

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Robust net exports of services reflected a significant expansion of financial services. Indeed services (over 90% of GDP) continue to drive growth on the supply side. The development of new financial services with the mainland under the Closer Economic Partnership Arrangement has helped, as has the launch and subsequent expansion of yuan-denominated retail banking services in Hong Kong, China.

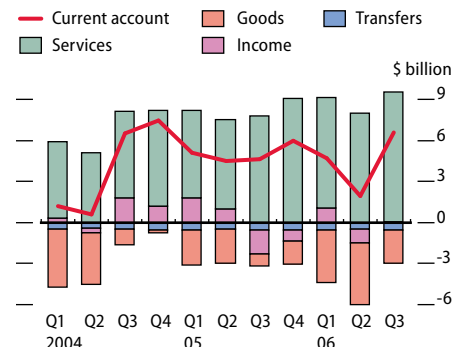
Financial services have also boomed outside retail banking. Initial public offerings (IPOs) have surged—with Hong Kong, China raising more funds through IPOs than the New York Stock Exchange in 2006. Corporate debt issuance is also on an upward trend. Hong Kong, China's sophisticated institutions assist PRC companies that seek access to international financial markets. With a large population in the PRC preparing for retirement, mainland banks are offering a growing array of retirement planning instruments, which are attracting considerable savings. These funds will require management, and financial institutions in Hong Kong, China are well placed to assist.

Thus, the economy is becoming increasingly specialized in high-end services. This is reflected in labor productivity growth rates, which between 2000 and 2005 were particularly high in the communications, international trade, and financial sectors (Figure 2.9.4). Labor market adjustments are apparent in the disaggregated unemployment figures, which, even as they show jobless rates falling for all classes of workers, display disparities by skill level. Only 1.9% of higher-skill workers were unemployed as of January 2007, compared with 4.8% among the lower skilled. The labor market is tightening faster higher up the skill spectrum. However, this tightening did not create inflationary pressures because aggregate labor productivity grew faster than wages in 2000–2006.

After climbing for over 2 years, property prices remained stable through 2006 (Figure 2.9.5), though rents, which usually follow property prices with some lag, continued to rise. With rents rising, inflation edged up, averaging 2.0%. Appreciation of the yuan against the Hong Kong dollar added upward pressure on food prices (Figure 2.9.6), since much food in Hong Kong, China, particularly perishables, is imported from the PRC. Large capital inflows (contributed, in part, by the successful IPOs), and the leveling-out of US interest rates, to which rates in Hong Kong, China are linked, in the latter half of 2006 contributed to liquidity growth (Figure 2.9.7).

Government revenues have grown rapidly on the strength of a strong economic performance since 2003. Accordingly, the budget for FY2007 (ending 31 March 2008) includes both tax cuts and new spending. Particularly noteworthy are: revisions of marginal income tax rates and brackets back down to FY2002 levels, a sizable tax waiver for FY2006 (50% of personal taxes up to a ceiling of HK\$15,000), an additional month's social security payment, a 2-quarter holiday on rates assessed on almost all residential and most nonresidential property, increased tax deductions for education and child-rearing, higher allocations for social expenditures, and commitments to infrastructure development. These provisions are likely to provide a significant boost to demand, while serving to reduce key prices. Private-sector analysts have commented that the measures are affordable and leave room for largesse in future budgets.

2.9.3 Trade and current account



Source: Hong Kong Monetary Authority.

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2.9.4 Productivity growth in selected services segments



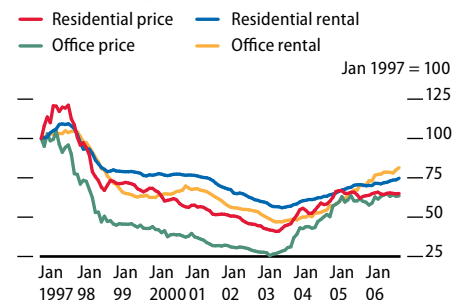
1 = communications; 2 = import and export trade; 3 = financing; 4 = transport and storage (excluding land transport); 5 = wholesale and retail trade; 6 = restaurants and hotels.

Note: Refers to average productivity growth in 2000–2005.

Source: 2006 Economic Background and 2007 Prospects, Government of the Hong Kong Special Administrative Region (2007).

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2.9.5 Property indexes



Source: Rating and Valuation Department, available at: <http://www.rvd.gov.hk>, downloaded 19 February 2007.

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Economic prospects

Given the importance of trade and financial services, the economy's performance depends critically on external conditions. *Asian Development Outlook 2007* expects a slowing of growth rates in the PRC in 2007 and 2008. It is assumed that the US economy will decelerate in 2007, before recovering a bit in 2008. This outlook considers further, mild, and gradual appreciation of the yuan possible. The baseline forecasts assume the yuan will be stable relative to the currencies of Hong Kong, China and the US.

On the basis of these assumptions, growth is expected to slow to 5.4% in 2007 (Figure 2.9.8). Trade expansion will fall as the PRC and US economies decelerate, but domestic spending is expected to strengthen further, with consumer spending supported by the large budget givebacks. The returns to taxpayers amount to about US\$2.6 billion, or 2.3% of consumption spending in 2006. The tightening labor market also supports consumption spending.

At the same time, the growth potential of new services facilitated by closer integration with the PRC will underpin a healthy rate of business investment. However, with trade slowing and domestic demand still healthy, the current account surplus is projected at 9.5% of GDP (Figure 2.9.9).

Budget initiatives will exert downward pressure on prices. The waiver of housing rates for 2 quarters as well as a waiver of public housing fees in February 2007 will arrest any inflationary pressures accruing from housing costs. Other budget concessions will also help, to a lesser extent.

Conversely, the budget (together with the strong domestic demand growth likely to follow) implies some upward price pressure, though in a small open economy heavily dependent on trade this is likely to be mostly felt through the prices of nontraded services. On balance, inflation of 1.6% is expected in 2007 (Figure 2.9.10). It could be slightly higher if the yuan appreciates further against the US dollar.

In 2008, since US interest rates are expected to ease and US economic growth is projected to turn up, trade volumes will grow faster, boosting reexports. Falling US interest rates will be matched in Hong Kong, China. Lower interest rates will limit the likely decrease in domestic spending as the effects of the 2007 budget on consumption fade. The trade deficit will therefore narrow, while GDP growth will slow slightly to 5.2%.

Continued expansion of financial linkages with the PRC will raise services exports. Tourism is likely to keep expanding, assisted by rising incomes in the PRC. The current account surplus is therefore projected to rise, to 11.5% of GDP in 2008. Inflation is likely to rise to 2.3%, as the effects of the FY2007 budget wear off and as monetary conditions loosen.

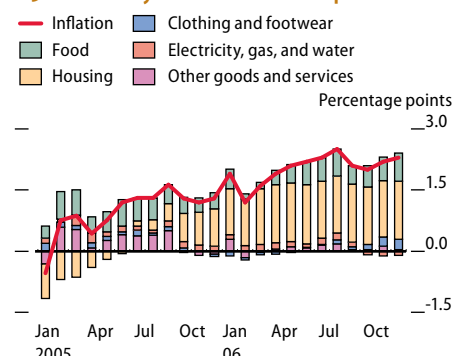
The key risks to this outlook are external. Reexports are volatile, and are very large relative to trade flows and GDP. Trade fluctuations therefore present a significant source of uncertainty for this economy. Moreover, given the loss of manufacturing jobs in North America and Europe, protectionist pressures abroad present a growing cause for concern.

2.9.1 Selected economic indicators

	2007	2008
GDP growth	5.4	5.2
Inflation	1.6	2.3
Current account balance (% of GDP)	9.5	11.5

Source: Staff estimates.

2.9.6 Monthly inflation and components

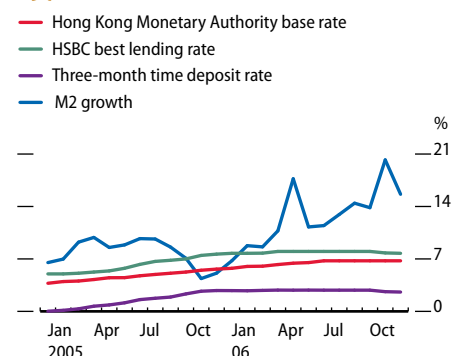


Note: Year-on-year rates of change from October 2005 were estimated using 2004/05-based consumer price indexes (CPIs). For earlier months, the year-on-year rates of change were derived from CPIs with a 1999/2000 base period.

Source: CEIC Data Company, Ltd., downloaded 19 February 2007.

[Click here for figure data](#)

2.9.7 Financial indicators



Sources: CEIC Data Company Ltd.; Hong Kong Monetary Authority, available: <http://www.info.gov.hk>; both downloaded 19 February 2007.

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Development challenges

The economy faces several challenges in the medium to long term. The Government obtains much of its revenues from income taxes, charges, and levies tied to property values. These are procyclical, which in an economy subject to externally driven volatility implies fiscal uncertainties. Holding excess reserves to provide assurance against such uncertainties is costly.

The Government wants to broaden the tax base, and launched public consultations in 2006 focusing on a proposal for a Goods and Services Tax (GST). A GST is economically appealing because it minimizes distortions to relative prices needed to raise revenue. However, some retailers opposed the GST, arguing that it might reduce sales and involve compliance costs. Advocates for the poor maintained that a GST would be regressive and would widen the wealth gap. The Government announced in December that while the consultation on the GST continues, it is seeking other ways to broaden the tax base.

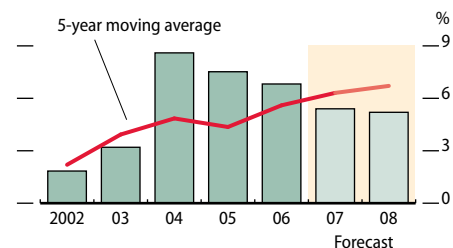
The economy stands to profit substantially from its high-quality institutions for ensuring financial stability and predictability, which facilitates the flow of capital into and out of the PRC. Hong Kong, China's capacity to minimize information asymmetries between players on financial markets is therefore vital. However, as the range of assets traded in its financial markets grows, and becomes increasingly tied to mainland companies that have historically operated to different financial standards, the difficulties associated with ensuring such transparency may increase. Thus ensuring institutional standards in the face of rapid financial development will require considerable effort.

On a related issue, several important markets, including those for basic services such as retailing leave market power concentrated in relatively few hands. Recent moves to liberalize entry into services suggest there will be new competitors from the mainland. This will be helpful, but only if it leads to more autonomous firms in the market, not just a rotation of new players into the market, and old ones out. Thus, the development of competition policies remains a challenge.

Rapid growth in the Pearl River Delta has degraded air quality, and this has led, reportedly, to difficulties in retaining internationally mobile services sector staff. Recognizing the transboundary dimension to this problem, in that many of the emitting plants are outside Hong Kong, China, the governments of Hong Kong, China and Guangdong province have developed a plan and signed agreements to substantially reduce four major air pollutants by 2010.

Finally, Hong Kong, China has an aging population, and must prepare for a surge in retirements. It has a mandatory pension fund that is well resourced and privately managed. This will help finance retirement expenses. However, health care presents concerns. The International Monetary Fund reports that 82% of in-patient and 46% of out-patient care is publicly funded. Thus fiscal pressure looms as the population ages. Discussions are under way on mechanisms to limit public health-care liabilities by encouraging potentially subsidized private insurance, especially for catastrophic incidents. Needless to say, to the extent that costs will be shifted to those about to retire, tensions will rise.

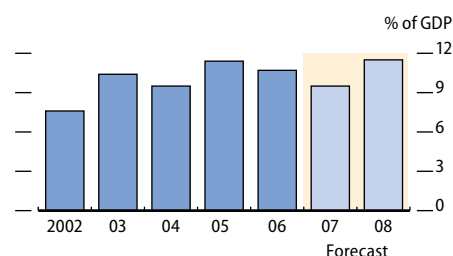
2.9.8 GDP growth



Sources: Census and Statistics Department, available: <http://www.censtatd.gov.hk>, downloaded 1 March 2007; staff estimates.

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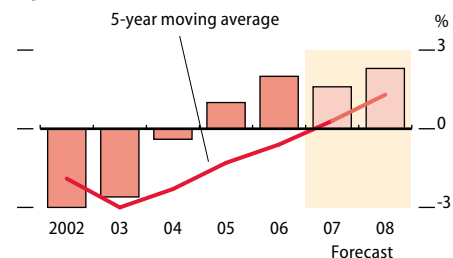
2.9.9 Current account balance



Sources: Hong Kong Monetary Authority; staff estimates.

[Click here for figure data](#)

2.9.10 Inflation



Sources: Census and Statistics Department, available: <http://www.censtatd.gov.hk>, downloaded 8 March 2007; staff estimates.

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