HONG KONG

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2002: MODERATE GROWTH

After a slow start in the first half of 2002, the economy of the Hong Kong Special Administrative Region, China (HKSAR), gained momentum on the back of a strong rebound in merchandise exports. Real GDP growth climbed to 4.3 per cent in the second half compared with 0.1 per cent in the first half, lifting full-year growth for 2002 to 2.3 per cent, an improvement from a meager 0.5 per cent growth in 2001. However, the buoyant external sector failed to boost private consumption and investment, which continued to slip. Deflation persisted in 2002, with the Composite Consumer Price Index falling by 3 per cent for the year.

The excellent 14.8 per cent real growth in exports in the second half and 8.7 per cent for the whole of 2002 was mainly attributable to the strong growth of mainland China's exports in 2002. Over 92 per cent of Hong Kong's exports were re-exports which either went into or came out from mainland China. Services exports have been boosted by increasing demand for trade-related services on surging offshore trade. Tourism was particularly strong, with the number of incoming visitors rising to 16.6 million, an increase of 20.7 per cent year-on-year. Visitors from mainland China accounted for 41 per cent of this total, having increased by 53.4 per cent over the previous year.

Domestic demand nonetheless remained sluggish. Private consumption and investment were curtailed by a number of negative factors, including high unemployment, persistent deflation, falling income and the threat of hostilities in the Middle East towards the end of 2002.

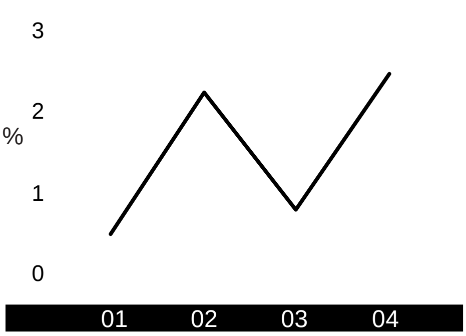
Deflation and fiscal challenge. During Hong Kong's ongoing economic restructuring, many challenges have emerged—two are prominent and related. The first is persistent deflation, which had lasted for 53 consecutive months by March 2003. The other is the ballooning fiscal deficit, which reached the alarming level of 5 per cent of GDP in fiscal years 2001–02 and 2002–03.

Deflation seems to have become an integral component of Hong Kong's economic restructuring given the continuing opening-up of mainland China with its competitive cost structure. The economic convergence between the two territories has brought in place the factor cost equalisation process.

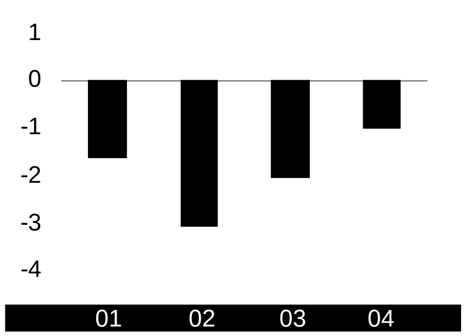
Persistent deflation has reshaped much economic behaviour. Median household income has fallen by 9.2 per cent between 1998 and 2002 and is likely to continue to drift lower. Persistent deflation also creates a tough business environment. Falling final product prices squeeze profit margins unless business costs can be contained. This has made firms more conscious of costs, particularly the labour input and capital investment costs.

Government revenue has also become a victim of persistent deflation. Direct tax revenue, such as salaries tax and profits tax—nearly 50 per cent of the government's operating revenue—have been hit by falling prices and income. Together with drops in other revenue, government operating revenue fell by 15

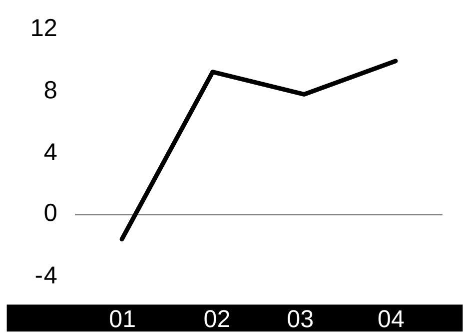
GDP growth



CPI inflation



Export growth



per cent from HK$177 billion in fiscal 1998–99 to an estimated HK$150 billion in 2002–03. On the other hand, operating expenditure rose from HK$177 billion to an estimated HK$203 billion during the same period because of rising social security payments and a civil service pay rise. Added to the significant decline in land sales revenue, the recurring budget deficit of around HK$70 billion per annum (or 5 per cent of GDP) has become a cause for concern.

POLICY RESPONSE

The need to revitalise Hong Kong's economy and tackle the fiscal deficit was the key message in both the Chief Executive's Policy Speech in January and the Financial Secretary's Budget Speech in March. The two objectives are intertwined, since revived growth and mild inflation could reverse the downward trend in government revenue.

The government's priority in driving long-term growth is expediting economic convergence with mainland China because a consensus has developed across all sectors of the community that Hong Kong's future depends on its becoming a metropolis of China. Under the 'one country, two systems' principle and because of capital controls exercised by mainland China, measures to facilitate the flows of people and funds between the HKSAR and mainland China require mutual consent. At present, discussions or studies underway include a Closer Economic Partnership Arrangement, relaxing the restrictions on people travelling from Guangdong Province to Hong Kong, relaxing conditions on the admission of mainland Chinese professionals, and a scheme to allow qualified mainland Chinese institutional investors to invest in the Hong Kong stockmarket. An experimental 24-hour boundary crossing at one control point has been implemented, and plans to improve the transportation links across the boundary are being drawn up.

On the fiscal deficit front, the Financial Secretary has taken bold steps to return the government budget to balance by 2006–07, cutting expenditure by an annual HK$20 billion in four years' time, raising the profit tax rate from 16 to 17.5 per cent and the personal standard tax rate from 15 to 16 per cent. The government also plans to securitise, or sell, a total of HK$112 billion worth of assets over the next five years. Although these austere measures are not consistent with reviving economic growth, the government is eager to demonstrate its determination to follow strict fiscal discipline as well as to safeguard the Hong Kong dollar peg.

OUTLOOK: 2003 AND BEYOND

In early 2003, Hong Kong is suffering from the spread of the Severe Acute Respiratory Syndrome (SARS). This has created immediate interruption to many economic activities, such as inward and outward travel, entertainment, retail sales, conferences and trade fairs. In April, incoming visitors fell 65 per cent year-on-year, while retail sales dropped 15.2 per cent year-on-year. As it might take at least 6 months for the number of visitors to return to pre-SARS levels, the repercussions on domestic demand and unemployment will be significant.

Real GDP growth in 2003 is projected to slip to 0.8 per cent from 2.3 per cent in 2002. Private consumption will be weak, falling by 2.5 per cent, while services export growth will be slower at 3.2 per cent. The Composite CPI is projected to fall by 2.0 per cent in 2003.

The benefits of economic restructuring and convergence with mainland China will take time to appear. The near-term performance of the economy thus relies on external sectors. Assuming modest growth in the United States and other key trading partners, Hong Kong's re-exports and offshore trade will be underpinned by mainland China's thriving exports. SARS so far has had only limited effects on external trade. Total exports are likely to grow by 9.4 per cent in real terms in 2003. Only about 30 per cent of employment in Hong Kong is now directly linked to external trade compared to some 60 per cent two decades ago. As a result, the re-cycling of export earnings to domestic consumption and investment will be slow. Government consumption expenditure is projected to grow by a real 4.0 per cent as the government introduced a HK$11.8 billion relief package to counter the impact of SARS on the economy.

Hong Kong's economic restructuring will last beyond 2003, as deeper economic integration with mainland China must take time. Any schemes allowing freer flows of people and funds to Hong Kong must pass the litmus test of being consistent with China's capital account controls given that the RMB is still not fully convertible. Sustained growth at a faster pace can take place only when domestic demand regains momentum, and this will be based on the services sector freely extending its services to mainland China enterprises and individuals. In 2004, real GDP growth is likely to remain at a low 2.5 per cent and deflation of 1 per cent is expected.

Government budget, fiscal years 1997–2006

The government projects that, if GDP grows by 3 per cent annually for the period 2003–07 and the fiscal measures proposed in the 2003–04 Budget are realised according to plan, the fiscal deficit will be eliminated by 2006–07.