

Statement by Mr. Zhang on the United Kingdom - Hong Kong
Executive Board Meeting 94/12
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1. Economic setting

Since the Fund began conducting Article IV consultations with respect to Hong Kong in 1990, we have continued to see the economic recovery gaining momentum. In 1993 economic growth was bolstered again by strong private domestic demand and increased trade opportunities, in particular with China's mainland. Despite a few unfavorable exogenous developments, consumer and business confidence have been solidified in light of China's promising economic prospects. However, although somewhat moderated, underlying inflationary pressures remain a source of macroeconomic concern.

Hong Kong's integration into the Chinese economy has become more pronounced and is mirrored in the following developments.

a. The manufacturing sector's relocation into neighboring provinces in southern China has continued. According to the staff report, this sector's contribution to GDP in Hong Kong declined from 24 percent in 1984 to about 15 percent in 1991, and even less since then.

b. Re-exports from China's mainland have played an increasingly important role in Hong Kong's external activity. In the report, the staff indicates that for the first nine months in 1993 the volume of re-exports grew by about 22 percent, while domestically-generated exports declined by 4 percent. The increased export volume has benefitted considerably from re-export activity, particularly with China's mainland.

c. Relative price changes in China's mainland and Hong Kong were quickly reflected in the Consumer Price Index (CPI) through foodstuff imports from China's mainland and made a positive contribution in moderating Hong Kong's inflationary pressure.

Keeping in mind the closer relationship between the Chinese and Hong Kong economies and the maintenance of Hong Kong's unique role as an international trade and financial center, China has undertaken, and will continue, to preserve economic and social stability in Hong Kong during the transitional period up to 1997 and in the years beyond. Against such a backdrop, my authorities are encouraged to see the robust momentum of economic growth in 1993, underpinned by continued consumer and business confidence in Hong Kong's prospects. However, they note some factors with concern; especially, the underlying inflation and decline in the domestic saving rate in recent years which, if not addressed adequately, may hinder sustained progress in the medium term.

2. Policy framework

a. Inflation

Inflation, a result of ongoing structural changes in the Hong Kong economy, has also been fueled by excess domestic demand triggered by, among other factors, negative real interest rates and the wealth effects in the wake of skyrocketing property prices and an enormous pouring of foreign capital into the local equity markets.

In addition, inflationary pressure may be even higher than indicated by the conventional measurement of general price levels--the CPI. According to staff estimates, both consumer prices and the implicit GDP deflator will be lower in 1993 than in 1992 and the plummeting prices of imported foodstuffs were a contributing factor in the lower consumer prices. However, both indexes may not fully reflect the price hikes in the property and equity markets. Therefore, the measured inflationary pressure could possibly be underestimated.

Although being anecdotal as a result of insufficient data to quantify its magnitude, the inflow of foreign capital is indeed the major force in the equity markets. We agree with the staff that developments in both the equity and property markets will have a direct effect on domestic demand. If such upward trends continue in asset markets, inflationary pressure will escalate. However, should external developments force the reversal of foreign capital, it would have an adverse impact on the economy through the erosion of consumer and business confidence as well as wealth effects. In this context, we urge the Hong Kong authorities to improve their data collection of these activities and monitor asset market developments.

b. Exchange rate and monetary policy

Although the linked exchange rate system restrains the capability of monetary policy to contain domestic demand and inflationary pressure, my authorities continue to believe that it serves the purpose of maintaining financial and economic stability in Hong Kong well. The evolution of the system proves its advantages over other alternatives. It is of vital importance in securing a stable financial and economic environment for sustained economic growth in the medium term.

However, some unwarranted implications overshadow the brightness of economic performance. Low nominal short-term interest rates, together with high inflation, have caused domestic demand to climb further when capacity is almost fully utilized. In addition, the resulting negative real interest rates also force property prices to rise. Notwithstanding the limited room for maneuvering monetary policy in such circumstances, prudential supervision can be further strengthened to maintain the soundness of financial institutions and shield the financial system from unexpected external shocks.

c. Saving and investment

In recognition of excess demand pressure precipitated by negative real interest rates, my authorities are more concerned about the decline in the domestic saving rate since 1990.

In Table 1 in the main text, it is clearly shown that since 1990 gross domestic investment, as a percentage of GDP, has been steadily increasing. In stark contrast, gross domestic saving as a percentage of GDP has continued to decline. The staff estimates that in 1994 there will be a gap between domestic saving and investment. Although there is no disaggregation between private and public saving, negative real interest rates will discourage an increase in private saving, and wealth effects caused by rises in asset prices will encourage current consumption. As Hong Kong undergoes tremendous structural change, there will be extensive investment demand in infrastructural and social areas. With the emerging gap between domestic saving and investment, efforts must be made to increase either private or public saving so as not to weaken the external position by seeking foreign saving to finance such a gap in the medium term. In light of the current situation in Hong Kong, more action is needed on the fiscal side, with the aim of increasing public saving, containing domestic demand, and encouraging private saving.

d. Fiscal policy

We agree with the staff that the fiscal policy stance should not be pursued to aggravate the prevailing excess private demand pressure on resource restraints. In addition, the Hong Kong authorities are encouraged to continue the fiscal discipline followed in the past decades and accrue reserves to fill the possible gap between domestic private saving and investment in the medium and longer term.

My authorities are well aware of the need for social and infrastructural investment in the process of structural changes in Hong Kong. However, they believe that public financing should be engineered so as not to worsen the consolidated budget position. The construction of the new airport and associated projects serve the medium- and long-term interests of Hong Kong. However, given the project's complexity and the enormous absorption of financial resources, in particular public financing, the implementation of this project should proceed in the cost-effective way agreed in the Sino-British Memorandum of Understanding on the Port and Airport Development Strategy (PADS). The Chinese Government has always supported the construction of Hong Kong's new airport. As long as the British side adheres strictly to the principles in the Memorandum of Understanding on the PADS, there will be no big difficulty in addressing this matter.

With regard to the recently proposed public pension plan, my authorities agree with the staff that it is necessary to "distinguish measures to enhance a social safety net for the most disadvantaged among the

elderly and those oriented to changing the saving behavior of current and future working generations". In this context, a step forward in protecting the elderly should not discourage the already worrisome savings behavior. This plan is relevant to the future Special Administrative Region and interests of the people of Hong Kong, as well as the continuity of fiscal policy stance before and beyond 1997. For these reasons this plan should be carefully addressed based on as broad a consensus as possible after consultation with China.

To conclude, a few final words on productivity. During the past few years, the Hong Kong economy has been racing around its full employment level. Excess domestic demand pressures have been compounded by shortages in the labor supply and capital formation. Given the demographic pattern and domestic saving and investment propensity in Hong Kong, improvements in the total factor productivity rather than the factors themselves will play a critical role in assuring sustained economic growth in the medium term. As ongoing structural change continues, Hong Kong entrepreneurs will surely embrace new technology to preserve their competitive edge in a more interdependent world economy. But, workers released as a result of outposting of the manufacturing sector into the provinces in southern China, will find it more difficult to find skilled jobs in the service sector. In this context, the establishment of retraining facilities will be more crucial for helping these people to reposition themselves and thus enhance productivity.