

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

**FOR
AGENDA**

MASTER FILES
ROOM C-525

0450

SM/95/23
Supplement 1

CONTAINS CONFIDENTIAL
INFORMATION

February 13, 1995

To: Members of the Executive Board

From: The Secretary

Subject: United Kingdom - Hong Kong - Staff Report for the
1994 Article IV Consultation Discussions

The attached paper provides additional information to the staff report on the 1994 Article IV consultation discussions with respect to Hong Kong (SM/95/23, 1/30/95).

Mr. Khor (ext. 37342) or Mr. Mihaljek (ext. 38539) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the GATT Secretariat, following its consideration by the Executive Board.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

UNITED KINGDOM - HONG KONG

Staff Report for the 1994 Article IV Consultation Discussions
Supplementary Information

Prepared by H. Khor, D. Mihaljek, O. Fratzscher (all CTA)
and L. Aylward (TRE)

Approved by the Central Asia Department

February 9, 1995

	<u>Contents</u>	<u>Page</u>
	Basic Data	v
I.	Hong Kong's Linked Exchange Rate System	1
	1. Linked exchange rate system	1
	2. Comparison with conventional currency board system	2
	3. Monetary management in Hong Kong	5
	References	12
II.	Business Cycles in Hong Kong	13
	1. Analytical framework	13
	2. Characteristics of Hong Kong's business cycles	14
	3. Synchronization of business cycles	18
	4. Evolution of monetary conditions over the business cycles	18
	5. Fiscal outcomes and the business cycle	21
	6. Conclusions	21
	References	22
III.	Fiscal Policy Framework in Hong Kong	23
	1. Actual budget outturn versus the initial budget	23
	2. Cyclical effects of the budget	27
	3. Conclusions	29

	<u>Contents</u>	<u>Page</u>
IV.	The Financial System and the Regulatory Framework in Hong Kong	31
	1. Banking sector	31
	2. Securities market	40
	3. Conclusions	48
	References	49
	<u>Attachment I</u> Summary of Hong Kong Banking Regulations	50
	<u>Attachment II</u> Cross-country Comparisons of Disclosure by Banks to Financial Authorities	53
V.	Economic Integration Between China and Hong Kong	54
	1. Trade links	54
	2. Production links	59
	3. Financial integration	62
	4. Other areas of economic integration	67
	5. Conclusions	67
	References	73
	<u>Annex</u> Economic Provisions of the Joint Declaration and Basic Law	74
 <u>Text Tables</u>		
1.	Business Cycles in Hong Kong, China, and the United States, 1961-1993	16
2.	Deviation of Actual Budget Outcomes from Initial Budgets, 1984/85-1993-94	24
3.	Discrepancy between Actual, Preliminary, and Projected Budgetary Outcomes, 1984/85-1993/94	26
4.	Medium-Range Fiscal Forecast, 1993/94-1997/98	30
5.	Economic Contribution of the Financial Sector, 1985 and 1993	32
6.	Balance Sheet of All Authorized Institutions, September 1994	35
7.	Loans and Advances by Type, September 1994	36
8.	Share of Property-Related Loans in Total Lending, 1986-94	38
9.	Hong Kong and World Stock Market Performance, 1985-94	42
10.	Stock Market Capitalization and Turnover by Sector, 1990-94	44
11.	Hong Kong and Regional Markets' P/E Ratios and Dividend Yields, 1989-94	46
12.	Share of Trade Between Hong Kong and China in Their Total Trade, 1975-94	55

	<u>Contents</u>	<u>Page</u>
 <u>Text Tables</u> (cont'd.)		
13.	Trade with China, 1975-94	57
14.	Trade Linked to Hong Kong Outprocessing Operations in China, 1989-94	60
15.	Hong Kong Banks' Claims and Liabilities to Banks in China, 1989 and 1994	64
16.	H-Share Launch and Market Data	65
17.	Hong Kong's Foreign Direct Investment in China, 1988-93	68
18.	Summary of Types of Economic Integration Between Hong Kong and China	70
19.	Benefits of Economic Integration to Hong Kong and China	71
 <u>Appendix Tables</u>		
1.	Gross Domestic Product by Expenditure Component at Constant (1990) Market Prices, 1989-94	82
2.	Gross Domestic Product by Expenditure Component at Current (1990) Market Prices, 1989-94	83
3.	Gross Domestic Product by Sector at Current Prices, 1988-92	84
4.	Composition of Gross Fixed Capital Formation at Constant (1990) Market Prices, 1989-93	85
5.	Selected Price Indicators, 1988-94	86
6.	Labor Force, Employment, and Unemployment, 1989-94	87
7.	Indicators of Wages, Labor Productivity, and Unit Labor Costs, 1988-94	88
8.	Real Estate Price and Rental Indices, 1989-94	89
9.	Consolidated Government Account, 1989/90-1994/95	90
10.	Revenue (General Revenue Account), 1989/90-1994/95	91
11.	Government Expenditure Under the General Revenue Account, 1989/90-1994/95	92
12.	Public Expenditure by Function, 1990/91-1994/95	93
13.	Monetary Indicators, 1989-94	94
14.	Loans for Use in Hong Kong, 1989-94	95
15.	Interest Rate Differentials, 1990-94	96
16.	Exchange Fund Balance Sheet, 1988-93	97
17.	Exchange Rate Indices, 1990-94	98
18.	Equity Price Developments, 1987-94	99
19.	Balance of Trade in Goods and Nonfactor Services, 1989-94	100
20.	Imports, Re-Exports, and Retained Imports, 1989-94	101
21.	Merchandise Trade Developments, 1989-94	102
22.	Direction of Trade by Area and Major Partners, 1989-94	103
23.	Structure of Trade with China, 1984-94	104

	<u>Contents</u>	<u>Page</u>
<u>Charts</u>		
1.	Exchange Rate Developments, 1983-94	3
2.	Interest Rate Developments, 1985-94	8
3.	Actual and Potential Output, 1961-93	15
4.	Indicators of Cyclical Position of the Economy, 1980-93	17
5.	Business Cycles in Hong Kong, China, and the United States, 1980-93	19
6.	Business Cycles, Monetary Conditions, and Fiscal Outcomes, 1980-93	20
7.	Actual Budget Outcomes Compared with Initial Budgets, 1984/85-1993/94	25
8.	Intended and Actual Effects of Fiscal Policy, 1984/85-1993/94	28
9.	Assets of Licensed Banks by Type, 1985-94	34
10.	Comparative Stock Market Capitalization Indices, 1985-93	41
11.	Hang Seng Index, 1982-94	47
12.	Trade with China, 1975-94	56
13.	Structure of Hong Kong's Trade with China	58
14.	Impact of Economic Integration with China, 1975-94	61
15.	The Hang Seng Index and the China Enterprises Index, 1993-94	66

Hong Kong

Basic Data

Area: 1,078 square kilometers
Population (mid-1994): 6.06 million
GDP per capita (1993): US\$19,385

	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u> ^{1/}
<u>GDP</u> (HK\$ billions, current prices)	523.9	582.5	668.5	778.9	887.6	472.6 ^{1/}
<u>Population growth</u> (percent)	1.0	0.3	0.9	1.0	1.8	2.4
<u>Annual percentage changes</u>						
Real GDP	2.6	3.4	5.1	6.0	5.8	5.5 ^{2/}
GDP deflator	12.3	7.5	9.2	9.9	7.8	8.5 ^{2/}
Hong Kong dollar M3	15.0	14.8	15.6	13.7	25.2	10.6 ^{3/}
Budget revenue ^{4/}	13.4	8.6	26.9	16.9	25.5	7.9
Budget expenditure ^{4/}	32.7	19.9	7.8	22.9	29.0	13.7
Exports of goods ^{5/}	15.7	12.2	19.7	20.8	13.1	11.0 ^{6/}
Domestic exports ^{5/}	3.0	0.8	2.3	1.3	-4.7	-2.1 ^{6/}
Re-exports ^{5/}	25.9	19.5	29.2	29.2	19.2	14.6 ^{6/}
Imports of goods ^{5/}	12.8	14.2	21.2	22.6	12.2	14.5 ^{6/}
Real effective exchange rate	6.5	5.7	7.2	4.2	6.3	6.7 ^{7/}
<u>Ratios to GDP</u>						
Gross domestic investment	26.7	27.4	27.2	28.5	26.6	32.9 ^{1/}
Balance of trade ^{5/}	1.0	-0.9	-2.4	-4.3	-3.3	-10.1 ^{1/}
Balance of goods and nonfactor services ^{5/}	11.5	8.5	6.6	5.8	8.0	1.7 ^{1/}
Budget revenue ^{4/,8/}	15.7	15.4	17.0	17.0	18.8	17.7
Budget expenditure ^{4/,8/}	13.6	14.7	13.8	14.6	16.5	16.3
Budget balance ^{4/,8/}	2.1	0.7	3.2	2.5	2.3	1.3
<u>Balance of payments</u> (US\$ billions) ^{5/}						
Exports of goods	73.1	82.2	98.6	119.5	135.2	109.8 ^{9/}
Domestic exports	28.7	29.0	29.7	30.2	28.8	20.7 ^{9/}
Re-exports	44.4	53.2	68.8	89.2	106.4	89.0 ^{9/}
Exports of nonfactor services	16.3	18.3	20.7	24.9	28.9	16.0 ^{1/}
Imports of goods	72.2	82.5	100.2	123.4	138.7	117.5 ^{9/}
Imports of nonfactor services	9.3	11.3	13.0	14.7	16.0	8.8 ^{1/}
Balance on goods and nonfactor services	7.7	6.3	5.7	5.8	9.2	1.1 ^{1/}

Sources: Data provided by the Hong Kong authorities; and staff estimates.

^{1/} First half of year.

^{2/} January-June over corresponding year-earlier period.

^{3/} Average increase for the three-month period ending in November.

^{4/} Consolidated account. Fiscal year begins April 1. Data for 1994/95 are staff projections.

^{5/} National accounts data.

^{6/} January-September over corresponding year-earlier period.

^{7/} January-November over corresponding year-earlier period.

^{8/} Fiscal year receipts and expenditures divided by calendar year GDP.

^{9/} January-September.

I. Hong Kong's Linked Exchange Rate System 1/

Hong Kong's existing monetary system and exchange rate regime, known as the "linked exchange rate system," is a variant of the conventional currency board system. This chapter describes the main characteristics of the linked exchange rate system, compares it with conventional currency boards and central banks, and describes the main monetary policy instruments that the Hong Kong authorities have developed in recent years to stabilize the interbank market.

1. Linked exchange rate system

The linked exchange rate system, established in its present form in October 1983, is basically a currency board arrangement under which bank notes are issued and redeemed against U.S. dollars at a fixed exchange rate. 2/ In particular, to issue Hong Kong dollar bank notes, the three note-issuing banks are required to submit U.S. dollars to the Exchange Fund in return for non-interest bearing Certificates of Indebtedness (which serve as legal backing for the note issue) at the rate of HK\$7.80 per US\$1. Other banks may purchase bank notes from the note-issuing banks at the Hong Kong dollar face value. All other foreign exchange transactions are conducted at the market determined rate.

By establishing the linked exchange rate system, Hong Kong essentially reverted to the currency board arrangement that operated between 1935 and 1972. The experience under the nine years of the floating exchange rate regime (1974-83) was, in general, unsatisfactory. Toward the end of this period, the Hong Kong dollar depreciated continuously, credit and money expanded rapidly, and inflation was persistently high, reflecting to a large extent a lack of effective monetary control. In 1983, uncertainties arising from Sino-British negotiations on Hong Kong's future exacerbated currency instability and led to a currency crisis. At the height of this crisis, the Hong Kong dollar depreciated by 15 percent in two days, and rumors spread about the solvency of depository institutions. To re-establish confidence in both the currency and the banking system, the authorities found it essential to revert to the trusted principles of the currency board. From October 17, 1983, the note-issuing banks were thus required to pay U.S. dollars to the Exchange Fund as full cover for bank notes issued, at a fixed

1/ The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

2/ Hong Kong's currency board--the Exchange Fund--was established under the Currency Ordinance of December 6, 1935 (later renamed as the Exchange Fund Ordinance). Since the establishment of the Hong Kong Monetary Authority (HKMA) on April 1, 1993, the Exchange Fund has been operated and managed by the HKMA.

rate of HK\$7.80 per US\$1. This measure laid the foundation for Hong Kong's linked exchange rate system. 1/

In subsequent years, the linked exchange rate system proved remarkably successful. Fluctuations in the market exchange rate have generally been less than 1 percent on either side of the parity, despite the political and economic shocks that have buffeted Hong Kong since 1983 (Chart 1). The foreign exchange reserves of the Exchange Fund had risen to US\$43 billion by end-1993, equivalent to almost five times the currency in circulation. A major part (about one third) of the foreign reserves is the counterpart of the fiscal reserves which had accumulated steadily over the years, reflecting prudent fiscal policy.

2. Comparison with conventional currency board system

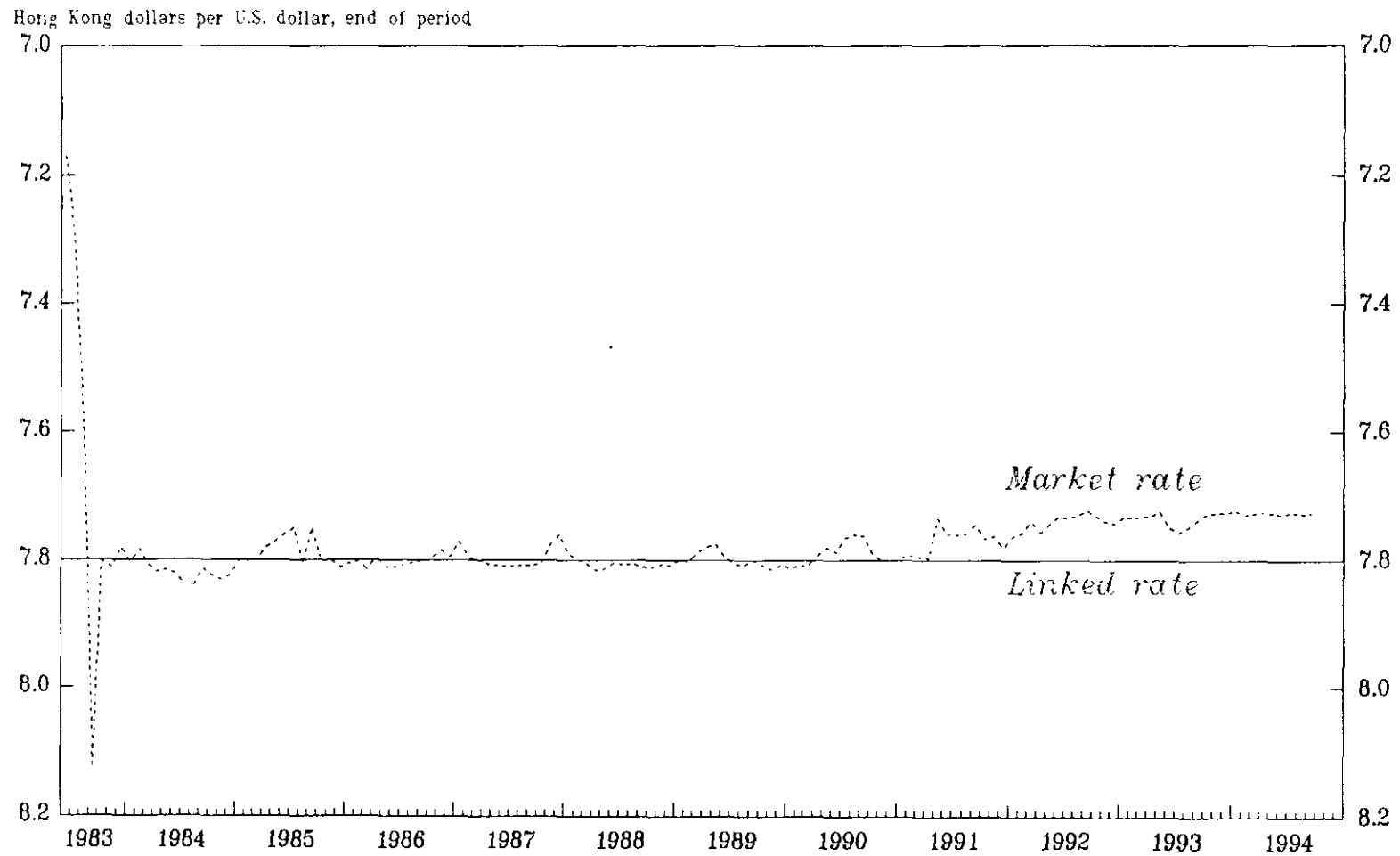
Under a currency board arrangement, the monetary authorities agree to supply or redeem local currency bank notes (and, if applicable, reserve deposits of commercial banks held with the currency board) for a convertible currency (usually of a trading partner country with low inflation) at a fixed exchange rate and without limit.

Under Hong Kong's version of a currency board, the legal tender notes are issued by three private commercial banks rather than by a government-appointed board of currency commissioners. 2/ The three note-issuing banks can convert Hong Kong dollar bank notes into U.S. dollars at the linked rate to arbitrage the gap between the market and linked exchange rates. Other banks do not have access to the linked rate but their

1/ Another measure taken at that time was to abolish the withholding tax on interest income from Hong Kong dollar deposits held with financial institutions, which removed the tax advantage from holding foreign currency deposits.

2/ The Hong Kong dollar bank notes are issued by, bear the name of, and are the liabilities of three private banks--the Hongkong and Shanghai Banking Corporation Limited (HSBC), the Standard Chartered Bank, and the Bank of China. Nevertheless, the Exchange Fund Ordinance provides that the backing for bank note issue may be used for the redemption of such notes in the event of a note-issuing bank being wound up. The Hong Kong Monetary Authority only issues coins.

CHART 1
HONG KONG
EXCHANGE RATE DEVELOPMENTS, 1983-94



Source: IMF, International Financial Statistics.

transactions are for Hong Kong dollar value. 1/ As a result, there is a slight deviation between the market exchange rate and the linked rate. 2/

Another important difference between the linked exchange rate system and a conventional currency board is that Hong Kong's monetary authorities do not operate the payments system. The clearing and settlement system in Hong Kong has been traditionally handled privately through a central clearing system under the management of the HSBC. As a result, the link between the supply of interbank liquidity and transactions between the Exchange Fund and the banking system was weaker than in the conventional currency board system. 3/ To address this problem, in July 1988, the Accounting Arrangements between the Exchange Fund and the Hongkong and Shanghai Bank were established under which the HSBC is required to hold a certain balance (i.e., the Balance) in a clearing account with the Exchange Fund, and to manage the net clearing balances (NCB) of the other banks at a level not to exceed the Balance. By varying the amount of the Balance, the HKMA is able to control liquidity in the interbank market. 4/ The effectiveness of these operations has been enhanced by the introduction of the Exchange Fund Bills Program in 1990, the Liquidity Adjustment Facility (Hong Kong's version of a discount window) in 1992, and the Exchange Fund Notes Program in 1993. However, the scope for controlling interest rates remains limited to the very short term because of the high degree of capital mobility in Hong Kong and absence of any exchange controls. As a result, the monetary activities of the HKMA in respect of liquidity management have

1/ Before January 24, 1994, bank note transactions among banks were carried out at the linked exchange rate. But with the market exchange rate staying slightly on the strong side of the linked exchange rate, banks that were net takers of bank notes incurred a foreign exchange loss. To recoup the loss, they imposed bank note handling charges, which were unpopular among bank customers. This problem was resolved when the note-issuing banks, after consultation with the HKMA, agreed that all bank note transactions would be for Hong Kong dollar value with effect from January 24, 1994. The bank note handling charge was removed as from the same date.

2/ See Bennett (1994) for a comparison with Argentina and Estonia.

3/ To illustrate this point, suppose the Hong Kong dollar is weakening from the linked rate and the Exchange Fund wants to tighten interbank liquidity to raise interbank interest rates. To this end, the Exchange Fund would borrow from the interbank market and the HSBC would debit the clearing account of the bank that lent to the Exchange Fund. At the same time, some other customer of the HSBC may have purchased U.S. dollars and the HSBC credited the clearing account of the bank that sold the U.S. dollars with an equivalent amount of Hong Kong dollars. The level of interbank liquidity would thus be restored.

4/ Unlike the quantity of banknotes in circulation, which adjusts to demand, the amount of commercial bank clearing balances (i.e., the interbank liquidity) is now under the control of the HKMA.

been mainly confined to smoothing out the fluctuations in short-term interest rates.

On April 1, 1993, the Hong Kong Monetary Authority was established against the background of the growing importance of Hong Kong as an international financial center, and the recognition that monetary stability, the soundness and integrity of the financial system, and the efficiency of the financial infrastructure are closely interrelated and should be coordinated in a single body. By performing the important regulatory and development roles with a high degree of professionalism, the HKMA helps to maintain confidence in the financial community.

The development of monetary instruments and institutional arrangements has enabled the HKMA to perform certain functions of a conventional central bank. These include: operating a discount facility; engaging in open market operations on a daily basis, managing the foreign exchange and gold reserves, exercising regulatory powers over financial institutions, and acting as a lender of last resort. Some of these functions (discount window, lender of last resort) were performed by the HSBC in the past. However, the HKMA is not involved in such central banking functions as the issue of legal tender notes, imposition of statutory reserve requirements or selective credit controls on depository institutions, the operation of the payments system, or acting as banker for the Government.

3. Monetary management in Hong Kong

As mentioned above, the limiting nature of the original linked exchange rate system has led to the development of policy instruments and institutional arrangements that allow the HKMA to conduct open market operations in order to smooth short-run fluctuations in monetary conditions. The ultimate target of these interventions remains exchange rate stability. However, the operating target for monetary management has changed with the evolution of the monetary policy framework, notably, from the Balance in the Account that the HSBC must hold with the Exchange Fund, to overnight Hong Kong interbank offered rate (HIBOR) (since March 1994). This section provides a summary of the institutional arrangements and policy instruments introduced over the past several years. 1/

a. Removal of the floor and the ceiling of interest rates (1987 and 1988)

Objective: To discourage and counteract speculation on the linked exchange rate system.

Operation: The Specified Rate Rule (1987) allows for a charge called the "specified rate" to be imposed on large Hong Kong dollar balances

1/ For further references, see Jao (1990), Yam (1993), and Hong Kong Monetary Authority (1994a) and (1994b).

maintained on clearing accounts of licensed banks, while Amendments to the Rules (1988) allow for deposit charges to be imposed on large Hong Kong dollar deposit balances of nonbank customers (including overseas banks, financial institutions, and corporations). The specified rate and deposit charges operate as a negative interest rate scheme--those taking a speculative long position in the Hong Kong dollar are made to bear a high opportunity cost.

Amendments to the Money Lenders Ordinance (1988) exempted authorized institutions from the legal ceiling on the lending rate of 60 percent per annum (which is intended to direct against unscrupulous moneylenders). The Amendment enables banks to raise their lending rates commensurately with deposit rates, which may have to be raised substantially to deter speculation on a devaluation of the Hong Kong dollar.

Examples of Interventions and Effects: The mechanism to charge negative interest rate was put in place in 1987-88 to deter speculation on a revaluation of the linked exchange rate. In the event, a negative interest rate was not imposed. The mere threat of it was apparently effective in fending off the speculation. There has not been any speculation on a revaluation of the linked rate since then.

The only instance of a speculative attack against the Hong Kong dollar took place in July 1984. 1/ However, since the establishment of the linked exchange rate system, the market exchange rate of the Hong Kong dollar has fluctuated within a margin of less than 2 percent around the linked rate. The fluctuations have been reduced since 1988 with the development of various instruments that allow the HKMA to intervene to bring about greater convergence of the market rate with the linked rate. Since 1991, the Hong Kong dollar has traded at a small premium over the linked exchange rate. The market exchange rate hit an 18-month low of HK\$7.77 per US\$1 on January 13, 1995, when the Hong Kong dollar (along with regional currencies) was subject to a speculative attack in the aftermath of the Mexican currency crisis. However, the exchange rate stabilized at about HK\$7.75 per US\$1 after the HKMA tightened liquidity and interbank interest rates rose.

b. Accounting Arrangements (July 1988)

Objective: To have effective control over the level of liquidity in the interbank market.

Operation: The Hongkong and Shanghai Bank, which acts as the Management Bank of the Clearing House of the Hong Kong Association of Banks, 2/ must maintain a certain balance in a clearing account with the Exchange Fund. The balance in that account (i.e., the Balance) can only be altered

1/ See Jao (1990).

2/ The payments system in Hong Kong is discussed below.

by the HKMA. The HSBC must manage the net clearing balances of the rest of the banking system having regard to the level of the Balance. 1/ If the NCB is greater than the Balance (i.e., if the HSBC has overlent to the rest of the banking system), the HKMA charges a penal interest on the HSBC in respect of the excess amount. If the NCB is negative, a penal interest is charged on the debit balance. Under the Accounting Arrangements, the Balance maintained by the HSBC with the Exchange Fund represents the total supply of interbank liquidity. When the HKMA reduces the level of the Balance, it tightens liquidity of the banking system, and vice versa. 2/ The changes in interbank liquidity, in turn, influence interbank interest rates and ultimately the market exchange rate of the Hong Kong dollar.

The HKMA can vary the amount of interbank liquidity (i.e., the Balance) by means of the following tools: (i) direct borrowing and lending of Hong Kong dollars in the interbank market; (ii) sale and purchase of foreign currencies against Hong Kong dollars; (iii) issue, sale, or purchase of Exchange Fund bills and notes; and (iv) transfer of funds between the Treasury and the Exchange Fund. The choice among these tools in particular circumstances depends on such factors as market conditions, cost, risk, and the cash flow at the time of the intervention.

Examples of interventions and effects: The Balance was changed on five occasions in 1993, mainly to accommodate the huge demand for interbank liquidity in the days just before major initial public offerings (IPOs) in the stock market. In the largest such IPO (which was 600 times over-subscribed) HK\$240 billion (two times the average daily turnover in the interbank market) had to be recycled, so the HKMA increased the Balance to HK\$2.2 billion by HK\$650 million which eased market conditions. Overall, the interbank interest rate has been more stable since the establishment of the Accounting Arrangements (Chart 2).

c. Exchange Fund Bills (1990) and Notes (1993) Programs

Objective: To facilitate open market operations and develop the domestic debt market.

Operation: Bills with maturities of three and six months and one year, and notes with maturity of two, three, and five years are issued regularly by the Exchange Fund and purchased mainly by the banks for liquidity management purposes.

Developments: From 1990, when the first bills were issued, to end-1994, the outstanding balance of bills and notes rose to HK\$52 billion.

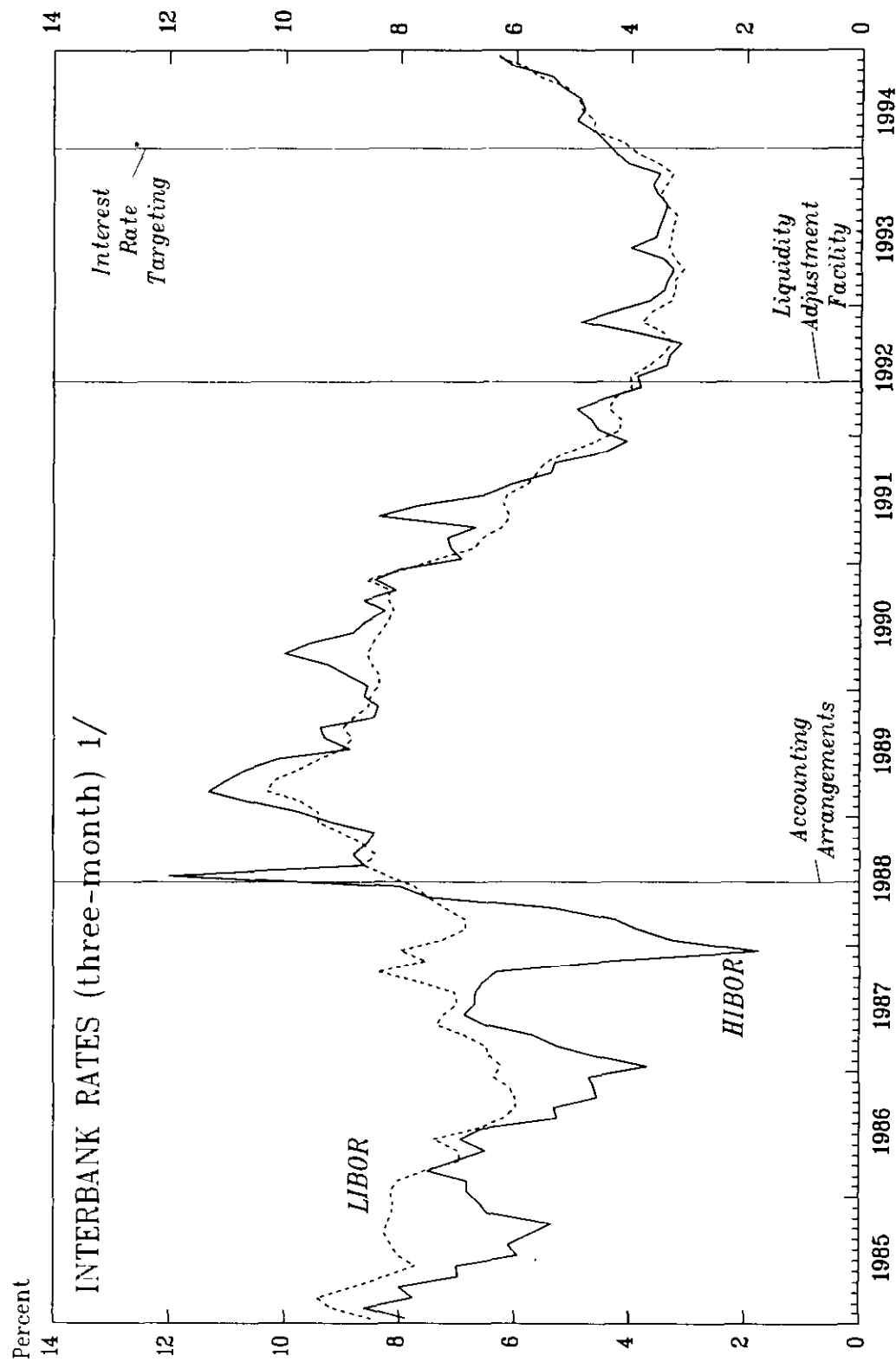
1/ The NCB is the net clearing balances of all licensed banks other than the HSBC, excluding Hong Kong dollar cash.

2/ The job of the HSBC as the clearing bank is to manage the net clearing balances of the rest of the banking sector at a level that does not exceed its own balance with the Exchange Fund.

CHART 2

HONG KONG

INTEREST RATE DEVELOPMENTS, 1985-94 (in percent per annum)



Sources: Hong Kong Monetary Authority, Monthly Statistical Bulletin; Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and IMF, International Financial Statistics.

1/ End-of period London interbank offered rate and Hong Kong interbank offered rate.

The HKMA has used the bills and notes to sterilize the strong capital inflows experienced during the past few years. The third issue of three-year Exchange Fund notes took place on July 25, 1994. These notes were the first to mature after July 1, 1997. On September 26, 1994, five-year Exchange Fund notes were issued for the first time at a spread of 37 basis points above the corresponding U.S. Treasury instrument. The yield curve for Hong Kong dollar debt instruments was thereby extended to five years. The yields on these three-year and five-year notes have served as benchmarks for the development of a Hong Kong dollar debt market.

d. Liquidity Adjustment Facility (June 1992)

Objective: To influence and stabilize short-term interbank interest rates.

Operation: The Liquidity Adjustment Facility (LAF) is a discount window facility that enables banks to make late adjustments to their liquidity positions through a Sale and Repurchase Agreement of government debt with the HKMA. The LAF is only open during the final hour of the working day. The spread between the offer and bid rates is currently 2 percentage points with the midpoint set equal to the U.S. Federal Reserve discount rate.

Examples of Interventions and Effects: LAF bid and offer rates were raised three times in 1994 in response to U.S. interest rate increases (in May, August, and November). During January-September, a total of HK\$44 billion was lent through the LAF, while the surplus funds placed with the HKMA amounted to HK\$133 billion, reflecting a surplus of interbank liquidity. The HKMA did not withdraw excess liquidity in order to prevent an increase in short-term interest rates, which would have put pressure on the exchange rate of the Hong Kong dollar, that was already on the strong side of the link. The LAF, in conjunction with the Accounting Arrangements, has helped to stabilize interbank interest rates (Chart 2).

e. Interest rate targeting (March 1994)

Objective: To stabilize overnight HIBOR within the range set by the LAF bid and offer rates.

Operation: The HKMA injects liquidity into the banking system to prevent the overnight HIBOR from breaching the LAF offer rate. Excess liquidity is withdrawn when the overnight HIBOR approaches the LAF bid rate.

Examples of Intervention and Effects: The HKMA injected additional liquidity amounting to HK\$4.2 billion on August 30 and September 20, 1994 to relieve a temporary tightness in the interbank market, as overnight HIBOR hit the LAF offer rate of 5 percent. As the overnight HIBOR dropped below the LAF offer rate and the market exchange rate stabilized, the additional liquidity was withdrawn. Since the introduction of this procedure, the overnight HIBOR has been effectively stabilized within the bid and offer

rates of the LAF. An exception was on January 13, 1995, when the overnight HIBOR briefly rose to 12 percent, much higher than the then-prevailing LAF offer rate at 5.75 percent. The interest rate hike was a result of a shortage in interbank liquidity engineered by the HKMA in response to speculations on the Hong Kong dollar (as well as other Asian currencies) following the Mexican currency crisis.

f. Recent (1993) and expected (1996) developments in payment and settlement system

Objective: To develop a sound and robust market infrastructure supporting Hong Kong's role as a major international financial center.

Operation: Hong Kong's existing payment and settlement system was established in 1981. It is operated by the Clearing House of the Hong Kong Association of Banks and managed by the Hongkong and Shanghai Bank (the Management Bank). The system consists of the Management Bank, 10 Settlement Banks, and 159 Subsettlement Banks. ^{1/} The system clears and settles over 600,000 items daily through an automated transfer system. The amount of payments settled as a ratio of GDP is comparable with that in the United States and the United Kingdom.

The Central Moneymarkets Unit (CMU), the centralized clearing and settlement system for Hong Kong dollar debt securities, extended its service to private sector debt securities in January 1994. The purpose of the CMU is to facilitate the development of Hong Kong's debt market by providing an efficient clearing system that reduces transactions costs and settlement risk. By end-1994, the CMU service had 174 members and the total value of debt issues lodged with the service was HK\$31 billion.

The HKMA has also announced plans for the introduction of a Real Time Gross Settlement (RTGS) system by 1996. This would be a single-tier system in which all licensed banks would maintain clearing accounts with the HKMA for final settlement of interbank fund transfers. It would allow for domestic and international linkages to facilitate real time delivery versus payment and real-time payment versus payment. This system would minimize the "contagion effect" stemming from the so-called Herstatt risk, which arises in foreign exchange transactions when one counterparty delivers currency in one time zone and receives value in the other currency in

^{1/} The Subsettlement Banks maintain clearing accounts with their respective Settlement Bank, which in turn maintain their clearing accounts with the Management Bank. A penal interest rate is charged on any negative clearing balance. The Management Bank itself did not have a clearing account before the Accounting Arrangements were established in 1988. The commercial transactions carried out by the HSBC and its customers could thus neutralize monetary policy operations undertaken by the Exchange Fund.

another time zone. 1/ The RTGS system would be linked to the new 18-hour Fedwire (to be introduced in early 1997) and to the new payments system to be established in China by 1997. This link would enable instantaneous settlement of payments on a 24-hour global basis and enhance Hong Kong's competitiveness as an international financial center.

Once the RTGS is in place, banks would clear through the HKMA rather than through the Hongkong and Shanghai Bank as at present. This would have important implications for monetary management because the HKMA would assume direct control of interbank liquidity. As described above, the HKMA presently controls the interbank liquidity indirectly, by adjusting the amount of the Balance that the Hongkong and Shanghai Bank must hold with the HKMA.

1/ It was named after a German commercial bank I.D. Herstatt which failed in 1974 because of foreign exchange losses incurred in transactions involving several time zones.

References

- Bennett, Adam G.G., "Currency Boards: Issues and Experiences."
IMF Paper on Policy Analysis and Assessment 94/18 (1994).
- Hong Kong Monetary Authority, Monetary Management in Hong Kong.
Proceedings of the Seminar on Monetary Management Organized by the
Hong Kong Monetary Authority on 18-19 October 1993 (Hong Kong:
Hong Kong Monetary Authority, 1994a).
- _____, The Practice of Central Banking in Hong Kong
(Hong Kong: Hong Kong Monetary Authority, 1994b).
- Jao, Y.C., "From Sterling Exchange Standard to Dollar Exchange Standard:
The Evolution of Hong Kong's Contemporary Monetary System, 1967-
1989."
In Y.C. Jao and Frank H.H. King, Money in Hong Kong: Historical
Perspective and Contemporary Analysis (Hong Kong: Centre of Asian
Studies, University of Hong Kong, 1990).
- _____, "Money and Banking." In H.C.Y. Ho (ed.), The Economic System
of Hong Kong (Hong Kong: Asian Research Service, forthcoming).
- Latter, Anthony, "The Currency Board Approach to Monetary Policy," in
Hong Kong Monetary Authority, Monetary Management in Hong Kong.
Proceedings of the Seminar on Monetary Management Organized by the
Hong Kong Monetary Authority on 18-19 October 1993 (Hong Kong:
Hong Kong Monetary Authority, 1994), pp. 26-43.
- Yam, Joseph, "The Development of Monetary Policy in Hong Kong," in
Monetary Management in Hong Kong: The Changing Role of the
Exchange Fund (1993).

II. Business Cycles in Hong Kong

This chapter reviews the business cycles in Hong Kong and analyzes interactions between monetary and fiscal conditions and the business cycles. Section 1 describes an analytical framework for measuring business cycles, and Section 2 the characteristics of the business cycles of Hong Kong. Section 3 reviews the synchronization of the business cycles in Hong Kong, China, and the United States. Section 4 discusses the evolution of monetary conditions over the business cycle in Hong Kong, and Section 5 looks at the relationship between the business cycle and fiscal outcomes. Section 6 summarizes the main findings of the study.

1. Analytical framework

A business cycle is an empirical phenomenon founded on historical experience. The question of what precisely constitutes "aggregate economic activity" is purposely left open, as the nature of business cycles depends on, and changes with, the major characteristics of the economy, society, and polity (Zarnowitz (1991), p. 8). The primary focus of contemporary studies of business cycles has been on fluctuations in real income and output, and their relationship with employment and prices. ^{1/}

This study defines the business cycle as a cyclical phenomenon affecting the path of real output. The cycles arise when output deviates from a stable long-term growth path (i.e., from potential output) because of domestic and external shocks. The amplitude of a business cycle is measured by the output gap, which is defined as the percentage deviation of actual output from potential output. In general, a positive output gap is expected to coincide with higher employment and higher inflation, and vice versa.

There are generally two methods for measuring potential output: the first is to estimate the production function based on factor inputs, while the second is based on statistically measuring trend movements in time series of aggregate output. This study adopts the latter approach which does not require good estimates of capital stock and has been widely used for comparative purposes.

^{1/} The real business cycle theory argues that economic fluctuations arise from technological changes on the supply side (Plosser (1989)). The new Keynesian theory (Mankiw (1989)) argues that economic fluctuations originate largely from the demand-side shocks such as monetary expansion, wage growth, and fiscal policy.

To estimate potential output, this study adopts the Hodrick-Prescott filter, which basically draws a smooth line through a time series. ^{1/} The smooth line represents the structural component (i.e., potential output), whereas the difference between the actual time series and the structural component represents the cyclical component (i.e., cyclical output). ^{2/}

2. Characteristics of Hong Kong's business cycles

Chart 3 illustrates actual and potential output in Hong Kong during the period 1961-93. The upper panel shows the output gap, and the lower panel the corresponding growth rates of actual and potential output. Three main characteristics are apparent from the results.

First, Hong Kong experienced four business cycles during the past three decades. The amplitudes are large, with output gaps of more than 5 percent of potential GDP. The most recent downturn started in 1989 and it was relatively shallow (with a negative gap of only 1.3 percent in 1991). Currently, Hong Kong is still operating slightly below potential, with an output gap of about 0.7 percent.

Second, growth rates of potential output steadily declined during the past 15 years, from over 8 1/2 percent in the late 1970s to about 5 1/2 percent in 1993. Currently, actual output is estimated to be growing at 5 3/4 percent (estimates for 1994 and 1995), which is slightly higher than potential output growth. Current trends imply that the output gap would be closed relatively soon, provided there are no exogenous shocks.

Third, the fluctuations in Hong Kong's business cycles have been large, with a standard deviation of 4 percent for the period from 1961 to 1993,

^{1/} See Hodrick and Prescott (1980). Specifically, the Hodrick-Prescott filter defines a trend (τ_t) for the series (y_t), which minimizes the weighted sum of two components: squared distances between τ_t and y_t , and squared distances between τ_{t+1} , τ_t , and τ_{t-1} . This filter is applied to standardized time series in log levels, with the weight of $\lambda=100$ proposed for annual data by Kydland and Prescott (1990).

Hodrick-Prescott filter : Curved line method with $\lambda=100$

$$\underset{\tau_t}{\text{MIN}} \sum_{t=1}^T (y_t - \tau_t)^2 + \lambda * \sum_{t=2}^{T-1} [(\tau_{t+1} - \tau_t) - (\tau_t - \tau_{t-1})]^2$$

For an application of the Hodrick-Prescott filter, see Chanda and Prasad (1993), and World Economic Outlook (October 1994).

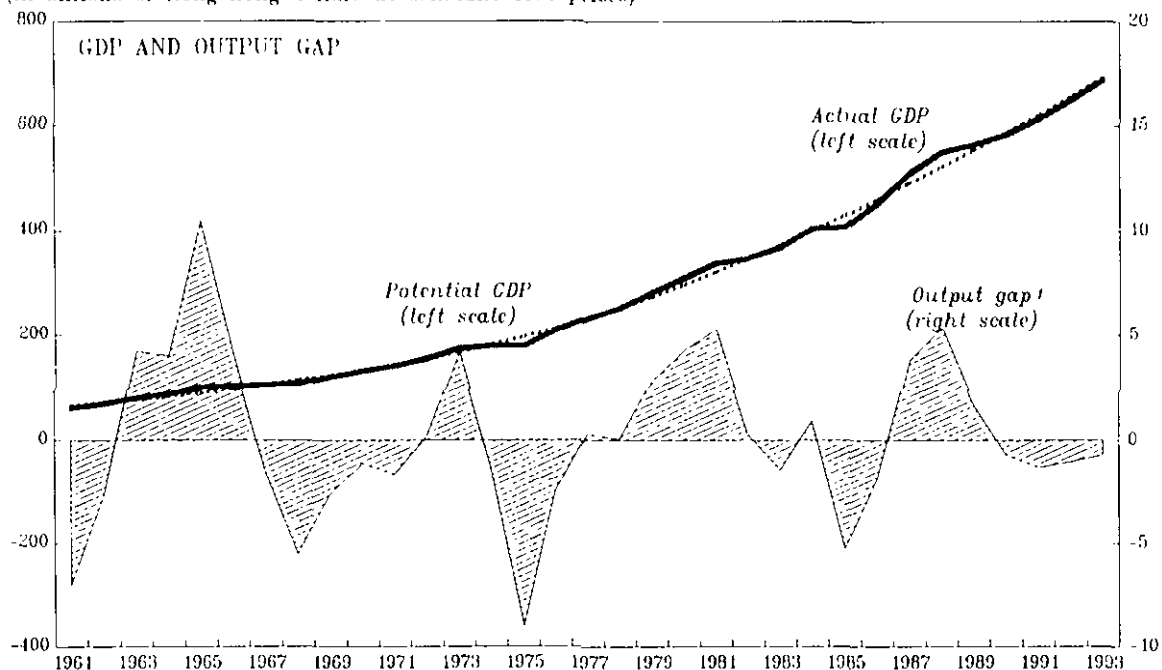
^{2/} This study also assumes that actual output continues to grow by 5 1/2 percent in 1995 and 1996, which is consistent with micro-based studies suggesting that Hong Kong's potential output has declined to annual growth rates of about 5.5-6 percent in the advanced phase of structural transformation.

CHART 3

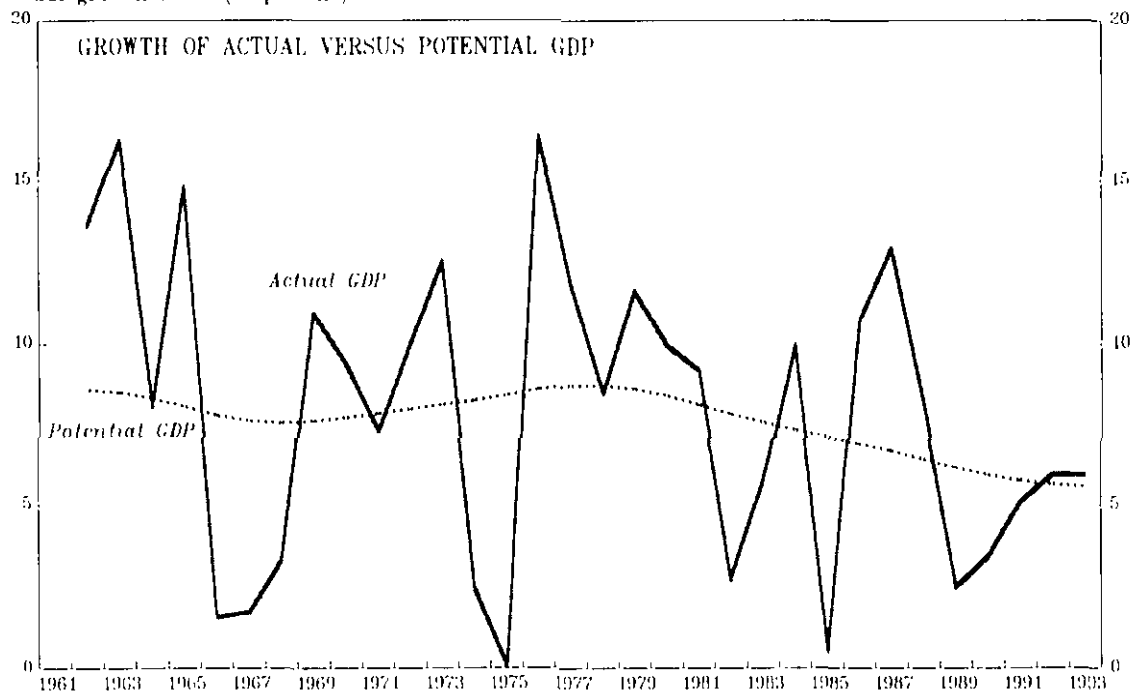
HONG KONG

ACTUAL AND POTENTIAL OUTPUT, 1961-93

Level of GDP (in billions of Hong Kong dollars at constant 1990 prices) Output gap (in percent of potential GDP)



Annual growth rates (in percent)



Sources: Census and Statistics Department, Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994; and Staff estimates

1/ Deviation of actual GDP from potential GDP.

compared with 2 percent for the United States (Table 1). However, the amplitude of the cycles appeared to have diminished greatly in recent years.

Table 1. Hong Kong: Business Cycles in Hong Kong, China, and the United States, 1961-93

	1961-93	1983-88	1988-93
Standard deviation of the output gap			
Hong Kong	3.91	3.59	2.37
China ^{1/}	3.34	3.10	3.66
United States	2.02	1.86	1.86
Correlation between the output gaps			
Hong Kong-China	0.15	0.40	0.77
Hong Kong-United States	0.38	0.48	0.78
China-United States	0.72	0.98	0.59

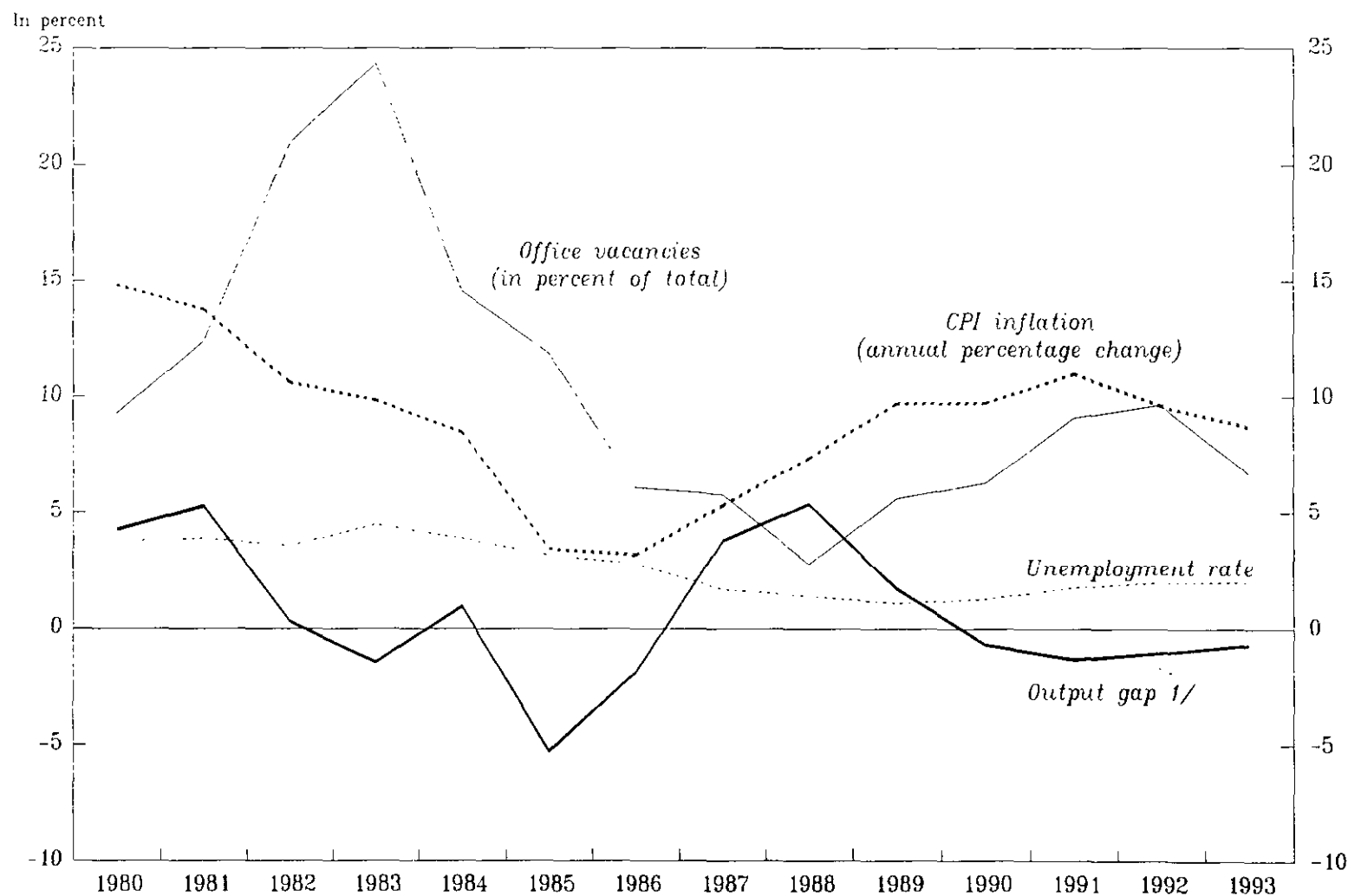
Source: Staff estimates.

^{1/} Data for China commence with 1978.

The above findings are broadly consistent with movements in other indicators of the cyclical position of the economy such as the office vacancy rate, the unemployment rate, and inflation (Chart 4). In particular, the office vacancy rate was lowest in 1988 when the output gap was at its highest, and it peaked in 1991-92 when the output gap became negative. The office vacancy rate fell in 1993 as the output gap narrowed. The movement in the unemployment rate was broadly consistent with the developments in the output gap through 1989. However, since 1989, the unemployment rate has barely moved, reflecting the large emigration of Hong Kong residents in 1990-92. Similarly, the trends in inflation were consistent with developments in the output gap through 1989. In 1990-91, however, inflation continued to rise despite a widening of the output gap, reflecting structural factors associated with the shift from low cost manufacturing into high value added manufacturing and service activities.

The developments in unemployment and inflation in 1989-91 suggest that the output gap measure does not always fully characterize the cyclical position of the economy. In particular, if excess demand develops in a given factor market (e.g., labor market), this excess demand may become the binding constraint for economic growth, notwithstanding the slack in other factor markets (e.g., the property market).

CHART 4
HONG KONG
INDICATORS OF CYCLICAL POSITION OF THE ECONOMY, 1980-93



Sources: Census and Statistic Department, Hong Kong Monthly Digest of Statistics, and Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994; and staff estimates.

1/ Deviation of actual GDP from potential GDP.

3. Synchronization of business cycles

Hong Kong's business cycle has become more synchronized with that of China since 1984. Chart 5 illustrates GDP growth rates and corresponding output gaps for Hong Kong, China, and the United States during 1980-93. Growth rates in Hong Kong and China were much higher than those observed in the United States during the past decade, and were very similar during the 1986-91 subperiod. The output gap data indicate that China's business cycle has been more volatile than that of Hong Kong, which is, in turn, more volatile than that of the United States. The recent downturn in Hong Kong and the United States has been relatively shallow, whereas the recovery in China since 1992 has been most pronounced.

China's business cycle followed the U.S. business cycle closely during 1983-88, but the two cycles have become less synchronized since then. The most recent downturn in China (as well as Hong Kong) started in 1989, one year ahead of that in the United States. Subsequently, China's economy rebounded sharply in 1992-93, whereas the U.S. economy recovered more gradually.

One measure of synchronization of the business cycles in Hong Kong, China, and the United States is the statistical correlation between output gaps. The magnitude of the correlation coefficient indicates the average degree of synchronization of the business cycles over several years. The results presented in Table 1 confirm that Hong Kong's business cycles have become more synchronized with the business cycles in both China and the United States in 1988-93. By contrast, the business cycles of China and the United States have become less synchronized over the same period.

4. Evolution of monetary conditions over the business cycles

Hong Kong's choice of the linked exchange rate system is motivated primarily by the need to maintain confidence and stability in the lead up to and beyond the transition in 1997. ^{1/} Since the adoption of this system in October 1983, monetary conditions in Hong Kong have been determined exogenously by those in the United States. To the extent that the business cycles of Hong Kong and the United States diverge, monetary conditions in Hong Kong may not correspond to the cyclical requirements of the domestic economy.

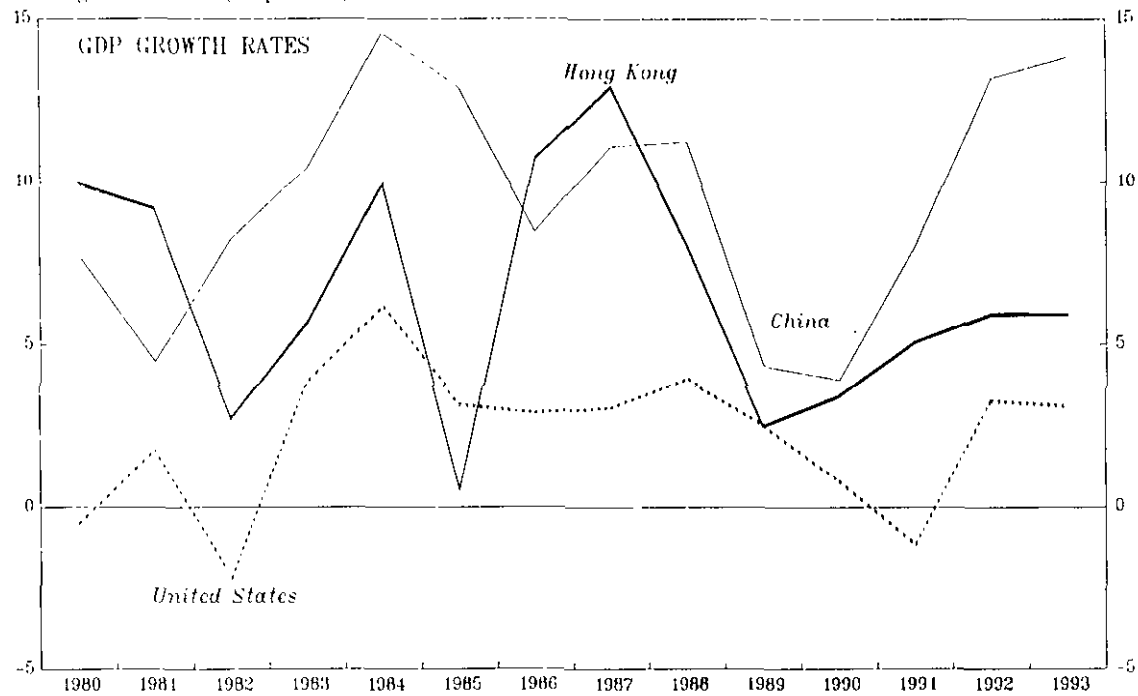
Chart 6 illustrates the evolution of real and nominal lending rates and the output gap during the period 1980-93. If the real lending rate is used as the indicator of monetary conditions, then it would appear that monetary conditions were generally procyclical during 1982-89, and countercyclical during 1990-93. However, it should be noted that inflationary pressures were high in 1990-91 and, by 1992, the economy was growing at above the potential rate and the negative output gap had narrowed significantly, so

^{1/} For a discussion of Hong Kong's monetary system, see Chapter I.

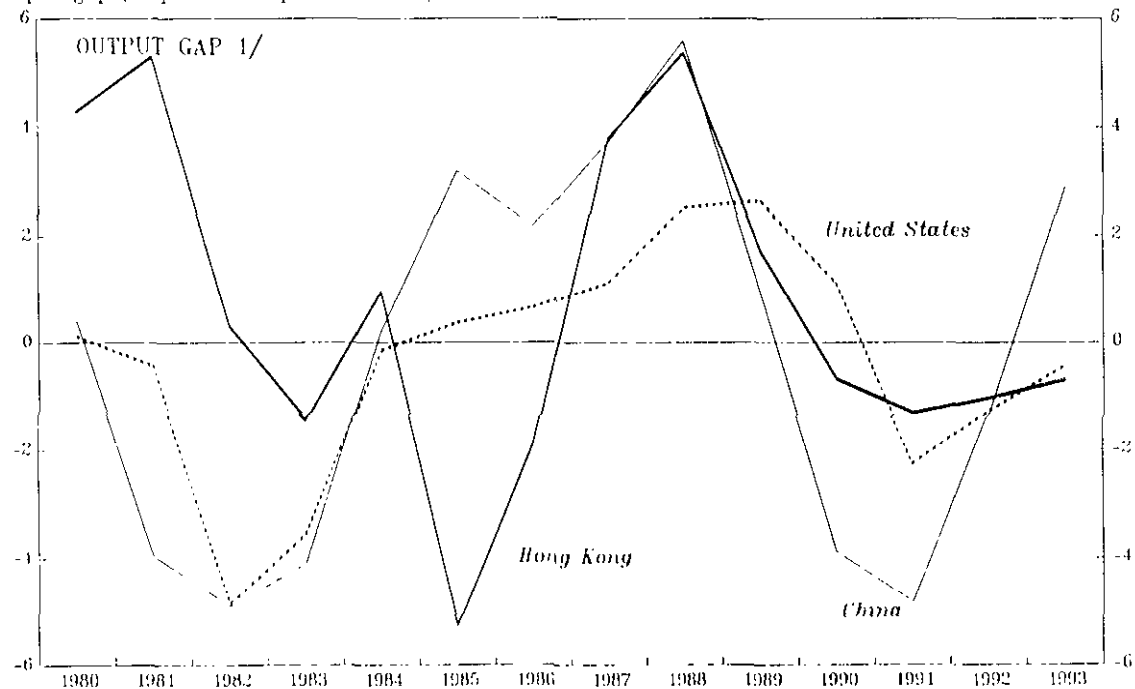
CHART 5

HONG KONG
BUSINESS CYCLES IN HONG KONG, CHINA, AND THE UNITED STATES, 1980-93

Annual growth rates (in percent)



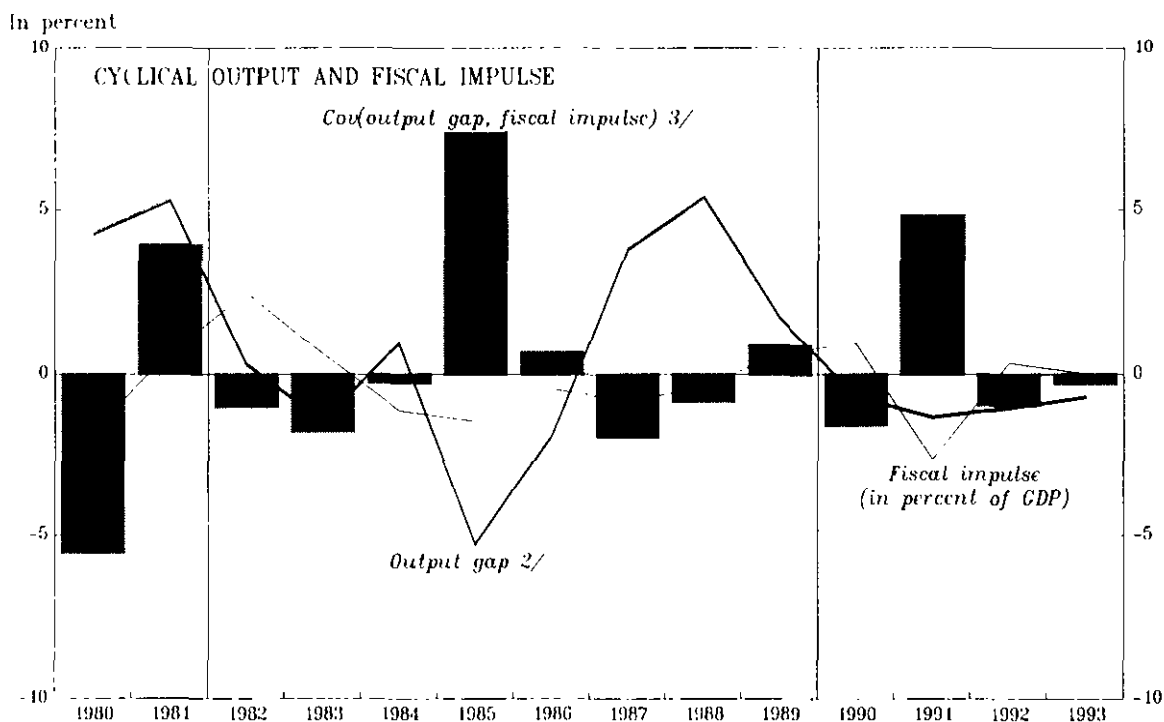
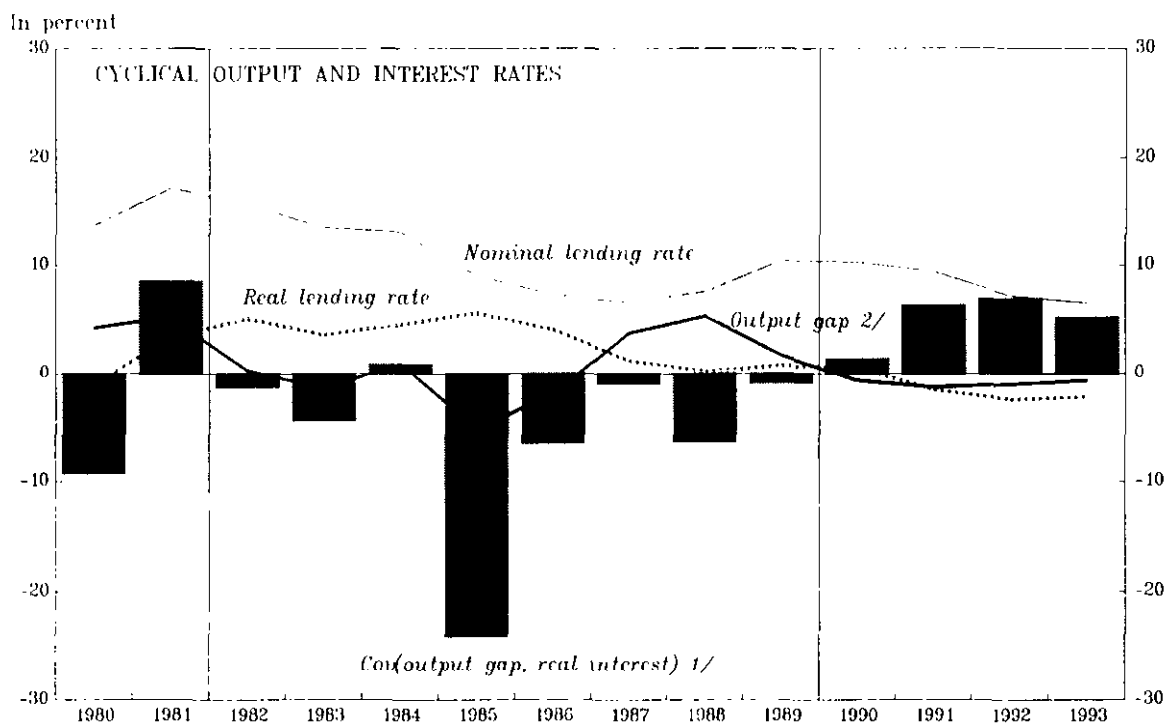
Output gap (in percent of potential GDP)



Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics, and Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994; State Statistical Bureau, China Statistical Yearbook, IMF, International Financial Statistics, and staff estimates.

1/ Deviation of actual GDP from potential GDP

HONG KONG
BUSINESS CYCLES, MONETARY CONDITIONS, AND FISCAL OUTCOMES, 1980-93



Sources: Census and Statistics Department, Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994, and Hong Kong Monthly Digest of Statistics; data provided by the Government Secretariat, Finance Branch; and staff estimates.

1/ Covariance between output gap and real lending rate.

2/ Deviation of actual GDP from potential GDP.

3/ Covariance between output gap and fiscal impulse.

that monetary conditions were generally too easy over the period. Indeed, the easy monetary conditions contributed to the boom in asset prices in 1993 and early March 1994. Since early 1994, with the rise in U.S. interest rates, Hong Kong's monetary conditions have become more in line with its cyclical requirements.

5. Fiscal outcomes and the business cycle

Fiscal policy in Hong Kong is generally prudent, aimed at achieving an overall surplus in the budget. ^{1/} Within the present analytical framework, the cyclical impact of the budget is measured by the covariance between the fiscal impulse (which measures the extent to which fiscal policy is expansionary or contractionary) and the output gap. A positive covariance indicates that the fiscal outcome had a procyclical effect in a given year, and vice versa.

The covariance analysis shows that, except for some years, the cyclical impact of the budget was small during 1980-93 (Chart 6). The covariance between the fiscal impulse and the output gap was negative in most years, indicating that fiscal outcomes were generally countercyclical. In 1985 and 1991, the covariance was highly positive, suggesting that fiscal outcomes were highly procyclical in those two years. However, the result for 1991 has to be considered in light of other indicators of the cyclical condition. In particular, inflation was rising, the labor market was tight, and growth was accelerating, which would suggest that the contractionary fiscal outcome was cyclically appropriate in 1991. In 1992-93, the covariances between the fiscal impulse and the output gap were small, which indicates that fiscal outcomes were cyclically neutral in those two years.

6. Conclusions

The discussion above has highlighted the interactions between the business cycles of Hong Kong, China, and the United States. In particular, the business cycles of Hong Kong and China have become more synchronized in recent years reflecting the increasingly close integration between the two economies. However, given the linked exchange rate system, monetary conditions in Hong Kong are determined by those in the United States. As a result, there is the potential for a misalignment between monetary conditions and the cyclical requirements of the Hong Kong economy whenever the business cycles of Hong Kong and the United States are not in phase, as was the case in 1990-93. This possibility underscores the importance of maintaining a high degree of flexibility in the factor markets and a prudent fiscal policy.

^{1/} For a detailed discussion, see Chapter III.

References

- Chadha, B., and E. Prasad, "Interpreting the Cyclical Behavior of Prices," Staff Papers, International Monetary Fund, Vol. 40 (1993), pp. 266-98.
- Hodrick, R., and E.C., Prescott, "Postwar U.S. Business Cycles: An Empirical Investigation" (unpublished, Carnegie Mellon University, 1980).
- International Monetary Fund, World Economic Outlook (Washington: IMF, October 1994).
- Kydland, F.E., and E.C., Prescott, "Business Cycles: Real Facts and a Monetary Myth," Federal Reserve Bank of Minneapolis Quarterly Review (Spring 1990), pp. 3-18.
- Mankiw, N.G., "Real Business Cycles: A New Keynesian Perspective," Journal of Economic Perspectives, Vol. 3 (1989), pp. 79-90.
- Plosser, C.I., "Understanding Real Business Cycles," Journal of Economic Perspectives, Vol. 3 (1989), pp. 51-77.
- Zarnowitz, V., "What is a Business Cycle," NBER Working Paper No. 3863 (October 1991).

III. Fiscal Policy Framework in Hong Kong

This chapter compares actual budget outturns with initial budgets and analyzes the cyclical effects of the budgets in the period 1984-93. Budgetary outcomes have persistently deviated from projections in initial budgets; as a result, the fiscal impulse of budgetary outcomes has deviated significantly from that derived from initial budgets, which has made analysis of the impact of the original budgets on the economy unreliable. The purpose of this study is to see whether there is a systematic pattern in the deviations, so that analysis of the fiscal impulse of the original budgets can take these systematic factors into account. In addition, the study analyzes the fiscal impulses of the actual outcomes to see if they have been pro- or countercyclical in relation to the business cycle.

1. Actual budget outturn versus the initial budget ^{1/}

Budgetary outcomes in the last ten years were characterized by a sizable discrepancy between actual budget outcomes and projections in initial budgets (Table 2 and Chart 7). Total revenue was, on average, 8 percent higher than projected, and total expenditure was 5 percent lower (Table 3). Current revenue was, on average, underestimated by 6 percent and capital revenue by 21 percent. The projections of current expenditure were remarkably accurate, but capital expenditure was, on average, overestimated by 12 percent in initial budgets.

Preliminary estimates of budgetary outcomes, made before the end of fiscal year in March, were in general close to actual outcomes, but preliminary estimates of actual capital expenditure were overestimated by about 5 percent on average (Table 3).

The discrepancy between actual budget outcomes and projections in initial budgets was especially pronounced in FY 1987-FY 1988 and FY 1991-FY 1993, resulting in substantial and unexpected budget surpluses of up to 3 percent of GDP (Chart 7). While in some years (FY 1986-FY 1988, FY 1993) the discrepancy resulted almost entirely from underestimates of revenue in the initial budgets, in others (FY 1991 and FY 1992) the discrepancy resulted almost equally from underestimates of revenue and overestimates of expenditure in initial budgets (Chart 7). Actual revenue was lower than projected in the budget only once in the past decade (FY 1990) and actual expenditure was higher than budgeted in three instances, but the spending overruns were relatively small (Table 2).

^{1/} The fiscal year in Hong Kong runs from April 1 to March 31. The initial budget for the coming fiscal year is usually presented in early March. The final budget outturn is available about eight months after the end of the fiscal year.

Table 2. Hong Kong: Deviation of Actual Budget Outcomes from Initial Budgets, 1984/85-1993/94

(In percent)

	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94
Actual revenue/ budget projection										
Total revenue	0.6	5.2	11.9	19.6	19.1	2.3	-2.4	7.1	5.1	11.0
Current revenue	0.4	4.6	9.7	18.2	21.5	2.1	-4.1	4.4	6.2	8.1
Capital revenue	1.8	8.3	27.8	31.5	3.3	4.7	19.8	32.4	-3.4	29.4
Actual expenditure/ budget projection										
Total expenditure	-4.7	6.6	-0.7	-0.2	1.9	4.8	-6.0	-12.0	-6.5	-3.9
Current expenditure	-3.5	-1.8	0.2	-0.2	0.3	-0.9	-4.2	-0.6	-0.4	-1.2
Capital expenditure	-7.8	35.5	-3.3	-0.4	6.5	20.2	-10.0	-36.1	-19.1	-8.4
Actual surplus minus budget projection										
In millions of Hong Kong dollars	2,040	-395	5,440	10,102	10,606	-1,407	3,248	20,111	14,309	22,521
In percent of GDP	0.8	-0.1	1.7	2.5	2.2	-0.5	0.6	3.0	1.8	2.5
Fiscal impulse--Actual budget outcome 1/										
In millions of Hong Kong dollars	-2,841	-3,904	-1,439	-3,153	-1,747	3,376	5,597	-17,576	2,812	121
In percent of GDP	-1.11	-1.44	-0.46	-0.82	-0.38	0.64	0.96	-2.63	0.36	0.01
Fiscal impulse--Intended budget outcome 2/										
In millions of Hong Kong dollars	-3,907	-1,825	63	-1,011	-1,251	-3,206	7,896	-3,967	5,483	19,980
In percent of GDP	-1.63	-0.64	0.02	-0.31	-0.31	-0.67	1.43	-0.64	0.76	2.36

Sources: Government Secretariat, Finance Branch: The Budget, 1983/84-1994/95 issues, and Estimates (various issues); Census and Statistics Department, Hong Kong Annual Digest of Statistics, and Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994; and staff estimates.

1/ Based on actual budget outcome unadjusted for government equity investments and revenue from land sales.

2/ Based on preliminary estimates of budget outcome for year (t) and projections for year (t+1), unadjusted for government equity investments and revenue from land sales.

HONG KONG

ACTUAL BUDGET OUTCOMES COMPARED WITH INITIAL BUDGETS, 1984/85-1993/94

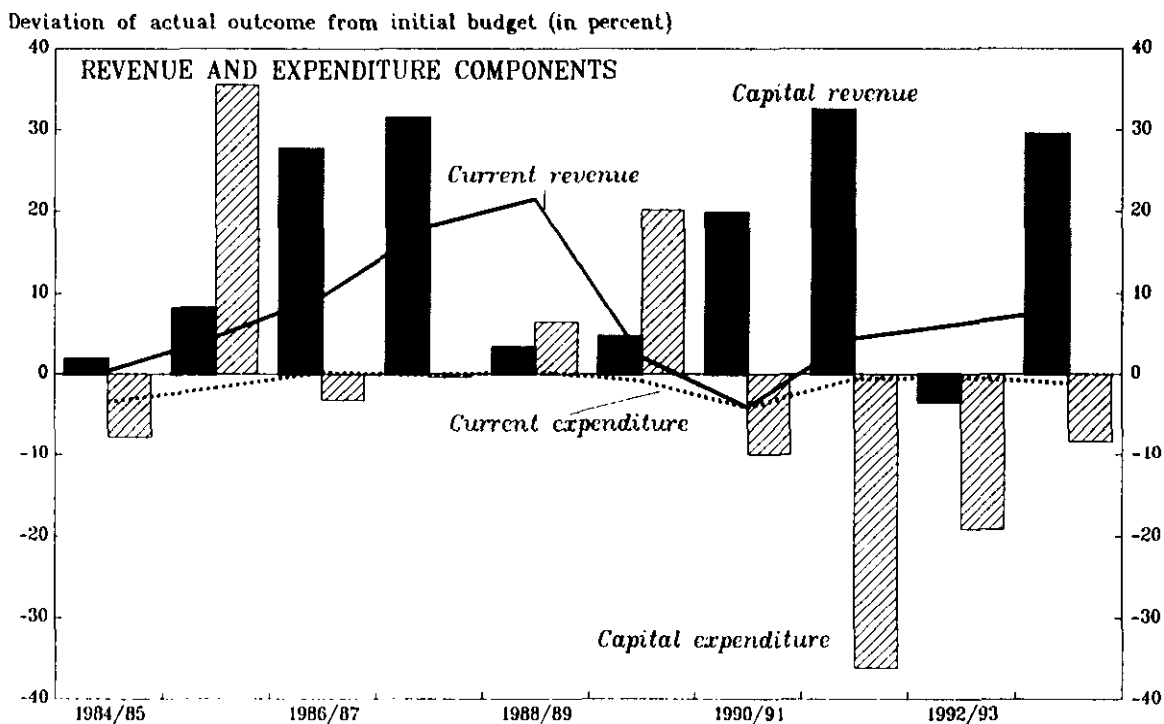
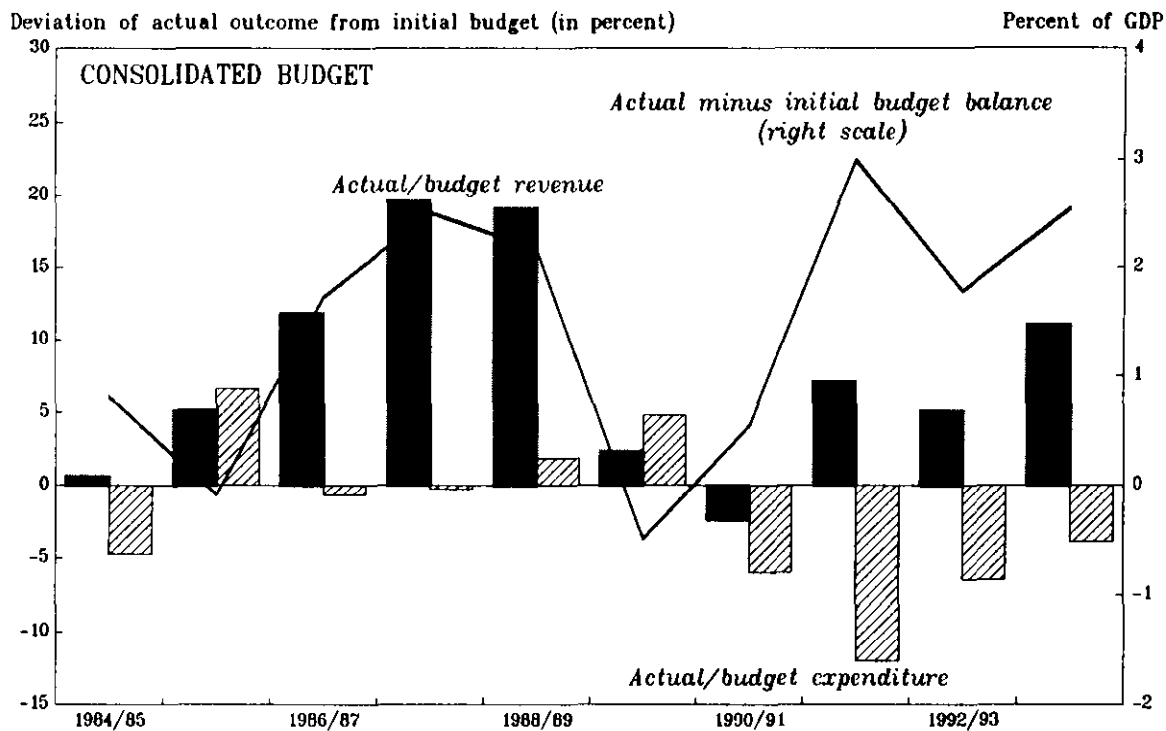


Table 3. Hong Kong: Discrepancy Between Actual, Preliminary, and Projected Budgetary Outcomes, 1984/85-1993/94 1/

(In percent)

	Deviation of Actual Outcome from Initial Budget	Deviation of Actual Outcome from Preliminary Estimate
Total revenue	7.7	1.2
Current	5.9	1.1
Capital	20.7	1.6
Total expenditure	-4.7	-2.2
Current	-1.2	-0.8
Capital	-12.4	-4.8

Source: Staff calculations.

1/ As a percentage of the initial budget (or preliminary estimate).
Estimated using ordinary least squares regressions.

The discrepancy in revenue estimates owes much to the cautious assessment of volatile sources of revenue--stamp duties on asset transactions and land sales revenue--in initial budgets. As such revenue is related to the turnover in the stock and property markets, it tends to overshoot the consistently conservative budget projections by a wide margin when the markets are very active. 1/ The underestimates of capital spending had largely resulted from project delays. In particular, forecasts of the time needed to start public works contracts had been overly optimistic in the past. 2/ Owing to improvements in planning procedures for public works projects, capital underspending has been substantially reduced since 1991.

1/ More than 50 percent of the budget surplus in FY 1993 resulted from buoyant stamp duty revenue, which was 80 percent higher than budgeted. Land revenue was 50 percent higher than projected in the FY 1993 budget.

2/ This was especially the case for public works projects outside the Airport Core Program in FY 1990-FY 1992.

2. Cyclical effects of the budget

a. Actual fiscal outcomes

To measure the impact of the budget on the economy, the fiscal impulse of the actual budgetary outcome is derived. 1/ By this measure, fiscal policy was contractionary in FY 1984-FY 1988 and FY 1991, expansionary in FY 1989-FY 1990, and neutral in FY 1992-FY 1993 (Table 2 and Chart 8). The fiscal impulse is then considered against the cyclical position of the economy to assess the cyclical impact of fiscal outcomes. 2/

In general, the fiscal impulses were either countercyclical or neutral. The fiscal contraction was countercyclical in 1986-88, when the actual GDP growth was above potential GDP growth, labor markets were tight, and inflation was on the rise. 3/ Although real GDP growth was slightly below potential in 1991, the fiscal contraction in FY 1991 was also appropriate in view of the tight labor market and high inflation. The fiscal expansion was countercyclical in 1989-90, when real GDP growth was weak and fiscal impulses (on the order of about 1 percent of GDP) had helped to stimulate the economy. The neutral impact of fiscal policy in 1992-93 was broadly in line with the cyclical requirements of the economy, which was operating at close to potential.

b. Intended effects of fiscal policy

The above analysis was conducted with reference to the impact of actual budget outcomes on the Hong Kong economy. It is equally useful to analyze the fiscal impulses implied by the original budgets, as this approach reveals what effects the budgets were intended to have at the time they were formulated. To this end, the projections contained in initial budgets are compared with preliminary budget estimates for the preceding fiscal year.

Until 1989, the original budgets in Hong Kong were generally intended to be slightly contractionary (Chart 8 and Table 2). As the economy was expected to grow rapidly in initial budgets during 1986-88, the

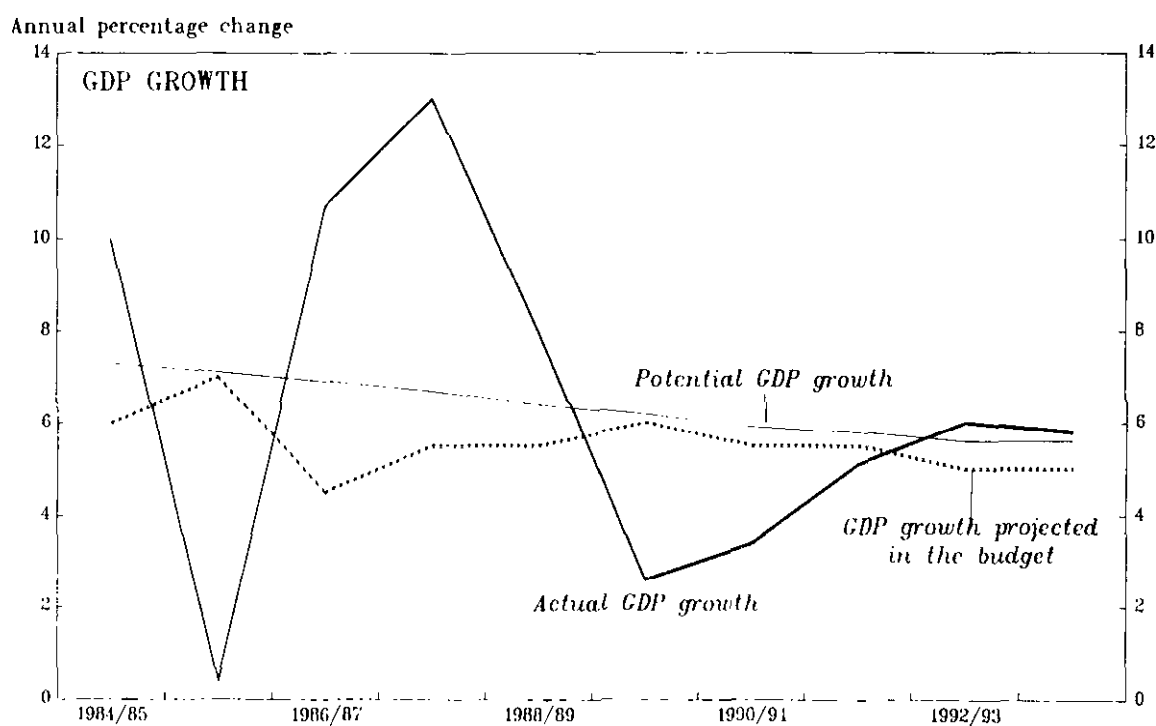
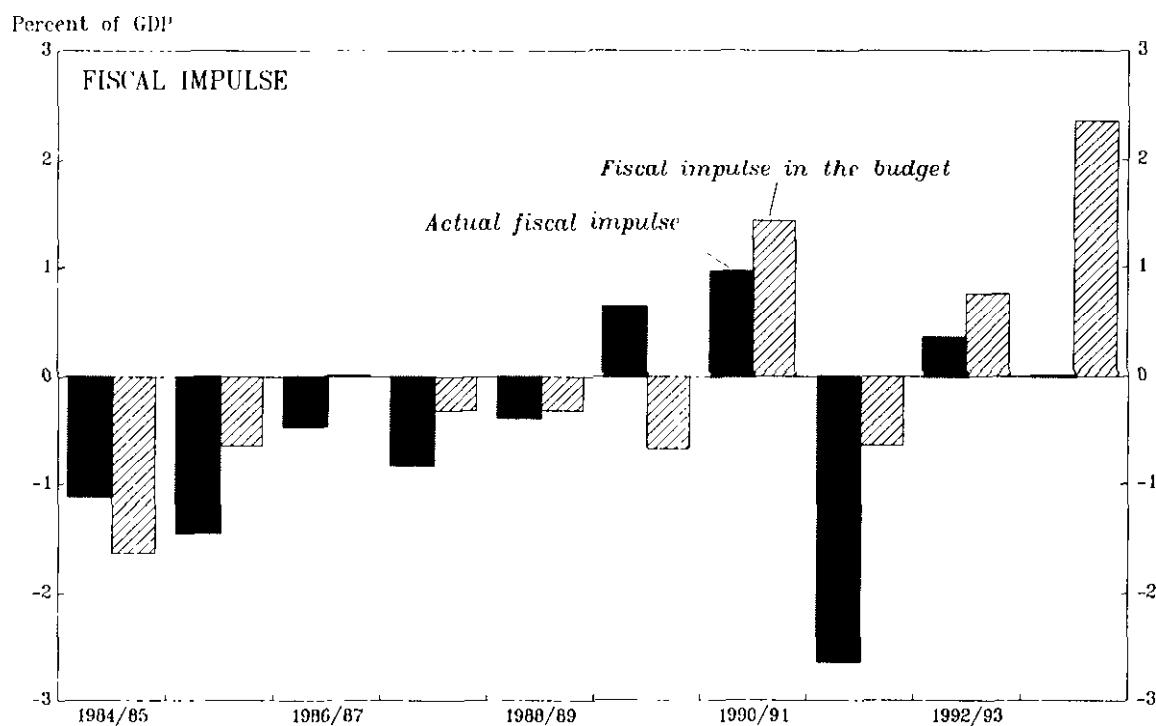
1/ The fiscal impulse measures the size of initial stimulus to aggregate demand arising from discretionary and other changes in fiscal policy after eliminating the cyclical component of the change in budget balance. A positive (negative) sign of the fiscal impulse measure indicates that fiscal policy has become more expansionary (contractionary) relative to the previous year.

2/ The determinants of the cyclical position of the economy that are considered include the level and growth rate of actual GDP relative to potential GDP; and indicators of tightness (or slack) in the labor and property markets.

3/ In 1985, however, the fiscal contraction was procyclical--the budget withdrew 1 1/2 percent of GDP in spending power from the economy, which was operating far below potential.

CHART 8

HONG KONG
INTENDED AND ACTUAL EFFECTS OF FISCAL POLICY,
1984/85-1993/94



Sources: Government Secretariat, Finance Branch, The Budget (1983/84 -1994/95 issues), and Estimates (various issues); Census and Statistics Department, Hong Kong Annual Digest of Statistics, and Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994; and staff estimates.

contractionary stance was, for the most part, in line with perceived cyclical requirements of the economy. Since 1989, however, the original budgets have tended to be expansionary, with the exception of FY 1991. As the Hong Kong economy was expected to grow strongly and inflation was expected to accelerate in initial budgets during this period, the fiscal stimulus embedded in initial budgets was not cyclically appropriate ex ante. In the event, the projected fiscal expansion did not materialize as the revenue growth was much stronger than budgeted and there were delays in capital spending.

c. Medium-term prospects

According to the latest medium-range fiscal forecast (prepared in conjunction with the FY 1994 budget), revenue buoyancy is projected to decline as a result of tax concessions granted in the FY 1994 budget, 1/ while the expenditure/GDP ratio would remain roughly constant at about 16 1/2 percent (Table 4). 2/ The budget is expected to have had an expansionary impact on the economy in 1994 and 1995 stemming from the tax cuts, lower buoyancy of revenue from volatile sources, and acceleration of works on large-scale public infrastructure projects. 3/ As the economy is operating at close to potential and the factor markets are expected to remain tight, the additional fiscal stimulus would have a procyclical impact, particularly in 1995, when the fiscal impulse is projected to reach 3 1/4 percent of GDP (Table 4). According to the medium-range fiscal forecast, a withdrawal of fiscal stimulus from the economy is projected after 1995 (Table 4).

3. Conclusions

Two results stand out from the above analysis: (1) budgetary outcomes have persistently deviated from projections in initial budgets, often resulting in large and unexpected budget surpluses; (2) in general, the actual fiscal outcomes have tended to be countercyclical: they were contractionary in 1986-88, expansionary in 1989-90, and neutral in 1992-93. However, this pattern is unlikely to prevail in the current and next fiscal

1/ The cumulative effect of tax concessions is estimated at over 3 percent of GDP. The medium-range forecast excludes revenue from land sales in FY 1994-FY 1996; however, the estimated land revenue is included in the revenue forecast for FY 1997.

2/ Current expenditure is projected to grow in line with nominal GDP over the next four years, while capital expenditure forecasts take into account the airport financing package agreed between China and the United Kingdom in November 1994.

3/ In particular, stamp duty revenue grew in line with (conservative) budgetary projections in the first half of FY 1994 (April-September 1994) and is unlikely to achieve, by the end of FY 1994, the buoyancy of the past three fiscal years because the property and stock markets have consolidated.

Table 4. Hong Kong: Medium-Range Fiscal Forecast, 1993/94-1997/98

	1993/94			1994/95		1995/96	1996/97	1997/98
	Budget	Prel.	Actual	Budget	Staff Proj.	Official Proj.	Official Proj.	Official Proj.
(In millions of Hong Kong dollars)								
Revenue	150,030	164,410	166,599	176,620	179,800	182,840	205,080	256,650
Current	129,450	138,030	139,960	144,720	150,000	157,210	177,400	205,160
Of which: New revenue measures	-3,960	...	...	-6,620	...	-9,160	-10,430	-12,060
Capital	20,580	26,380	26,639	31,900	29,800	25,630	27,680	51,490
Of which: Capital Works Reserve Fund <u>1</u> /	12,660	19,070	19,329	25,080	...	19,510	20,410	43,880
Expenditure	152,190	148,110	146,238	166,660	166,250	196,420	209,700	232,600
Current	94,280	94,300	93,181	107,750	106,950	124,770	143,540	165,080
Capital	57,910	53,810	53,047	58,910	59,300	71,650	66,160	67,520
Of which:								
Capital Works Reserve Fund <u>2</u> /	31,570	34,500	34,494	33,050	...	44,850	52,460	60,790
Capital Investment Fund <u>3</u> /	19,730	12,270	12,275	20,640	...	22,040	8,620	1,200
Surplus (+)/deficit (-)	-2,160	16,300	20,361	9,960	13,550	-13,580	-4,620	24,050
Borrowing (+)/repayment (-)	-1,200	-1,200	-1,197	-2,300	-2,300	...	...	...
Fiscal reserve balance, March 31	116,230	136,130	140,196	143,790	151,446	130,210	125,590	149,640
Balance in the Land Fund of the Hong Kong Special Administrative Region <u>4</u>/	...	...	65,525	...	...	...	...	125,000
(In percent of GDP)								
Revenue	17.7	19.4	18.8	18.3	17.7	16.6	16.4	18.0
Expenditure	18.0	17.5	16.5	17.3	16.3	17.8	16.7	16.3
Current	11.1	11.1	10.5	11.2	10.5	11.3	11.5	11.6
Capital	6.8	6.3	6.0	6.1	5.8	6.5	5.3	4.7
Surplus (+)/deficit (-)	-0.3	1.9	2.3	1.0	1.3	-1.2	-0.4	1.7
Reserves at March 31	13.7	16.1	15.8	14.9	14.9	11.8	10.0	10.5
Fiscal impulse	2.36	...	0.01	0.48	0.77	3.10	-1.80	-0.67
(In millions of Hong Kong dollars)								
GDP at market prices	845,990	847,810	887,614	965,900	1,018,000	1,100,400	1,253,600	1,428,200

Sources: Government Secretariat, Finance Branch: The 1994/95 Budget, and Estimates for the Year Ending March 31, 1995; and staff estimates.

1/ Includes mainly revenue from land sales.

2/ Includes financing of seven airport-related projects.

3/ Includes government equity injections into Provisional Airport Authority and Mass Transit Railway Corporation.

4/ Balance shown is as of March 31, 1994 and July 31, 1997.

year, so that the impact of the budget could be expansionary and procyclical. In particular, faced with large and "unexpected" budget surpluses in recent years, the Government had provided for generous tax concessions in the FY 1994 budget. These concessions, together with accelerated spending on infrastructure projects, are expected to lead to a significant reduction in the budget surplus in FY 1994 and FY 1995.

IV. The Financial System and the Regulatory Framework in Hong Kong

Hong Kong is one of the top ten financial centers of the world, and one of the three leading centers in Asia. Its status as an international banking center is indicated by the presence of 81 of the world's 100 largest banks in Hong Kong in 1993. The financial sector makes a significant and rising contribution to Hong Kong's economy in terms of employment, payroll, value added, and foreign exchange earnings (Table 5). Until recently, the regulatory framework of Hong Kong's financial sector tended to be relatively lax. However, in response to recurrent instability in the financial sector, the authorities began a concerted effort in the late 1980s to strengthen the regulatory framework. This effort has been highly successful and most reform measures were completed in 1994. This chapter reviews recent developments in the financial system and the regulatory framework. Section 1 focuses on the banking sector and Section 2 on the securities market. Brief conclusions are provided in Section 3.

1. Banking sector

a. Structure and characteristics

Hong Kong has a three-tiered banking system. Licensed banks (LBs) take all types of deposits and dominate the sector, accounting for 94 percent of total banking assets. Restricted license banks (RLBs) and deposit-taking companies (DTCs) perform specialized functions such as merchant banking, consumer finance, and investment services. Except for deposit taking, banking regulation in Hong Kong does not restrict the types of activities in which the three different types of institutions can engage. Representative offices of foreign banks are required to confine their customer business to liaison activities. As of September 1994, there were 179 licensed banks, 61 restricted license banks, 139 deposit-taking companies, and 160 representative offices of foreign banks in Hong Kong.

Domestic banking is dominated by the Hongkong and Shanghai Banking Corporation Limited group. While it is difficult to measure the domestic market share of individual local banks in Hong Kong because they are not required to distinguish global and local assets in their balance sheets, it is estimated that the HSBC accounts for at least half of all local deposits and assets. The second largest banking group is that under the Bank of China (BOC). It is estimated that the BOC and its "12 sister" banks and their many branches account for about one fourth of local deposits. Locally

Table 5. Hong Kong: Economic Contribution
of the Financial Sector, 1985 and 1993 1/

(In percent)

	1985	1993
Employment		
Financial services employment as a share of total private sector employment	3.9	5.5
Payroll		
Financial services payroll as a share of total private sector payroll	10.3	2.0
GDP		
Value added in financial services as a share of GDP	5.3	8.9 <u>2/</u>
Balance of payments		
Net exports of financial services as a share of total net exports of services	6.6	7.8 <u>2/</u>
Number of establishments	4,050	7,337
Memorandum item:		
Value added in financing, insurance, real estate and other business services as a share of GDP (In percent)	15.0	22.9

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics, Annual Digest of Statistics, and Revised Estimates of Gross Domestic Product, 1961 to First Quarter, 1994; and staff estimates.

1/ The financial sector is defined to include only financial institutions such as banks and stockbroking firms, and does not include insurance, real estate, and other business service companies.

2/ Data for 1992.

incorporated but foreign-owned banks are primarily active in the offshore bank market, notably in external interbank activity and syndicated lending.

The regional ownership structure reflects the growing internationalization of Hong Kong as a financial center. About four fifths of the 179 licensed banks registered as of September 1994 are incorporated outside Hong Kong. The majority of restricted license banks and deposit-taking companies are incorporated in Hong Kong, but many of them are foreign owned. The market share of local banks that are not affiliated with foreign institutions (the so-called private Chinese banks) has shrunk substantially over the years.

The growth of aggregate bank assets in Hong Kong has outpaced that of the economy as a whole. Total assets of the licensed banks grew from HK\$1.1 trillion in 1985 (four times the GDP) to HK\$6.6 trillion (six times the GDP) as of September 1994 (Chart 9). The main impetus for this growth was external--foreign assets (interbank claims plus loans not for use in Hong Kong) increased by 600 percent over 1985-94, double the growth rate of domestic assets. The openness of the banking system is further indicated by the high share of foreign currency-denominated assets in total assets, and their faster growth than Hong Kong dollar-denominated assets (Chart 9).

The aggregated balance sheet for Hong Kong's banking system (i.e., LBs, RLBs, and DTCs) as of September 1994 shows that about two thirds of the banks' liabilities consist of interbank liabilities and about one fourth of customer deposits (Table 6). Negotiable certificates of deposit (NCDs) and other debt instruments account for just 2 percent of total liabilities. Reserve capital and other liabilities account for the remaining 6 percent of liabilities. The offshore character of Hong Kong's banking sector is indicated by the fact that 85 percent of total interbank liabilities are owed to overseas banks.

On the assets side, about 44 percent of total bank assets consist of interbank claims, most of them to overseas institutions. Loans constitute another 46 percent of total assets, of which about half are for use in Hong Kong (Table 7). NCDs and other securities account for most of the remaining assets.

An important characteristic of Hong Kong's banking system is the prevalence of foreign currency denomination for many categories of bank liabilities and assets. Interbank liabilities and assets abroad denominated in foreign currency exceed their Hong Kong dollar counterparts by about 20 to 1, while loans and advances denominated in foreign currency exceed their Hong Kong dollar counterparts by 2 to 1 (Table 6). However, for customer deposits, only about half are denominated in foreign currency (of which about half are in U.S. dollars).

The concentration of lending for purchases of property is another feature of the Hong Kong banking system. As of September 1994, residential mortgages represented 24 percent of loans for use in Hong Kong. If loans

CHART 9

HONG KONG
ASSETS OF LICENSED BANKS BY TYPE, 1985-94

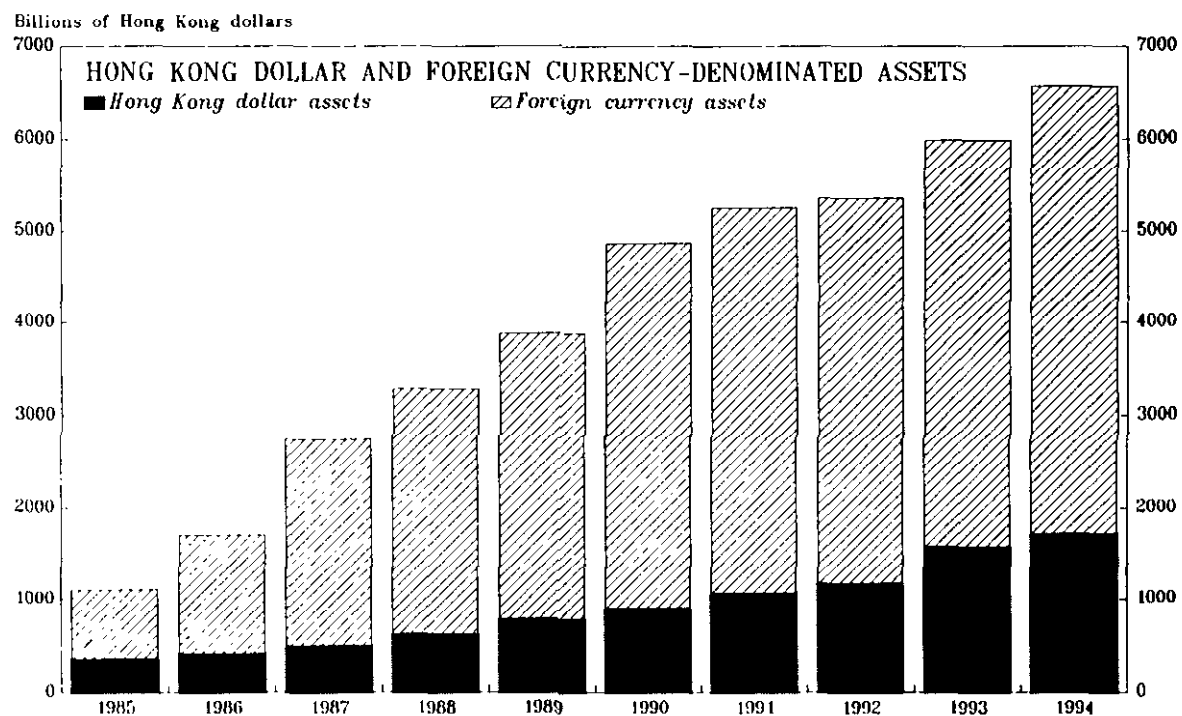
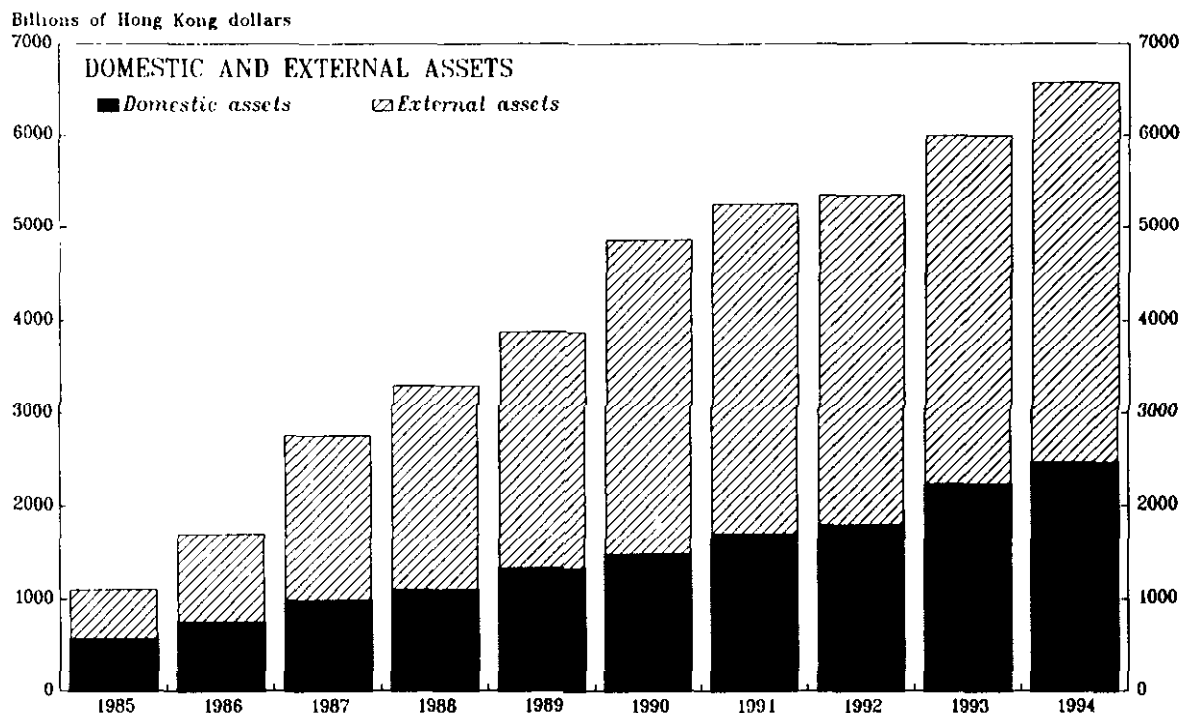


Table 6. Hong Kong: Balance Sheet of All Authorized Institutions,
September 1994

	Hong Kong Dollar (In billions of Hong Kong dollars)	Foreign Currency (In billions of Hong Kong dollars)	Total	Share in Total Assets/ Liabilities (In percent)	Share of Hong Kong Dollar Assets/ Liabilities (In percent)
Liabilities					
Amount due to authorized institutions in Hong Kong	415	272	687	9.8	60.4
Amount due to banks abroad	172	3,695	3,867	55.4	4.5
Deposits from customers ^{1/}	882	994	1,876	26.9	47.0
Negotiable certificates of deposit (NCDs) outstanding	51	39	90	1.3	56.2
Other debt instruments outstanding	1	26	27	0.4	3.8
Other	263	173	436	6.2	60.4
Total liabilities	1,783	5,199	6,983	100.0	25.5
Assets					
Notes and coins	9	2	10	0.1	85.4
Amount due from authorized institutions in Hong Kong	416	271	687	9.8	60.6
Amount due from banks abroad	104	2,286	2,390	34.2	4.3
Loans and advances to customers	1,091	2,117	3,208	45.9	34.0
NCDs held	25	21	45	0.6	54.3
Negotiable debt instrument held, other than NCDs	117	315	432	6.2	27.0
Investments in shareholdings	14	3	17	0.2	82.7
Interest in land and buildings	38	1	38	0.6	98.7
Other	58	96	153	2.2	37.6
Total assets	1,871	5,112	6,983	100.0	26.8
Memorandum items:					
Number of authorized institutions	374				
Number of branches	1,686				

Source: Hong Kong Monetary Authority, Monthly Statistical Bulletin.

^{1/} Unadjusted for the foreign currency swap deposits.

Table 7. Hong Kong: Loans and Advances by Type, September 1994

	Hong Kong Dollar (In billions of Hong Kong dollars)	Foreign Currency (In billions of Hong Kong dollars)	Total	Share of HK\$ Loans in Total Loans (In percent)	Share of Loan Type in Total Loans (In percent)
Loans for use in Hong Kong	1,067	284	1,351	79.0	42.1
Trade-related	62	65	126	48.9	3.9
Other	1,005	219	1,224	82.1	38.2
Loans for use outside Hong Kong	21	1,792	1,813	1.1	56.5
Trade-related	3	10	13	21.8	0.4
Other	18	1,782	1,800	1.0	56.1
Loans for which the place of use is not known	4	41	45	8.5	1.4
Total loans	1,091	2,117	3,208	34.0	100.0

Source: Hong Kong Monetary Authority, Monthly Statistical Bulletin.

for building, construction, and property development and investment are included, then the share of property-related lending in total loans for use in Hong Kong rises to 42 percent (Table 8). The share of property-related lending in total loans is much lower (16 percent).

Overall, Hong Kong banks have been highly profitable and well capitalized in recent years, with strong asset quality and high liquidity. The HSBC was one of the most profitable banks in the world in 1993, and Hong Kong banks were reported to generate post-tax returns on equity approaching 30 percent, compared with rates of return of about 15 percent for banks in industrial countries. In the first three quarters of 1994, bank profitability has also been high, albeit lower than in 1993, reflecting in part narrowing interest rate margins and slower growth in property lending.

b. Regulatory framework for the banking
sector and developments in 1994

The strong performance of Hong Kong's banking sector in recent years belies its volatile past. Banking crises occurred in 1982-86, and most recently in 1991. ^{1/} However, a major source of banking sector instability--regulatory weakness--has now been virtually eliminated through a series of regulatory and supervisory measures taken since the mid-1980s.

The revised Banking Ordinance of 1986 addressed many of the earlier weaknesses of the regulatory framework in Hong Kong and brought it more in line with international standards. The Ordinance expanded the powers of the then Commissioner of Banking, tightened controls on credit concentration, strengthened liquidity requirements, and introduced capital adequacy requirements. In 1993, most responsibility for developing standards and regulations, supervising banks, and overseeing the stability and the development of the banking system as a whole was transferred to the Hong Kong Monetary Authority, which was then established.

Attachment I summarizes the key features of Hong Kong's banking regulatory framework. This framework is in accord with the standards established by the Bank for International Settlements and is comparable with those of the United States and other major industrial countries. ^{2/} Attachment II shows that the standards for disclosure of key financial and operational information meet or exceed those of the United States, the United Kingdom, Japan, and Singapore.

^{1/} The most recent crisis was triggered by the collapse of BCCI (HK) which led to bank runs on some of the other local banks. The earlier crises involved local banks, which were too aggressive in their lending. For an analysis of banking crises in Hong Kong, see Jao (forthcoming).

^{2/} See Hall (1994).

Table 8. Hong Kong: Share of Property-Related Loans in Total Lending, 1986-94

(In percent)

	1986	1987	1988	1989	1990	1991	1992	1993	1994 ^{1/}
Loans for building, construction, property development and investment									
As a share of loans for use in Hong Kong	12.8	11.2	12.9	16.5	15.7	15.4	15.6	16.9	17.5
As a share of total loans and advances	6.9	5.1	6.1	7.6	6.0	5.6	5.8	6.4	6.7
Residential mortgages									
As a share of loans for use in Hong Kong	18.2	18.5	18.8	18.8	21.2	24.2	24.6	25.2	24.4
As a share of total loans and advances	9.8	8.4	8.9	8.7	8.2	8.8	9.1	9.5	9.3
Total real property-related loans ^{2/}									
As a share of loans for use in Hong Kong	30.9	29.7	31.7	35.3	36.8	39.6	40.3	42.1	41.9
As a share of total loans and advances	16.7	13.5	15.1	16.2	14.2	14.4	14.8	15.8	16.0
Memorandum item:									
Loans for manufacturing and other industry									
As a share of loans for use in Hong Kong	56.6	57.9	55.2	54.0	52.3	50.75	50.15	48.7	48.4
As a share of total loans and advances	30.6	26.2	26.2	24.8	20.2	18.4	18.4	18.3	18.5

Sources: Census and Statistics Department, Hong Kong Annual Digest of Statistics 1993; Hong Kong Monetary Authority, Monthly Statistical Bulletin; and staff estimates.

^{1/} As of end-September 1994.

^{2/} Total property-related loans are the sum of loans for building, construction, property development and investment, and loans for residential mortgages.

In 1994, the HKMA took a number of measures to further strengthen Hong Kong's regulatory framework. The new loan classification system is expected to improve the ability of the HKMA to monitor the banks' asset quality. Banks will report to the HKMA on the quality of their portfolios by putting loans into standardized categories (e.g., performing, special mention, nonperforming). Banks will also report on the provisions held against loans in the nonperforming categories. The new liquidity regime will take into account not only the size of a bank's pool of liquid assets but also the bank's maturity mismatch profile, its ability to borrow in the interbank market, and the diversity and stability of its deposit base. The new requirement for all authorized institutions to disclose, inter alia, true profits and information on transfers to and from their inner (or hidden) reserves, to be initiated with the banks' 1994 accounts, enhances the transparency of Hong Kong's banking system and brings it substantially in line with international standards on bank disclosure.

The HKMA also promoted banking competition in 1994 through its recommendation to the Hong Kong Association of Banks (HKAB) on the gradual deregulation of interest rates on time deposits. The Interest Rate Rules were originally established in 1964, in response to banks' excessive competition for deposits which threatened the stability of the banking system. The rules set ceilings on the rates paid on deposits according to their type, maturity, and size. On October 1, 1994, the ceiling on the rate payable on time deposits of more than one-month maturity was removed. The HKAB intends to deregulate time deposits of shorter maturity by April 1995, and 24-hour call deposits in stages during the rest of 1995. The latter would, however, be subject to both HKAB and HKMA concluding, prior to each stage, that there is not likely to be any resultant instability in the monetary and banking system. Controls on savings and demand deposits under the Interest Rate Rules will remain unchanged. The deregulation is likely to impact both the distribution of deposits by type and maturity, and bank profitability. However, the impact is not likely to be disruptive because of phased deregulation and the fact that time deposits that were not subject to the Rules have existed for some time. 1/

The risk of excessive property lending has been a concern for Hong Kong's banking sector for the last several years. In response to the higher perceived risk, banks have voluntarily adopted a 70 percent maximum loan-to-valuation ratio for residential mortgage loans since November 1991, which was strongly supported by the HKMA. Several banks reduced this ratio to 50 percent for luxury apartments in early 1994. Nevertheless, as of

1/ Foreign currency swap deposits are deposits involving customers buying foreign currencies in the spot market and placing them as deposits with authorized institutions, while at the same time entering into a contract to sell such foreign currencies (principal plus interest) forward in line with the maturity of such deposits. This provided a way of circumventing the Interest Rate Rules. Large denomination deposits of HK\$500,000 or above were also not subject to the Rules.

September 1994, about 40 percent of outstanding loans for use in Hong Kong were used either by the building, construction, and property development sector, or for purchase of private residential property (Table 8). ^{1/} As property prices rose sharply in 1993 and the early part of 1994, property lending by some banks exceeded the sector-wide average of about 40 percent. However, residential mortgage lending slowed considerably toward the end of 1994 in response to rising interest rates.

Other regulatory developments in 1994 include the proposal of a new Banking Amendment Bill that may further consolidate the supervisory powers of the HKMA, and a review of banking and monetary legislation in the context of the work to harmonize legislation in advance of the transfer of sovereignty in 1997.

2. Securities market

a. Structure and characteristics

Share trading in Hong Kong dates back to 1866. The present unified exchange, the Stock Exchange of Hong Kong Limited (SEHK), was established in 1986. According to several criteria, including market capitalization, turnover, total value traded, number of listed companies, and average company size, the SEHK is among the top ten stock markets in the world. ^{2/} Like other emerging Asian markets, the stock market in Hong Kong has been characterized by rapid increases in market capitalization and volatile price movements in recent years (Chart 10 and Table 9).

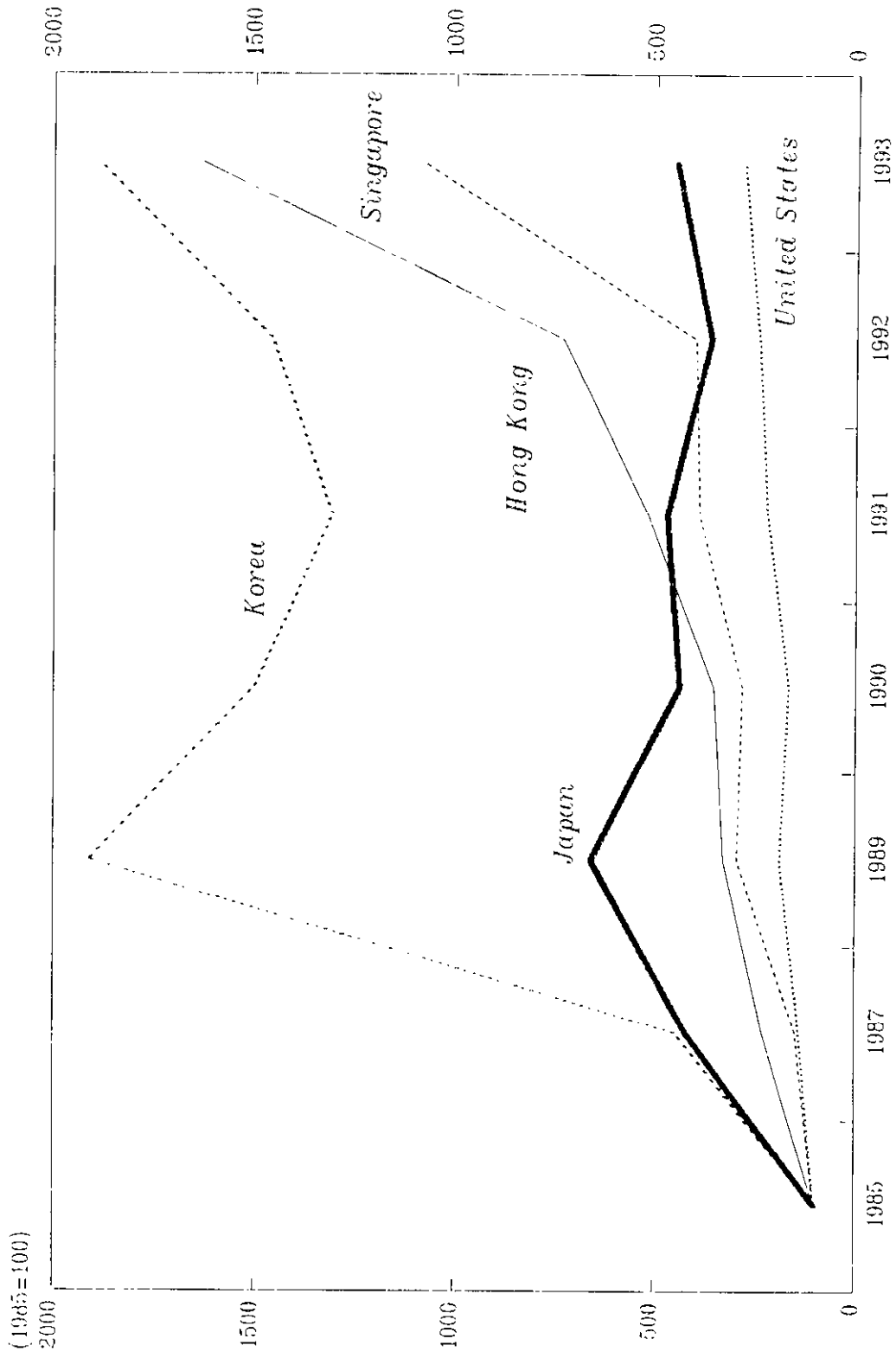
The Hong Kong stock market has grown rapidly in recent years. As of September 30, 1994, a total of 515 public companies and 980 securities were listed on the SEHK, compared with 455 public companies and 835 securities a year ago. The market has also become more diversified. There were 515 equity shares, 289 warrants, 116 debt instruments, and 49 mutual funds listed as of end-September 1994. However, equities accounted for 92 percent of market turnover. Market capitalization increased by 28 percent over a 12-month period ending September 30, 1994, to reach HK\$2,438 billion (US\$312 billion), reflecting not only price gains, but also buoyant new issue activity. The amount of funds raised on the SEHK between July 1993 and June 1994 was HK\$432 billion (19 percent of market capitalization).

Despite its size, the Hong Kong stock market shares some of the attributes of other emerging markets in Asia. It provides financing mainly for domestic rather than international interests; it is dominated by a

^{1/} The exposure to real estate price changes may be even greater to the extent that property is used as collateral for other lending.

^{2/} Exact rankings of the world's financial centers vary according to the criteria (e.g., assets, number of institutions) and depending on the specific financial market in question (e.g., commercial banking versus foreign exchange).

COMPARATIVE STOCK MARKET CAPITALIZATION INDICES, 1985-93



Source: International Finance Corporation, Emerging Stock Markets Factbook 1994.

Table 9. Hong Kong: Hong Kong and World Stock Market Performance, 1985-94

(Percentage change in the market index)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 <u>1/</u>
IFC Asia Index <u>2/</u>	6.6	23.3	28.3	68.3	53	-36.6	-0.4	-0.1	67.8	7.2
Hong Kong	55.4	25.0	47.2	-11.4	8.8	8.8	14.7	59.8	38.8	-19.9
Korea	14.7	66.9	92.6	72.8	0.3	-23.5	-12.2	11	27.7	21.4
Singapore	-24.3	41.8	0.8	31.2	40.2	-13.1	22.7	4.4	65.5	-3.9
United States (Standard and Poors 500)	26.3	14.6	2.3	12	27.3	-6.6	26.3	4.5	7.6	-1.2
Japan (Nikkei)	43.6	65.2	73.7	30.7	12.2	-35.1	4.9	-26.4	15.1	26.6

Sources: International Finance Corporation, Emerging Stock Markets Factbook 1994, and Quarterly Review of Emerging Markets, Third Quarter 1994; Census and Statistics Department, Hong Kong Monthly Digest of Statistics, and Hong Kong Annual Digest of Statistics.

1/ Change from end-1993 to third quarter 1994.

2/ The IFC Asia Index is an index of stocks from emerging Asian markets compiled by the International Finance Corporation. It does not include Hong Kong or Singapore.

relatively small number of firms; and it provides relatively few products. The domestic character of the market is reflected in the fact that most companies listed on the SEHK are Hong Kong-based, although many of them are incorporated abroad (especially in Bermuda or the Cayman Islands).

Among foreign-based firms, Chinese interests represent a high and increasing share of market capitalization. The direct funding of Chinese enterprises on the SEHK takes place through the issuance of H shares. H shares are a special class of ordinary shares of Chinese enterprises denominated in renminbi, and which are subscribed for and traded in Hong Kong currency on the SEHK. From July 1993 to end-1994, a total of 15 H shares were listed on the SEHK; six of these are from the second batch of 22 enterprises approved for listing by the Chinese Government in January 1994. The 15 H shares listed as of end-1994 raised a total of HK\$17.9 billion at launch. A new index, the Hang Seng China Enterprises Index, was introduced in August 1994 (and backdated to July 1993, when the first H-share company was listed) to track these new stocks.

Regarding the degree of market concentration, the 20 leading stocks accounted for 64 percent of market capitalization, while the 20 most active stocks accounted for 56 percent of market turnover as of September 1994.

In terms of the range of products, in addition to equities, futures and options contracts and stock short selling contracts are also traded on Hong Kong's securities markets, while stock options trading is to be introduced in 1995. 1/ The introduction of short selling in 1994 has enhanced the prospects for developing derivatives and risk management transactions in the future. In addition, about 900 authorized unit trusts and mutual funds operate in Hong Kong, with a total net asset value of about HK\$350 billion at end-1993.

Property and finance firms account for a high share (30 percent and 20 percent, respectively) of total market capitalization of the SEHK (Table 10). The small share of industrial companies reflects the small size of manufacturing firms in Hong Kong and their reliance on bank loans for financing. Listings of H shares are expected to increase the weight of the industrial sector in market capitalization over time.

Share ownership is widespread among Hong Kong households. 2/ Foreign ownership is also estimated to be significant, mainly as a result of large inflows of foreign investment in 1993-94. Institutional investment was restrained in the past, in part because of inefficiencies or irregularities in Hong Kong share trading. Following strong efforts by Hong Kong to

1/ Futures and options contracts on the Hang Seng Index and commodities contracts are traded on the Hong Kong Futures Exchange (HKFE).

2/ It is estimated that about two thirds of Hong Kong households own stocks listed on the SEHK.

Table 10. Hong Kong: Stock Market Capitalization and
Turnover by Sector, 1990-94

(In percent of total)

	1990	1991	1992	1993	1994 <u>1/</u>
<hr/>					
Market capitalization by sector					
Finance	12.8	16.2	22.4	20.2	19.3
Utilities	20.3	18.5	16.7	14.1	14.7
Properties	26.1	26.9	25.0	28.8	27.9
Industrials	6.5	6.9	7.0	6.3	6.4
Consolidated enterprises	30.8	28.5	26.5	27.9	28.6
Hotels	2.9	2.2	2.1	2.5	2.9
Miscellaneous	0.7	0.7	0.4	0.3	0.3
Total	100	100	100	100	100
Trading value by sector					
Finance	9.8	14.2	21.0	16.5	14.9
Utilities	7.4	9.0	8.2	7.7	10.3
Properties	35.6	35.6	33.0	29.5	35.3
Consolidated enterprises	27.8	27.2	24.2	28.3	23.1
Industrials	13.9	12.1	10.8	14.5	13.5
Hotels	2.6	1.3	2.3	2.5	2.3
Miscellaneous	2.9	0.7	0.4	1.0	0.6
Total	100	100	100	100	100

Sources: The Stock Exchange of Hong Kong, Stock Exchange Fact Book 1993; and
The Securities Journal, September 1994.

1/ As of end-September 1994.

bolster its financial regulatory framework, such investment has grown in recent years.

The prices of Hong Kong stocks have outperformed other regional markets in recent years. The average dividend yield for Hong Kong stocks was 3.4 percent through the third quarter of 1994, compared with 1.2 percent for Korea (Table 11). Hong Kong's stock market has also traditionally offered lower price earnings (P/E) ratios than other Asian countries' stock markets. The P/E ratio for Hong Kong stocks averaged 13.1 in 1994, compared with 36.4 in Korea (Table 11). However, the Hong Kong stock market also is more volatile (Table 9). The ratio of the high to low value of the stock price index for 1994 was 1.6 in Hong Kong, compared with 1.1 in the United States, 1.2 in Japan, and 1.3 in Singapore.

The greater volatility of Hong Kong's stock market is attributable in part to Hong Kong's greater sensitivity to political uncertainties. However, the sharp drops in stock prices in October 1987 and in 1994 were driven by economic factors (Chart 11). In October 1987, in the wake of the global market crash, the Hong Kong stock market plunged 11 percent on October 19. The SEHK was closed for four days, so was the futures market. When the market re-opened on October 26, the stock market dropped a further 33 percent. The 30 percent drop in stock prices in early 1994, and the 20 percent drop in the later part of the year, were both part of a worldwide decline in equity prices related to U.S. interest rate rises. However, in contrast to the dramatic events of October 1987, the rise and fall of stock prices during the past year and a half have been sustained by the market in an orderly fashion, owing largely to strengthened regulation and infrastructure of the securities markets.

b. Regulatory framework for the securities market
and developments in 1994

The stock market crash of October 1987 brought to light serious flaws in both the regulation and operation of Hong Kong's securities markets. In response to these flaws, the Securities and Futures Commission (SFC) was established in 1989, with responsibility for supervising the stock and futures exchanges, regulating other financial intermediaries, enforcing codes of conduct, and recommending securities market legislation. The SFC has taken measures that have moved Hong Kong's securities markets closer to international standards with regard to systems and practices, increased market transparency and efficiency, and strengthened investor protection. The SEHK and the HKFE were reorganized, resulting in vastly improved self-regulation and trading practices and systems. Both the SFC and the SEHK now

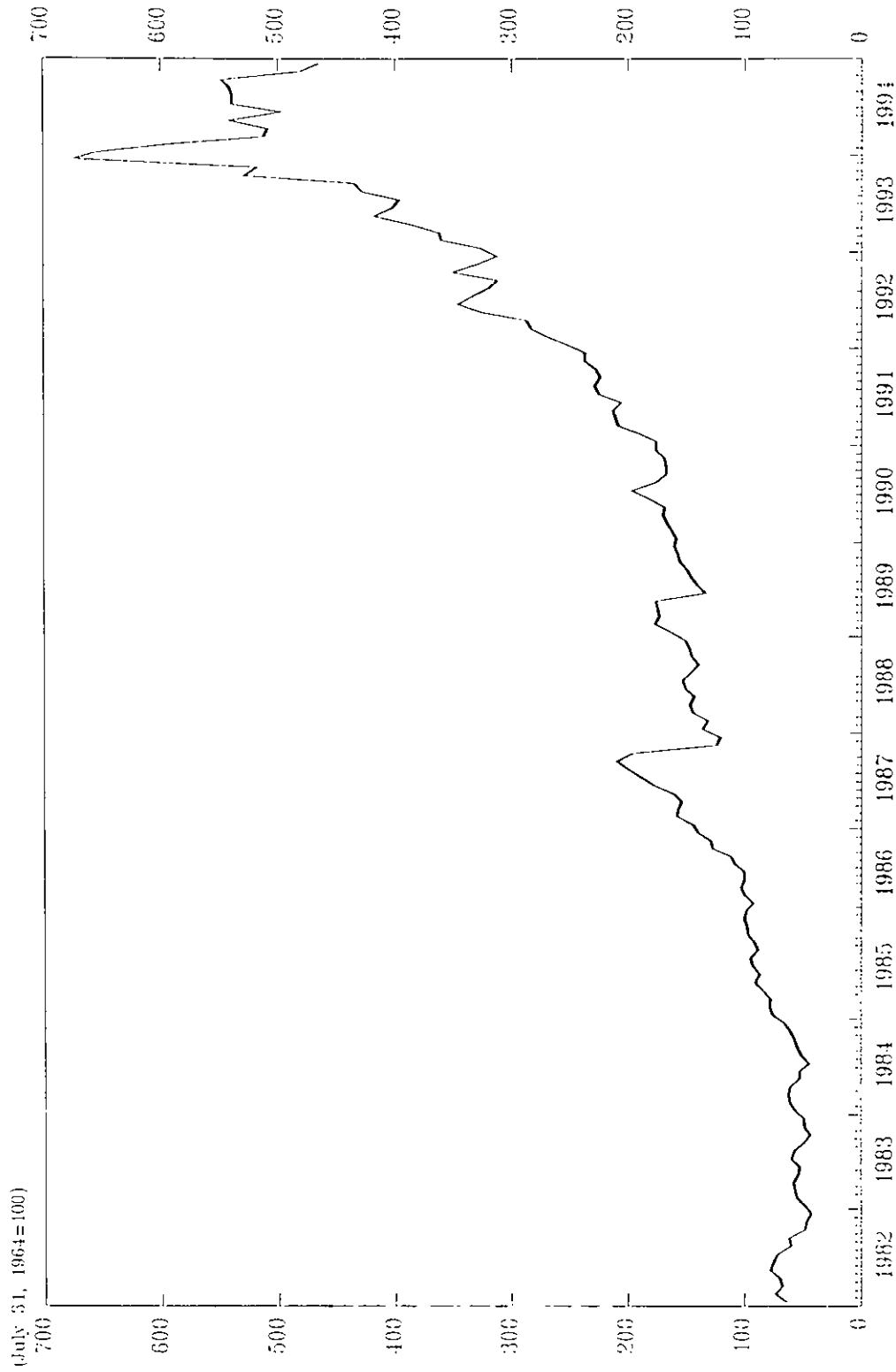
Table 11. Hong Kong: Hong Kong and Regional Markets' P/E Ratios and Dividend Yields, 1989-94

	1989	1990	1991	1992	1993	1994 ^{1/}
<u>P/E Ratios</u>						
Market						
Hong Kong	10.8	9.9	13.0	13.1	21.6	13.1
China	...	...	...	...	64.3	38.0
Korea	28.1	16.4	21.3	21.4	25.1	36.4
Taiwan Province of China	53.6	25.0	22.3	16.6	34.7	34.7
<u>Dividend Yields</u>						
Market						
Hong Kong	6.1	5.3	4.2	4.1	2.3	3.4
China	...	...	...	...	0.2	1.5
Korea	1.3	0.5	1.6	1.8	0.6	1.2
Taiwan Province of China	0.6	...	0.9	1.8	0.8	0.5

Sources: The Stock Exchange of Hong Kong, Stock Exchange Fact Book 1993; International Finance Corporation, Quarterly Review of Emerging Markets, Third Quarter, 1994; Emerging Stock Markets Factbook 1994; and staff estimates.

^{1/} As of third quarter 1994.

CHART 11
HONG KONG
HANG SENG INDEX, 1982-94



Source: Data provided by the Stock Exchange of Hong Kong.

carry out extensive surveillance and investigative work in order to ensure intermediaries' compliance, market integrity, and investor protection. 1/

Regulatory developments in 1994 include the introduction of Codes of Conduct for futures and securities dealers by the HKFE and the SFC, and new disclosure requirements for all listed companies. 2/ However, the major engine of market development in 1994 was the issuance of H shares, reflecting the strategic goal of both regulators and market participants to make Hong Kong the main conduit for equity investment in China. The SFC, the SEHK, and the Chinese authorities recognized that a sound regulatory environment for the introduction of H shares was crucial and established a framework for their listing. H share companies are required to meet all of the listing and reporting standards that apply to Hong Kong listings. The Chinese and Hong Kong authorities also coordinated efforts to curtail backdoor listings, since such practices allowed the Chinese enterprises to circumvent the stringent accounting and fiduciary standards required to obtain and maintain listing on the SEHK. 3/

3. Conclusions

The development of the financial sector in Hong Kong has been underpinned by a fully convertible and stable currency, a sound legal framework, an efficient administrative system, and the absence of restrictions on foreign exchange and capital flows. At the same time, the openness of the financial sector, combined with a relatively lax regulatory framework, resulted in financial instability in the 1980s. In response to this instability, the authorities made a strong effort to bolster Hong Kong's financial regulatory framework. These efforts have been highly successful: Hong Kong's financial sector now meets all major international standards, such as those of the Basle Committee and the International Organization of Securities Commissions. In view of Hong Kong's history of bank runs and its special political circumstances, these achievements have enhanced the robustness of Hong Kong's financial system.

1/ In the fiscal year ending March 1994, the SFC examined trading records in over 1,000 cases of unusual price/volume movements and handled over 300 investigations concerning takeovers, disclosure of securities interests, unregistered dealing of securities, and investor protection.

2/ The new disclosure requirements, announced in October 1994, require companies to report on directors' and managers' salaries, liquidity and capital resources, material changes in operational items, investments, and prospective merger negotiations.

3/ Backdoor listing is known as the practice whereby Chinese enterprises enter the Hong Kong stock market by purchasing listed Hong Kong companies and using them as shell companies to raise equity finance in Hong Kong. Between April 1993 and March 1994, there were 16 cases of takeover of firms incorporated and listed in Hong Kong by Chinese enterprises.

References

- Hall, Maximilian, Banking Regulation and Supervision: A Comparative Study of the United Kingdom, the United States, and Japan (Aldershot: Edward Elgar, 1994).
- Jao, J. C., "Money and Banking," in H.C.Y. Ho (ed.), The Economic System of Hong Kong (Hong Kong: Asian Research Service, forthcoming).

Summary of Hong Kong Banking Regulations

Exchange controls

None.

Types of financial institutions

Licensed banks, restricted license banks, and deposit taking companies are authorized institutions. "Non-authorized institutions" are representative offices of overseas banks, insurance companies, mutual funds, securities brokers, and finance companies. Non-authorized institutions are subject to a number of different regulatory frameworks.

Structure

Licensed banks are akin to retail or "high-street" banks; restricted license banks are principally engaged in merchant banking and capital market activities. Deposit-taking companies are mostly owned by or otherwise associated with banks and engage in a range of activities, including consumer finance and securities business. However, authorized institutions are differentiated according to the types of deposits they can accept, rather than the types of activities they can engage in.

Entry/ownership requirements

1. Domestic entities applying to become licensed banks: Entity must not be a subsidiary of a local or overseas bank already licensed in Hong Kong; must have been an authorized institution for ten years, with deposits not less than HK\$3 billion and assets not less than HK\$4 billion. The HKMA exercises control over shareholding issues and over banks' controllers and executives.

2. Foreign entities: An overseas bank must obtain the approval of the HKMA, have assets in excess of US\$16 billion, and reciprocity in the applicant bank's home country must be available to Hong Kong banks (the latter has been temporarily lifted for World Trade Organization members until June 30, 1995 in accordance with Hong Kong's commitment in the GATT negotiation).

Reserve requirements

None.

Capital adequacy

1. BIS standards apply to domestic authorized institutions (the BIS 8 percent ratio may be increased for any particular institution, up to 12 percent for a licensed bank and 16 percent for a restricted license bank or deposit-taking company).

2. Monthly liquidity ratios reporting system.

Liquidity

1. 25 percent minimum liquidity ratio applies in each calendar month.
2. A reporting system on monthly liquidity ratios applies.

Deposit insurance

None. 1/

Interest rate controls

The Interest Rate Rules which set maximum rates paid on certain Hong Kong-dollar deposits, are gradually being removed beginning in October 1994. Presently, interest cannot be paid on current deposits.

Lending restrictions

1. Limit on loans to one borrower or a group of related borrowers of 25 percent of capital base applies.

2. Sectoral exposure limits: Moral suasion is used to urge prudence in real estate lending, in particular with regard to loan-valuation ratios for mortgage lending. Banks may not hold real estate of an aggregate value exceeding 25 percent of their capital base (exceptions are the bank's own premises and land for which the bank is mortgagee).

3. Country exposure limits: Guidelines on provisioning exist, based on the Bank of England matrix. There are controls on exposure to foreign banks.

4. Loans to affiliates (including any director, controller, and companies with director/controller common to that of the bank) are subject to the following limits: maximum of HK\$1 million can be provided to any one affiliate, and maximum of 10 percent of capital base can be provided for total such loans by a bank.

5. Security market exposure: An authorized institution may not hold shares to an aggregate value exceeding 25 percent of capital base. Underwriting is permitted if the commitment is disposed of in seven working days, or for a longer period if prior consent from the HKMA has been obtained.

1/ The Hong Kong Government is considering a priority scheme for small depositors in the event of a bank liquidation.

6. Exchange rate risk: (i) For locally incorporated authorized institutions, there is a limit on aggregate overnight open position of 15 percent of capital base, and a limit on aggregate overnight open position on individual currency of 10 percent of capital base. (ii) For foreign banks, controls on adherence to internal limits are in place. (iii) There are monthly reporting requirements on both domestic and foreign banks.

Reporting

Monthly reports on assets and liabilities, external claims and liabilities, foreign exchange and liquidity are required. Quarterly reports on profit and loss, loan classification, interest rate risk, etc., are also required.

Prudential supervision

Approximately annual to biannual on-site examinations take place to check bank records and management practices, particularly asset quality. Off-site annual reviews of bank statistics and management accounts, followed by prudential interviews with senior management of banks are conducted. Auditing of banks' systems for compiling prudential returns and ensuring compliance with certain banking regulations is carried out. Tripartite meetings with senior management and external auditors of banks also take place.

Public disclosure

Audited annual financial statements are required under the Companies Ordinance, which apply to licensed banks regardless of whether they are incorporated under the Ordinance. Reporting on transfers to and from inner reserves is required for all banks incorporated in Hong Kong. Banks incorporated outside Hong Kong can apply for an exemption to these requirements, subject to auditing and accounting requirements of their home country.

Hong Kong: Cross-Country Comparisons of Disclosure by Banks to Financial Authorities 1/

	Hong Kong	United States	United Kingdom	Japan	Singapore
Liquidity					
Are individual banks required to disclose their deposit balance by the maturities of the deposits (re: exposure to maturity mismatching and interest-rate risk)?	Y	Y	Y	Y	Y
Loan concentrations					
Are banks required to disclose loan concentrations by:					
a. single borrower?	Y	Y	Y	Y	Y
b. single individual?	Y	Y	Y	Y	Y
c. group of firms?	Y	Y	Y	Y	Y
d. developing countries?	Y	Y	Y	Y	Y
Loan portfolios					
(i) Are banks required to disclose their loan portfolios by:					
a. the maturities of loans?	Y	Y	Y	Y	Y
b. the uses of the loans (e.g., property loans, merger and acquisition) and the corresponding outstanding principal amounts	Y	Y	Y	Y	Y
c. geographical location?	Y	Y	N	N	Y
(ii) Are individual banks required to disclose:					
a. the principal amount of nonperforming loans?	Y	Y	N	Y	Y
b. bad debt provisions?	Y	Y	Y	Y	Y
Foreign exchange activities					
(i) Are banks required to disclose their profits and losses from foreign exchange trading?	Y	Y	N	Y	Y
(ii) Are they required to disclose the amount of their open foreign exchange position?	Y	Y	Y	Y	Y
Other					
(i) Are banks required to provide a fair assessment of the foreseeable changes in their financial condition in the coming year?	Y	Y	N	N	Y
(ii) Are individual banks required to disclose information on:					
a. holdings of investment securities?	Y	Y	Y	Y	Y
b. security holdings' gains and losses?	Y	Y	N	Y	Y
c. off-balance sheet activities?	Y	Y	Y	N	Y

Source: The Consumer Council of Hong Kong, Are Hong Kong Depositors Fairly Treated? (Hong Kong: February 1994).

1/ Y=yes, N=no.

V. Economic Integration Between China and Hong Kong

Since the late 1970s, when China began its policy of reform and opening up, the economies of Hong Kong and China have become progressively more integrated. This chapter reviews recent developments in economic integration between Hong Kong and China. The chapter also assesses the determinants of and mutual benefits from integration. Hong Kong's unique attributes as a gateway to China, as well as China's favorable growth potential, suggest that economic integration between the two countries will increase further.

1. Trade links

China is Hong Kong's largest trading partner and Hong Kong China's second largest. In 1993, China purchased about one third of Hong Kong's total exports, and provided about 40 percent of its imports (Table 12). Hong Kong, in turn, was the destination for one fourth of China's exports and the source of 10 percent of its imports. Trade between Hong Kong and China has grown exponentially since the mid-1970s (Chart 12 and Table 13).

The trade flows between Hong Kong and China are complex (Chart 13). About one half of Hong Kong's total exports to China are the inputs to outprocessing activities by Hong Kong firms in China, and three fourths of Hong Kong's imports from China are the outputs of these operations, which are subsequently re-exported by Hong Kong to the rest of the world, particularly the United States, Japan, and the European Union. ^{1/} These re-exports incorporate a wide range of service inputs added by Hong Kong, including insurance, transportation, and financial services, as well as ancillary production processes such as quality control and packaging. Many products carrying the label "Made in China" are, in fact, designed, financed, packaged, and transported by Hong Kong firms with the manufacturing base in China.

Adding to the complexity of trade links between Hong Kong and China in recent years is the growing importance of transshipments--goods transported from China to their final destination under a single bill of lading. ^{2/} Transshipment cargoes increased from 3 million metric tons in 1991 to 5 million metric tons in 1993, and there are indications that they may be replacing some re-export trade. While transshipments involve a lower degree of value added than re-exports, they still generate value added in the

^{1/} Some exports from southern China to Hong Kong are re-exported back to other regions of the mainland.

^{2/} Re-exports enter Hong Kong under one bill of lading and leave with another one, identifying Hong Kong as a transfer point.

Table 12. Hong Kong: Share of Trade Between Hong Kong and China in Their Total Trade, 1975-94 ^{1/}

(In percent)

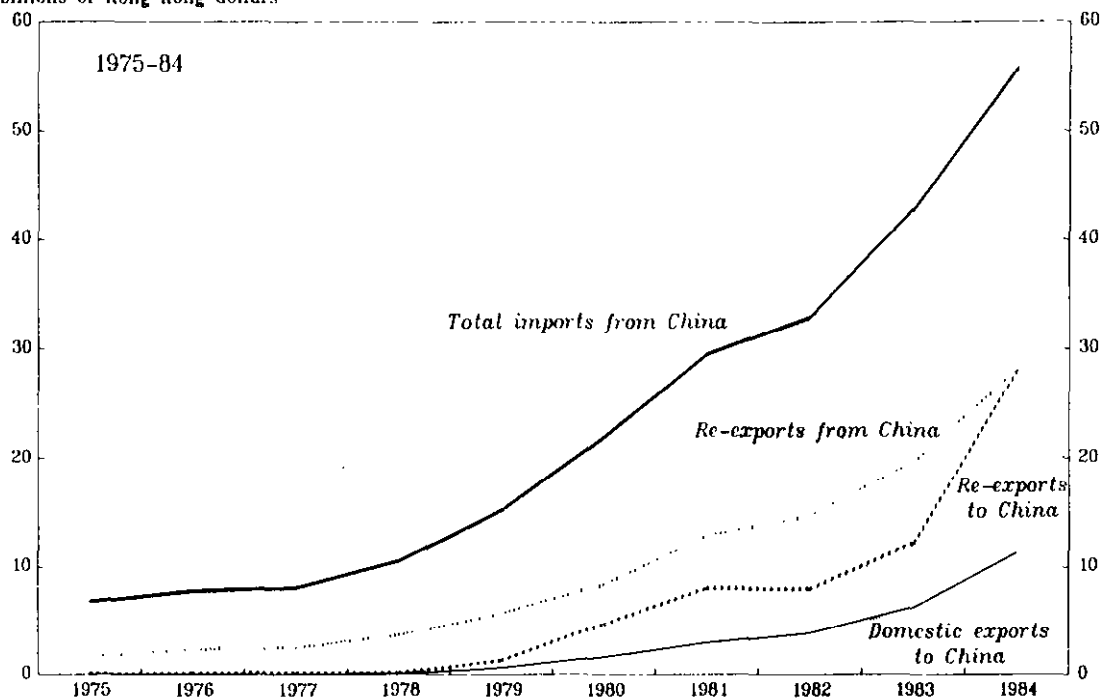
	1975	1980	1985	1990	1991	1992	1993	<u>1994</u> Jan. - June
Hong Kong's trade with China								
Total exports to China	0.6	6.4	26.0	24.8	27.1	29.6	32.3	30.6
Domestic exports to China	0.1	2.4	11.7	21.0	23.5	26.5	28.4	28.5
Re-exports to China	2.0	15.4	43.7	26.8	28.7	30.7	33.4	31.1
Total imports from China	20.3	19.7	25.5	36.8	37.7	37.1	37.5	31.4
Re-exports of China origin	25.0	27.9	32.9	58.1	59.0	58.4	57.6	52.7
China's trade with Hong Kong								
Total exports to Hong Kong	21.5	22.0	26.2	45.7	44.7	44.2	24.3	29.1
Total imports from Hong Kong	0.6	7.0	11.2	31.4	27.5	25.5	10.2	8.8

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; Annual Digest of Statistics; IMF, Direction of Trade Statistics Yearbook; and Direction of Trade Statistics Quarterly.

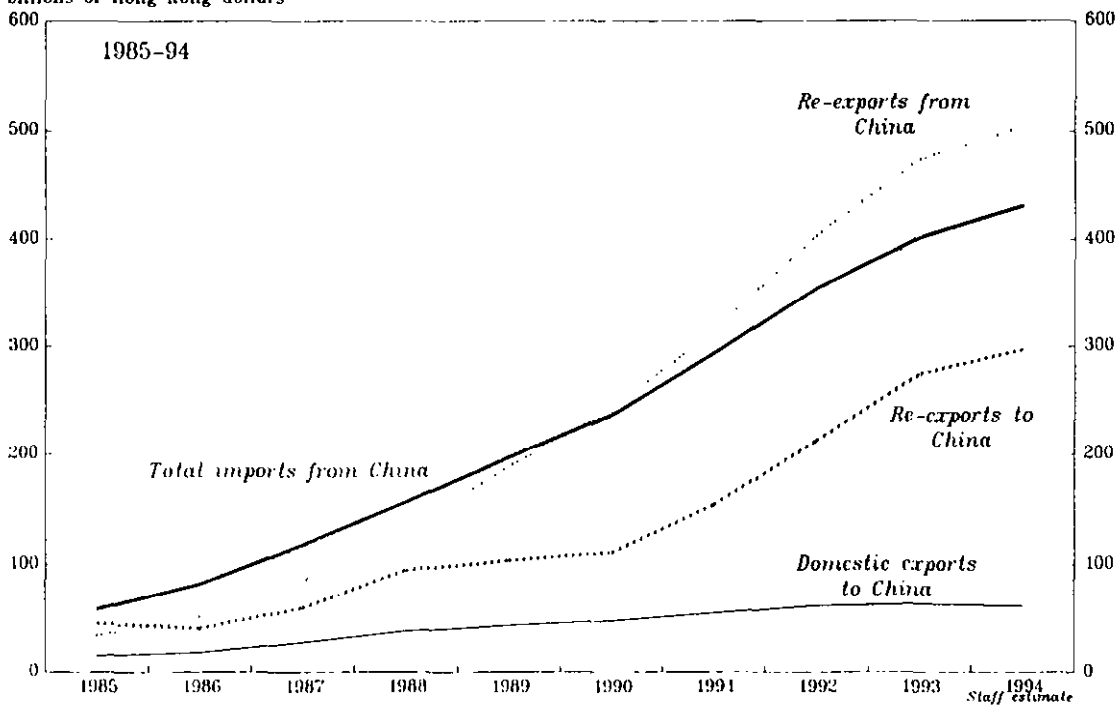
^{1/} Percentage shares are calculated with respect to the total in the corresponding category of trade.

HONG KONG
TRADE WITH CHINA, 1975-94

In billions of Hong Kong dollars



In billions of Hong Kong dollars



Source: Census and Statistics Department, Hong Kong Monthly Digest of Statistics, and Hong Kong Annual Digest of Statistics, and staff estimates.

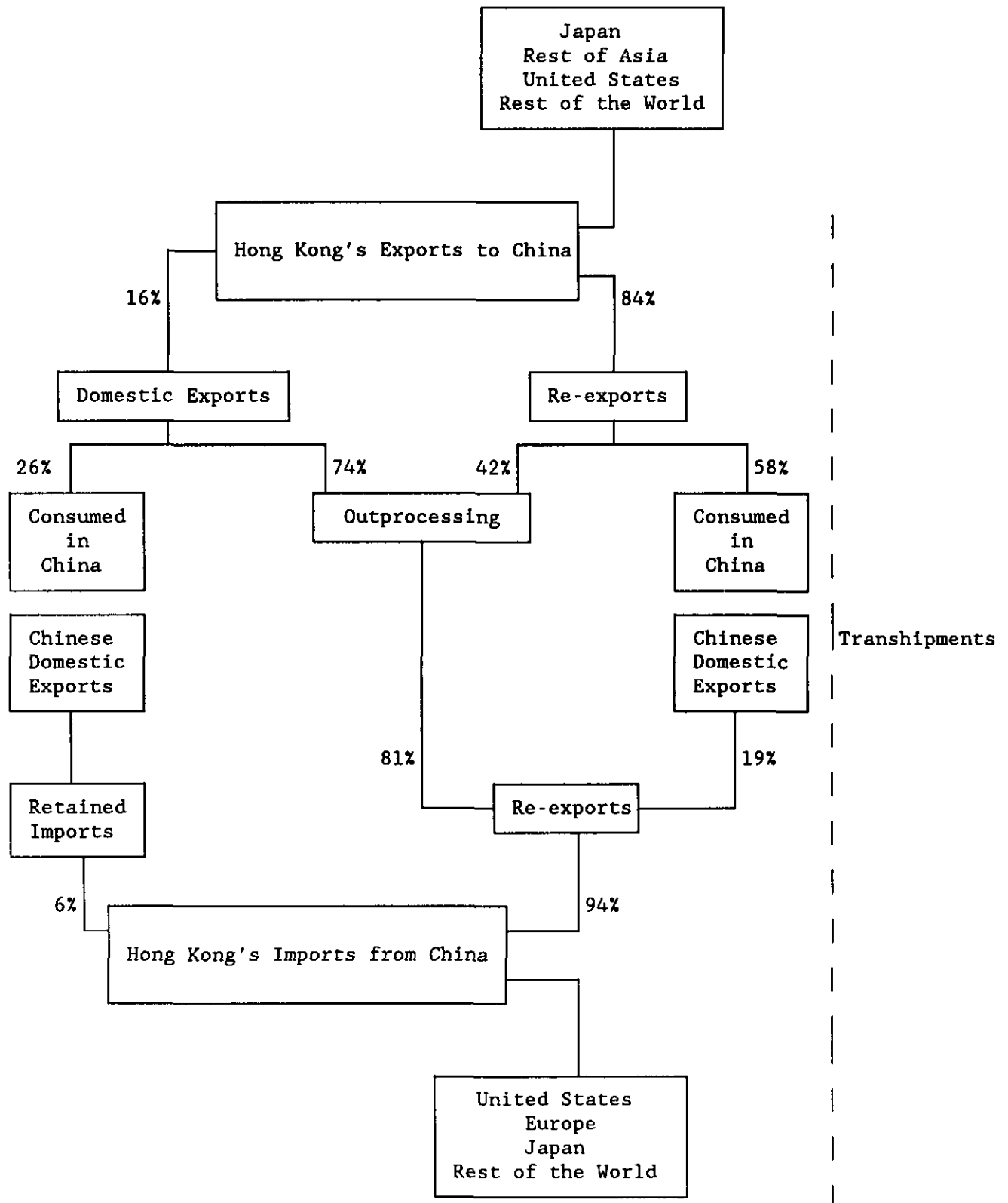
Table 13. Hong Kong: Trade with China, 1975-94

	1975	1980	1985	1990	1991	1992	1993	1994 Jan. - June
(In millions of Hong Kong dollars)								
Trade balance	-6,640	-15,701	2,249	-77,756	-85,634	-80,286	-64,233	-28,874
Total exports to China	165	6,247	61,212	158,378	207,722	274,062	337,928	179,774
Domestic exports	28	1,605	15,189	47,470	54,404	61,957	63,367	28,492
Re-exports to China	137	4,642	46,023	110,908	153,318	212,105	274,561	151,282
Total imports from China	6,805	21,948	58,963	236,134	293,356	354,348	402,161	208,648
Re-exports of China origin <u>1/</u>	1,743	8,394	34,628	240,410	315,689	403,782	474,007	238,604
(Annual percentage change)								
Total exports to China	-10.9	225.7	55.6	7.9	31.2	31.9	23.3	12.3
Domestic exports	-14.3	166.2	34.6	9.7	14.6	13.9	2.3	-7.1
Re-exports	-10.2	253.0	64.0	7.2	38.2	38.3	29.4	17.0
Total imports from China	14.0	45.1	5.8	20.1	24.2	20.8	13.5	15.6
Re-exports of China origin <u>1/</u>	37.8	48.2	23.2	27.7	31.3	27.9	17.4	14.0

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and Annual Digest of Statistics.

1/ Shows value of re-exports of China origin at the time these re-exports leave Hong Kong for the third markets. This value reflects the value added by Hong Kong entrepreneurs to goods processed in China.

Chart 13. Structure of Hong Kong's Trade with China 1/



Source: Census and Statistics Department, Hong Kong Monthly Digest of Statistics.

1/ Based on trade flows for January-June 1994.

transportation, communication, and banking sectors, which is captured in Hong Kong's services trade statistics. ^{1/}

2. Production links

Outprocessing activities by Hong Kong manufacturers in China started soon after China announced its open door policy in the late 1970s. ^{2/} These activities involve contracting with firms in China to produce semi-manufactures or finished manufactured goods that are subsequently imported into Hong Kong for re-export to third markets. Initially, these activities were confined to special economic zones in southern China. As the Chinese authorities have opened up cities and whole economic regions to foreign trade and investment, the location of Hong Kong's outprocessing activities has moved to other parts of China. It is estimated that about 25,000 Hong Kong firms presently operate about 60,000 plants and employ more than three million workers in southern China. ^{3/} Inputs into outprocessing activities in China were valued at HK\$160 billion in 1993; the output of outprocessing plants at HK\$295 billion; and re-exports of these goods from Hong Kong to third countries at HK\$365 billion (Table 14).

When the outprocessing activities first started in the early 1980s, labor costs were up to 15 times lower in southern China than in Hong Kong and facility costs were 5-10 times lower. This cost differential has been a major determinant of Hong Kong's remarkable structural shift from low value-added manufacturing for exports, to providing trade and financial services with ancillary higher value-added export manufacturing (Chart 14). ^{4/} Employment in the manufacturing sector fell almost by one half between 1985 and 1993, while the share of manufacturing in GDP fell from 21 percent in 1985 to 13 percent in 1992. The flexibility of the labor market has allowed this transformation to occur without a fall in employment. The declines in employment and value added in the manufacturing sector were offset by corresponding increases in the services sector, in particular the trade-related services (wholesale, retail, and import/export trades) and the financial sector (banking, insurance, real estate, and business services) which were needed to support Hong Kong's growing role as a gateway to China. The structural shift has also resulted in the upgrading of skills in manufacturing industries that remained in Hong Kong (to supervisory and

^{1/} Exports of services were revised upward substantially in the non-routine revision of GDP estimates in August 1994. As a result, the goods and nonfactor services balance now looks substantially stronger than in the past.

^{2/} For a review of the opening-up policy of China, see Bell, Khor, and Kochhar (1993).

^{3/} See GATT (1994).

^{4/} The textile and garment industry remains relatively strong in Hong Kong because of export quotas under the Multifiber Arrangement. However, the range of products has been almost completely upgraded to high-end fashion clothes.

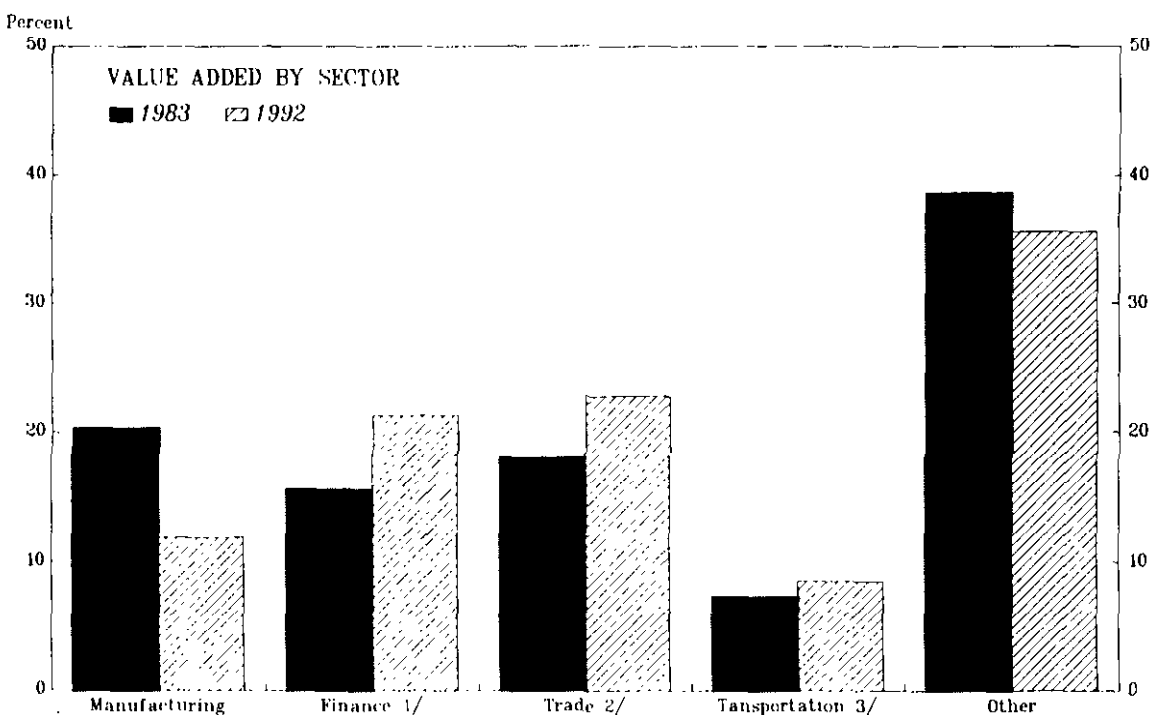
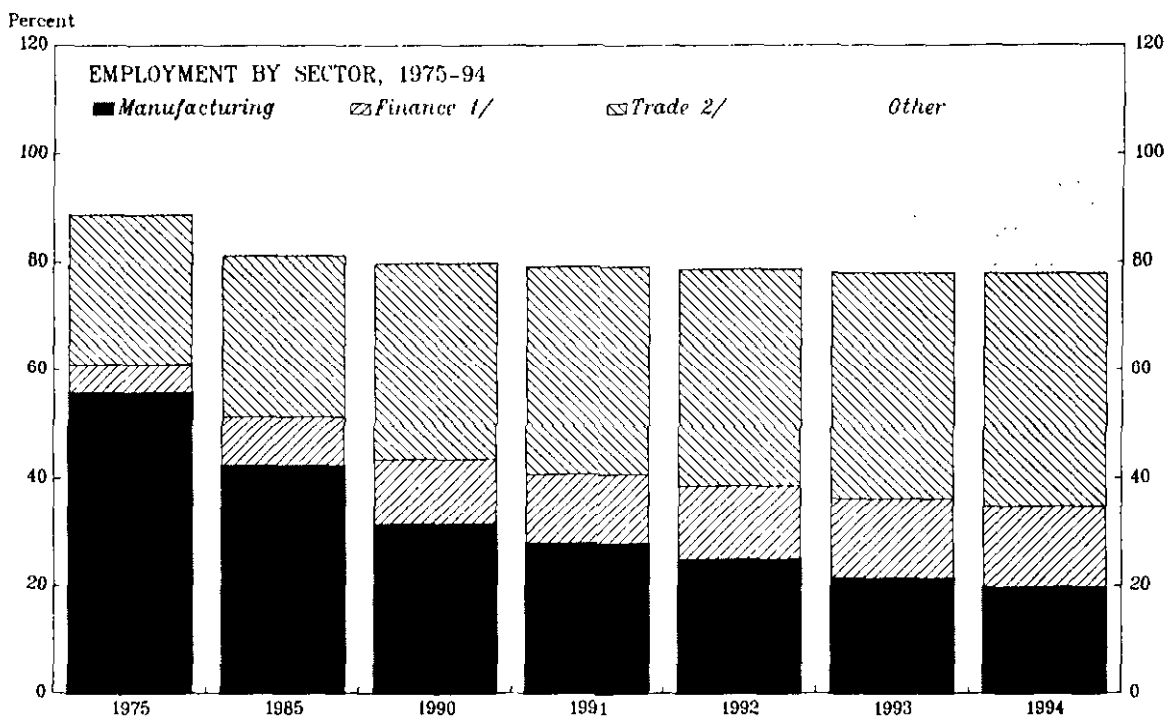
Table 14. Hong Kong: Trade Linked to Hong Kong Outprocessing Operations in China, 1989-94

	1989	1990	1991	1992	1993	<u>1994</u> Jan. - June
<u>(In millions of Hong Kong dollars)</u>						
Total exports from Hong Kong to China linked to manufacturing operations in China	76,868	91,914	113,931	141,639	160,178	80,631
Inputs of Hong Kong domestic exports	31,962	36,418	40,369	44,271	45,141	19,771
Inputs of Hong Kong re-exports	44,906	55,496	73,562	97,368	115,037	60,859
Total imports to Hong Kong from China linked to manufacturing operations in China	113,581	145,103	197,384	254,013	295,203	158,157
Output re-exported from Hong Kong	--	--	221,450	299,833	364,536	183,022
<u>(In percent of total trade with China)</u>						
Total exports from Hong Kong to China linked to manufacturing operations in China	52.4	58.0	54.8	51.7	47.4	45.3
Inputs of Hong Kong domestic exports	73.9	76.7	74.2	71.5	71.2	72.0
Inputs of Hong Kong re-exports	43.4	50.0	48.0	45.9	41.9	40.4
Total imports to Hong Kong from China linked to manufacturing operations in China	57.8	61.4	67.3	71.7	73.4	76.2
Output re-exported from Hong Kong	--	--	70.1	74.3	76.9	80.7

Source: Census and Statistics Department, Hong Kong Monthly Digest of Statistics.

HONG KONG

IMPACT OF ECONOMIC INTEGRATION WITH CHINA, 1975-94



Source: Census and Statistics Department, Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994.

1/ Includes financing, insurance, real estate, and other business services.

2/ Includes wholesale, retail, and import/export trades, restaurants, and hotels.

3/ Includes transport, storage, and communication.

technical functions such as product design and marketing) and higher productivity in manufacturing.

The pace of relocation of manufacturing industries from Hong Kong to southern China appears to have peaked in the early 1990s, in part because of rising wages in southern China. 1/ However, Hong Kong manufacturers have started relocating higher value-added and more complex production processes to China, and expanding existing facilities in southern China or moving lower value-added processes to other parts of China, mainly to northern and western provinces where costs of labor and land are still low.

In recent years, a different pattern of economic integration has emerged, as Hong Kong firms have begun outsourcing services to China. 2/ So far, outsourcing has been limited to labor-intensive activities such as data processing, financial back-office operations, and printing. Nevertheless, the large potential for expansion of outsourcing in Hong Kong's service-based economy has raised some concerns about competitiveness of the services sector.

As for the presence of Chinese manufacturing interests in Hong Kong, China was the third largest foreign investor in Hong Kong's manufacturing sector in 1991, after the United States and Japan. Chinese firms have also been active in Hong Kong's trade and retail sectors. The total number of Chinese firms operating in Hong Kong was estimated at about 2,000 in 1991.

3. Financial integration

a. Cash and bank flows

As a result of close production and trade linkages between Hong Kong and China, about one third of the Hong Kong dollar currency (HK\$20 billion as of end-August 1994) circulates in southern China. 3/ In recent years, some stores, hotels, and restaurants in Hong Kong have started to accept the renminbi brought in by Chinese residents. 4/ The amount of renminbi in circulation in Hong Kong is very small, but the Chinese currency can be exchanged easily.

1/ The wage differential between southern China and Hong Kong is presently estimated at about 1:5.

2/ Outsourcing involves contracting with firms in China to provide non-core services traditionally done internally.

3/ China's new foreign exchange regime, introduced in January 1994, prohibits the use of foreign currency as a means of payment. Nevertheless, the Hong Kong dollar is still widely held as a store of value.

4/ In March 1993, Chinese residents traveling abroad were authorized to carry up to Y 6,000 (about US\$900) on each trip. The exchange rate of the renminbi in Hong Kong is market-determined and provides a good indicator of its underlying market value.

Total external claims and liabilities between Hong Kong and Chinese banks amounted to HK\$458 billion (US\$59 billion) as of end-August 1994, compared with HK\$50 billion at end-1985 (Table 15). Hong Kong dollar deposits of Chinese banks comprise about 60 percent of all such deposits by foreign banks in Hong Kong. Likewise, claims of Hong Kong banks on Chinese banks comprise about 44 percent of their Hong Kong dollar-denominated external assets. Generally, Hong Kong banks have had net liabilities to Chinese banks; in aggregate, these net liabilities amounted to HK\$43 billion at end-August 1994 (Table 15). A large part of the liabilities to Chinese banks are foreign exchange deposits of enterprises in China that are recycled to Chinese enterprises through the Hong Kong banking system.

As discussed in Chapter IV, 15 Chinese banks, including the Bank of China and its "twelve sisters," operate in Hong Kong, mostly in retail banking. The Chinese banks' integration into Hong Kong's financial system deepened when the Bank of China became Hong Kong's third note-issuing bank in 1994. While foreign banks are still barred from engaging in renminbi business in China, 16 Hong Kong banks had 25 branches and 20 representative offices in China as of end-September 1994. 1/

b. Equity flows

The rapid growth of the Chinese economy in the 1990s and underdeveloped domestic capital markets have prompted Chinese enterprises to seek capital abroad. Initially, some Chinese enterprises entered the Hong Kong stock market by purchasing listed Hong Kong companies and using them as shell companies to raise equity finance in Hong Kong. In 1993, Chinese companies issued H shares for the first time on the Stock Exchange of Hong Kong. 2/ The shares of these companies were many times oversubscribed at issuance (Table 16), and the Hang Seng Chinese Enterprises Index, which tracks the H share companies, has moved closely with the Hang Seng Index (Chart 15). Although the combined market capitalization of the enterprises that issued H shares represented less than 1 percent of total SEHK capitalization at end-October 1994, this share is expected to grow rapidly in the future. In addition to the enterprises that issued H shares, it is estimated that about one fourth of companies listed on the SEHK are closely related to China in terms of ownership, location of operations, or origin of their profits.

H shares represent an important aspect of economic integration between Hong Kong and China because listing on the SEHK exposes Chinese premier state-owned enterprises to international competition. At the same time, H-share listings raise the international profile of the SEHK and allow it to diversify into industrial stocks over time, thereby reducing the weight of property and financial sectors in its stock market capitalization.

1/ According to recent reports, Chinese authorities may allow a few foreign banks to engage in renminbi business on an experimental basis.

2/ For a discussion of H shares, see Chapter IV.

Table 15. Hong Kong: Hong Kong Banks' Claims and Liabilities to Banks in China, 1989 and 1994

(In billions of Hong Kong dollars)

	December 1989			August 1994		
	Hong Kong- denominated	Foreign currency- denominated	Total	Hong Kong- denominated	Foreign currency- denominated	Total
Total liabilities to banks in China	46.7	31.2	77.9	102.8	120.6	223.4
To banks	46.7	31.2	77.9	101.8	113.3	215.1
To nonbanks	--	--	--	1.0	7.3	8.3
Total claims on banks in China	12.6	74.5	87.1	48.5	185.5	234.0
On banks	10.2	31.7	41.9	45.7	125.9	171.6
On nonbanks	2.4	42.8	45.2	2.8	59.6	62.4
Gross liabilities and claims	59.3	105.7	165.0	151.3	306.1	457.4
Net liabilities to banks in China	34.1	-43.3	-9.2	54.3	-64.9	-10.6
To banks	36.5	-0.5	36.0	56.1	-12.6	43.5
To nonbanks	-2.4	-42.8	-45.2	-1.8	-52.3	-54.1
Memorandum items:						
Total liabilities to foreign banks	81.3	2,254.7	2,336.0	192.6	4,024.5	4,217.0
Total claims on foreign banks	33.9	2,562.3	2,596.2	124.1	4,317.7	4,441.8

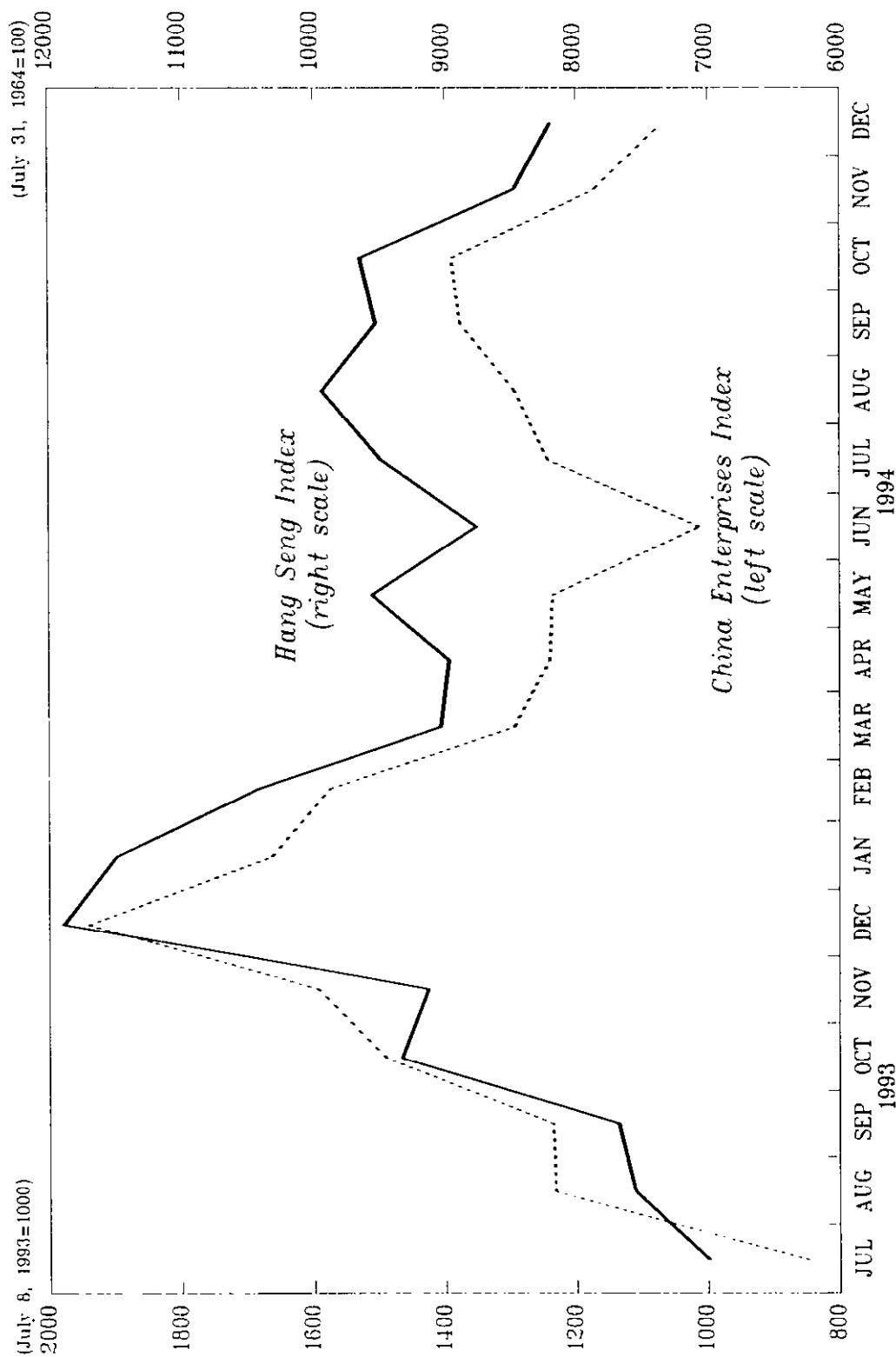
Source: Census and Statistics Department, Hong Kong Monthly Digest of Statistics.

Table 16. Hong Kong: H-Share Launch and Market Data

	Launch Date	Times Oversubscribed	Shares Issued	Value (HK\$ millions)	Price at Launch (HK\$)	Close of First Day Trading (HK\$)	Price on Oct. 31, 1994 (HK\$)	Capitalization on Oct. 31, 1994 (HK\$ millions)
Tsingtao Brewery Co. Ltd.	July 15, 1992	109.47	317.6	889.28	2.80	3.60	5.800	2,011.73
Beiren Printing Machinery Holdings Ltd.	August 6, 1993	24.00	100.00	208.00	2.08	2.75	3.525	352.50
Guangzhou Shipyard Inter- national Co. Ltd.	August 6, 1993	76.00	145.00	301.60	2.08	2.40	4.000	629.59
Shanghai Petrochemical Co. Ltd.	July 26, 1993	0.73	840.00	1,327.20	1.58	1.61	2.675	4,494.00
Maanshan Iron and Steel Co. Ltd.	November 3, 1993	67.70	1,732.90	3,933.68	2.27	3.65	2.450	4,245.68
Kunming Machine Tool Plant Co. Ltd.	December 7, 1993	627.00	65.00	128.70	1.98	5.80	3.050	198.25
Yizheng Joint Corporation of Chemical Fiber Co. Ltd.	March 29, 1994	19.17	300.00	714.00	2.38	2.42	3.075	3,075.00
Tianjin Bohai Chemical Industry (Group) Co. Ltd.	May 17, 1994	0.26	340.00	408.00	1.20	1.10	1.360	462.40
Dongfang Electrical Machinery Co. Ltd.	June 6, 1994	14.10	170.00	481.10	2.83	3.17	4.250	722.50
Luxiang Glass Co. Ltd.	July 8, 1994	0.02	68.50	250.03	3.65	2.92	4.450	1,112.50
Qingling Motors Co. Ltd.	August 17, 1994	22.50	100.00	207.00	2.07	2.75	3.275	3,209.50
Shanghai Hai Xin Shipping Co. Ltd.	November 11, 1994	12.95	216.00	315.36	1.46	1.65	...	...

Source: Data provided by the Hong Kong Monetary Authority.

THE HANG SENG INDEX AND THE CHINA ENTERPRISES INDEX, 1993-94



Source: Data provided by the Stock Exchange of Hong Kong.

4. Other areas of economic integration

Hong Kong accounts for about two thirds of realized foreign direct investment (FDI) in China (Table 17); of the US\$48 billion in cumulative realized FDI since 1981, about half was made in 1993-94. ^{1/} Until 1992, about four fifths of FDI was in manufacturing and the remainder in real estate, infrastructure development, and retail businesses. In recent years, however, an increasing share of FDI has been directed into real estate and infrastructure development such as port facilities and highways, reflecting higher rates of return than comparable investments in Hong Kong.

China is the third largest investor in Hong Kong, with cumulative realized FDI estimated at US\$12-20 billion since 1981. Chinese and Hong Kong firms jointly participate in major infrastructure and real estate development projects both in China and Hong Kong. Many of these projects (e.g., construction of highways in southern China, port facilities along China's eastern coast, and the Hong Kong airport) have been made economically viable by the success of integration through trade and production.

Economic integration is also reflected in the massive movements of tourists and business people across the China-Hong Kong border. In 1993, Chinese residents made two million visits to Hong Kong, while Hong Kong residents made 23 million visits to China (implying four trips per Hong Kong resident). About 30,000 Chinese residents work in Hong Kong under the provisions of Hong Kong's labor importation schemes. Although relatively small in number, Chinese workers make an important contribution to relieving pressure on certain sectors of the economy such as construction. Hong Kong provides employment directly for about three million workers in southern China, and about 64,000 Hong Kong residents were employed in China in 1992 (about 2 percent of Hong Kong's labor force).

5. Conclusions

Economic integration between Hong Kong and China has been spurred by the countries' geographical and cultural proximity, and the complementarity of their resource endowments and economic systems. China has abundant land and labor resources, but a developing economy with a system that is still characterized by many features of central planning, despite significant progress made in transforming the economy to a more market-oriented system. Hong Kong faces land and labor constraints, but is a highly open international business center with sophisticated transportation, telecommunication, and financial sectors, a stable currency, a highly-skilled labor force, and excellent legal and administrative systems. The comparative advantages implied by these complementary factor endowments have been the impetus for

^{1/} Estimates provided by the Hong Kong Monetary Authority, based on data by the Chinese Ministry of Foreign Trade on Economic Cooperation.

Table 17. Hong Kong: Hong Kong's Foreign Direct Investment
in China, 1988-93

(In billions of U.S. dollars)

	1988	1989	1990	1991	1992	1993
Pledged FDI	3.5	3.2	3.8	7.2	40.0	74.0
Realized FDI	2.1	2.0	1.9	2.4	7.5	17.2
Memorandum items:						
Growth of realized FDI (annual percentage change)	30	-2	-8	28	212	129
Share of realized FDI in total FDI in China (in percent)	65	60	54	55	68	66

Source: Ministry of Foreign Trade and Economic Cooperation, Almanac of China's Foreign Economic Relations and Trade.

the various facets of economic integration (Table 18). They are likely to spur further integration because of the benefits offered to both economies (Table 19).

From Hong Kong's perspective, trade with China not only provides it with its largest export market and import source, but also supports the services sectors, particularly transportation, commerce, and finance, that contribute substantially to its economy. From China's perspective, trade with Hong Kong provides an estimated one third of all its foreign exchange earnings. ^{1/}

Outprocessing has allowed Hong Kong's manufacturers to leverage their manufacturing and entrepreneurial skills over a vastly larger labor force and industrial sector, and thus overcome domestic land and labor constraints. To date, most outprocessing has been for exports to third countries, but the trend toward joint-venture production for Chinese consumption gives Hong Kong manufacturers access to a huge market that it otherwise lacks. From the Chinese perspective, joint ventures with Hong Kong firms offer its industrial sector manufacturing know-how and foreign financing. Outprocessing also channels resources such as foreign exchange and imported inputs to more efficient operations in China. It has also led to major infrastructure projects in southern China and along the coast.

Financial integration with China has enhanced Hong Kong's role as a regional and international financial center and attracted many foreign financial institutions, notably Japanese banks and U.S investment houses, to establish Hong Kong offices. As noted above, China is a significant source of Hong Kong dollar-denominated interbank deposits, while Hong Kong banks have traditionally played an important role in the syndication of loans for Chinese enterprises. More recently, premier Chinese enterprises have been raising equity capital through the issuance of H shares in the SEHK. These companies would have found it difficult to obtain funds of this scale through domestic stock exchanges in China. ^{2/} It has also allowed Hong Kong to play a small but important role in the enterprise reform in China. Thus, economic integration with Hong Kong has provided additional flexibility for China to selectively open, develop, and deregulate its domestic markets.

^{1/} The one-third share appears to be a widely accepted estimate although, as reported in Chai (1992), estimates of Hong Kong's contribution to China's foreign exchange earnings vary.

^{2/} For a description of the evolution of China's emerging capital market, see IMF, International Capital Markets (Washington: IMF, September 1994).

Table 18. Summary of Types of Economic Integration Between
Hong Kong and China

Trade

In 1993, China accounted for:

- 32 percent of Hong Kong's total exports
- 38 percent of Hong Kong's total imports
- 33 percent of Hong Kong's re-exports by destination
- 58 percent of Hong Kong's re-exports by origin

Production

Output of outprocessing operations in China exported to Hong Kong valued at US\$38 billion in 1993; exports of goods processed in China and re-exported from Hong Kong valued at US\$47 billion in 1993.

Financial

Cash and Bank Flows:

One third of Hong Kong dollar notes (HK\$20 billion) are circulating in southern China (as of end-August 1994).

Most of China's foreign syndicated loans are intermediated by Hong Kong banks (since 1990).

China's banks are the major source of Hong Kong dollar funding in Hong Kong's interbank market (HK\$103 billion, as of August 1994).

China's banks are a net source of funds to Hong Kong's banks (HK\$43 billion as of August 1994).

Equity Market:

H share capitalization of over HK\$25 billion in 1994.

Twenty five percent of the firms listed on the SEHK in 1994 estimated to have interests in China.

Transactions of B shares on the Shenzhen stock exchange are conducted in Hong Kong dollars since the introduction of B shares in 1992.

Foreign direct investment

Cumulative FDI flows from Hong Kong to China from 1981 to 1993 estimated at US\$48 billion.

Cumulative FDI flows from China to Hong Kong from 1981 to 1992 estimated at US\$12-20 billion.

Labor

Three million Chinese workers employed by Hong Kong firms in southern China in 1994.

Large proportion of employment in the Hong Kong manufacturing, import/export trade, transportation and storage, and financial and business services sectors dependent on outprocessing activities in China since early 1980s.

Direct employment of 30,000 Chinese workers in 1994 relieves labor supply pressures in Hong Kong; 2 percent of Hong Kong's labor force estimated to work in China in 1992.

Source: Data provided by the Hong Kong authorities; and staff estimates.

Table 19. Hong Kong: Benefits of Economic Integration
to Hong Kong and China

Benefits to Hong Kong	Activity	Benefits to China
<u>Trade</u>		
Major source of growth and income.		Provides one third of all foreign exchange.
<u>Outprocessing</u>		
Allows Hong Kong to upgrade its industrial sector and shift workers into higher value-added, higher paid jobs.		Fixed capital formation. Provides employment, channels resources to productive sectors.
Potential to provide Hong Kong with the large market it lacks.		Motivates major transportation and infrastructure development in China.
Demand for financial and other business services.		
Major source of national income (as yet unmeasured).		
<u>Foreign Direct Investment</u>		
Provides Hong Kong firms with vast investment opportunities that have high rates of return.		Provides Chinese enterprises a foothold in Hong Kong where they can acquire advanced technology and develop markets. Allows Chinese enterprises to diversify investment.
<u>Banking</u>		
Enhances Hong Kong's stature as an international financial center. Attracts more foreign financial institutions to Hong Kong.		A convenient and important source of funding for economic development. Provides Chinese banks with opportunity to learn modern banking practices.
Potential for Hong Kong banks to expand into wholesale or retail banking operations in China.		

Table 19. Honk Kong Benefits of Economic Integration
to Hong Kong and China (concluded)

Benefits to Hong Kong	Activity	Benefits to China
<u>H Shares</u>		
Diversification of the stock market, dominated by property and financial companies, into the industrial sector through the listing of Chinese companies.	Allows public offering of premier Chinese companies at international standards for accounting, disclosure, etc., without making such requirements uniform for all Chinese enterprises.	
Enhancement of Hong Kong's role as an international financial center.	Lends Hong Kong's administrative and legal framework to the fund raising, possibly lowering the cost of raising capital.	
	Allows Chinese state enterprises to restructure into modern corporations and raise equity capital from abroad to upgrade and expand their operations.	

References

Bell, Michael W., Hoe Ee Khor, and Kalpana Kochhar, China at the Threshold of a Market Economy, International Monetary Fund Occasional Paper 107 (Washington: IMF 1993).

Chai, Joseph, D.H., "Economic Relations with China," in The Economic System of Hong Kong, eds. H.C.Y. Ho and L.C. Chau (Hong Kong: Asian Research Service, 1992).

General Agreement on Tariffs and Trade, Trade Policy Review Mechanism: Hong Kong 1994 (Geneva: GATT, 1994).

Economic Provisions of the Joint Declaration and Basic Law

This annex summarizes the main economic provisions of the Sino-British Joint Declaration of 1984 and the Basic Law of the Hong Kong Special Administrative Region (HKSAR) of the People's Republic of China of 1990. The Joint Declaration and Basic Law provide for the capitalist system of Hong Kong to remain unchanged and for the HKSAR to be autonomous in all but two areas--foreign affairs and defense--for 50 years after July 1, 1997. The main difference between the two documents is that the Joint Declaration is an international treaty registered with the United Nations, while the Basic Law is a Chinese statute adopted by the National People's Congress of the People's Republic of China and may be regarded as a mini-constitution for Hong Kong that will become effective on July 1, 1997.

The transfer of sovereignty to China in 1997 is being coordinated by the Joint Liaison Group (JLG), a Sino-British standing committee stationed in Hong Kong that was established under the Joint Declaration to oversee its implementation and address issues not explicitly provided for in the Declaration or the Basic Law. Much of this work is legal in nature. For example, some 1,600 pieces of Hong Kong legislation have to be "adapted," that is, brought into conformity with the Basic Law. Also, some 300 pieces of U.K. legislation have to be "localized." In addition, there are many substantive issues such as Hong Kong's continuing distinct membership of or participation in some 40 international organizations and the continued application of some 160 international treaties to the HKSAR. So far, agreements have been reached in the JLG on Hong Kong's continued distinct membership of or participation in most relevant international organizations (including the IMF). Considerable progress has also been achieved in enabling Hong Kong to negotiate a number of bilateral treaties of its own, which deal with issues such as investment protection, surrender of fugitive offenders, reciprocal enforcement of judgments, and mutual legal assistance.

An important achievement of the JLG so far has been agreement on a number of large projects straddling 1997, including electricity generation, cable television, landfills and waste management, and airport financing. ^{1/} The JLG has also reached agreement on the future of the military estate.

The pace of negotiations in the JLG is expected to quicken considerably as 1997 approaches. The Joint Declaration did not provide for a binding dispute resolution mechanism; however, there is a provision, as yet unused, that unresolved matters are to be referred to the Chinese and British Governments for solution through consultation. The JLG is to continue to function until the year 2000, 2 1/2 years after the transfer of sovereignty to China.

^{1/} Agreement on the franchise for Container Terminal 9, the second largest infrastructure project in Hong Kong, is pending.

Budget preparation is one significant area where consultations on the transfer of sovereignty will begin early in 1995. The FY 1997/98 budget, which straddles July 1, 1997, will be prepared by the Hong Kong Government for the whole fiscal year in close consultation with China. 1/ As the budget cycle in Hong Kong takes 12 months to complete, Chinese representatives will need to participate in the budget preparation process from April 1996. Furthermore, as Chinese representatives have to familiarize themselves with budgetary procedures in order to participate actively in the budget discussions in 1996, the Hong Kong Treasury will organize seminars for Chinese representatives in January-March 1995, and invite them to observe the 1996/97 budget cycle beginning in April 1995.

With respect to the monetary system, the Joint Declaration and the Basic Law provide for the monetary independence of the HKSAR, and for the Hong Kong dollar to remain the legal tender and a freely convertible currency fully backed by foreign exchange. The People's Bank of China has recently reiterated its full support for the linked exchange rate system and its continuation up to and beyond 1997. 2/

1/ The fiscal year in Hong Kong begins on April 1.

2/ See "Address on the Linked Exchange Rate System and the Smooth Transition in Hong Kong" by Mr. Chen Yuan, Deputy Governor of the People's Bank of China (Hong Kong, October 26-29, 1994).

HONG KONG SPECIAL ADMINISTRATIVE REGION (HKSAR)
MAIN PROVISIONS OF THE JOINT DECLARATION AND BASIC LAW 1/

I. GENERAL PROVISIONS

1. Economic system

(JD 16, 42, 84; BL 5)

The socialist system and policies shall not be practiced in the HKSAR, and the previous capitalist system and way of life shall remain unchanged for 50 years.

2. Property relations

(JD 18, 86; BL 6)

The right of private ownership of property shall be protected.

3. Land and natural resources

(BL 7)

The land and natural resources within the HKSAR shall be state property. Land shall be managed, developed, and leased by the HKSAR and revenue derived therefrom shall be left with the HKSAR.

4. Legal system

(JD 10, 53; BL 8)

The laws previously in force in Hong Kong--the common law, rules of equity, ordinances--shall be maintained, except for any that contravene the Basic Law.

1/ Based on the Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong [Initialed on September 26, 1984; Signed on December 19, 1984; Ratified on May 27, 1985] (Hong Kong: Government Printer); and The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China [Signed on April 4, 1990] (Hong Kong: Government Printer, 1993). Parentheses contain cross-references to the corresponding Articles of the Joint Declaration (JD) and the Basic Law (BL). The summary presented is not exhaustive.

II. PROVISIONS ON THE ECONOMY

1. Legal and economic framework

(JD 18, 86; BL 105)

The rights of private ownership of property and investments shall be protected by law.

(JD 20, 94; BL 109)

The HKSAR shall provide an appropriate economic and legal environment for
(i) the maintenance of the status of Hong Kong as an international financial center;

(BL 118)

(ii) encouraging investments, technological progress, and the development of new industries;

(BL 119)

(iii) the development of various trades;

(BL 119)

(iv) the protection of the environment.

2. Public finance

Independent finances

(JD 23, 24, 79, 81, 82;
BL 106)

The HKSAR shall have independent finances and use its resources exclusively for its own purposes. The Central Government shall not levy taxes in the HKSAR.

**Budget policy and
public expenditure**
(BL 107)

The HKSAR shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve fiscal balance, avoid deficits, and keep the budget commensurate with the growth rate of its GDP.

Tax laws and tax policy
(JD 24, 81; BL 108)

The HKSAR shall practice an independent taxation system. Taking the low tax policy as reference, it shall enact its own tax laws.

3. Monetary and financial systems

Legal foundation
(BL 110)

The monetary and financial systems of the HKSAR shall be prescribed by law.

Monetary independence
(JD 96, 97; BL 110)

The HKSAR shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with law.

Legal tender
(JD 22, 100; BL 111)

The Hong Kong dollar shall continue to circulate as the legal tender.

Currency issue and backing
(JD 101; BL 111)

The authority to issue Hong Kong currency shall be vested in the Government of the HKSAR. The issue of Hong Kong currency must be backed by a 100 percent reserve fund. The system regarding the issue of Hong Kong currency and the reserve fund system shall be prescribed by law.

(JD 102; BL 111)

Designated banks may be authorized to issue Hong Kong currency. The arrangements for such issue must be consistent with the object of maintaining the stability of the currency.

Foreign exchange controls, convertibility, financial markets
(JD 20, 22, 98, 99, 100; BL 112)

No foreign exchange controls shall be applied in the HKSAR. The Hong Kong dollar shall be freely convertible. Markets for foreign exchange, gold, securities, futures, and the like shall continue.

Capital flows
(JD 21, 97; BL 112)

The HKSAR shall safeguard the free flow of capital within, into and out of the region.

Exchange Fund
(JD 104; BL 113)

The Exchange Fund shall be managed and controlled by the Government of the HKSAR primarily for regulating the exchange value of the Hong Kong dollar.

4. Trade and industry

Free port status and free trade policy
(JD 19, 87; BL 114, 115)

The HKSAR shall maintain the status of a free port and shall not impose any tariff. It shall pursue the policy of free trade and safeguard the free movement of goods, intangible assets, and capital.

Separate customs territory
(JD 19, 89, 90; BL 116)

The HKSAR shall be a separate customs territory and may participate in relevant international organizations and trade agreements under the name "Hong Kong, China."

(JD 91; BL 116)

Export quotas and tariff preferences obtained by the HKSAR shall be enjoyed exclusively by the region.

(JD 92; BL 117)

The HKSAR may issue its own certificates of origin for products.

5. Land leases

Protection of land leases
(JD 18, 86, 202; BL 120)

Land leases and related rights granted before the establishment of the HKSAR and extending beyond June 30, 1997 shall continue to be recognized and protected under the law of the HKSAR.

Payment of rent
(JD 203, 204, 207, 208;
BL 121)

Land leases extending beyond June 30, 1997 shall not be subject to additional premium, but to an annual rent equivalent to 3 percent of the rateable value of the properties concerned.

Rural properties
(JD 205; BL 122)

Indigenous villagers holding rural properties shall continue to pay the previous rent.

6. Shipping

(JD 105; BL 124)

Hong Kong's existing system of shipping management and regulation shall be maintained.

(JD 108; BL 125)

Hong Kong shall continue to maintain a separate shipping register.

(JD 109; BL 126)

Ships (except foreign warships) shall continue to enjoy access to the ports of the HKSAR.

(JD 107; BL 127)

Private shipping and port businesses may continue to operate freely.

7. Civil aviation

(JD 112; BL 129)

Hong Kong's previous system of civil aviation management shall be maintained.

(JD 118-122; BL 133)

The HKSAR, acting under authorization from the Central People's Government, shall regulate all air services to, from, or through Hong Kong which do not operate to, from, or through the mainland of China.

(JD 115-117; BL 132)

International and domestic air services involving the HKSAR and the mainland of China shall be regulated by the Central People's Government, taking into account the special conditions and economic interests of the HKSAR.

8. Immigration and labor

(JD 165; BL 22)

For entry into the HKSAR, people from other parts of China must apply for approval. Among them, the number of persons who enter the region for the purpose of settlement shall be determined by the competent authorities of the Central People's Government after consulting the government of the Region.

(JD 166; BL 154)

The Government of the HKSAR may apply immigration controls on entry into, stay in, and departure from the Region by persons from foreign states and regions.

(BL 147)

The HKSAR shall on its own formulate laws and policies relating to labor.

(JD 129; BL 142)

Hong Kong's previous system of assessing and certifying professional qualifications shall be maintained. The HKSAR shall continue to recognize the existing professions and professional organizations.

9. Social services

(BL 144)

The policy of subventions for nongovernmental organizations in education, medicine and health, culture, art, recreation, sports, social welfare, and social work shall be maintained.

(BL 145)

The HKSAR shall formulate its own policies on the development and improvement of the social welfare system in the light of the economic conditions and social needs.

Table 1. Hong Kong: Gross Domestic Product by Expenditure Component
at Constant (1990) Market Prices, 1989-94

	1989	1990	1991	1992	1993	1994 Jan.-June 1/
(In millions of Hong Kong dollars)						
Consumption	353,757	373,742	405,636	463,010	465,039	240,826
Private	312,682	330,459	359,019	383,421	411,653	212,958
Government	41,035	43,283	46,617	52,589	53,386	27,868
Gross fixed capital formation	142,204	153,776	168,059	183,141	189,826	102,980
Private	123,381	134,006	148,914	163,001	161,674	...
Government	18,823	19,770	19,145	20,140	28,152	...
Final domestic demand	495,921	527,518	573,695	619,151	654,865	343,806
Private	436,063	464,465	507,933	546,422	573,327	...
Government	59,858	63,053	65,762	72,729	81,538	...
Change in stocks	3,376	5,728	4,081	8,453	2,587	10,692
Total domestic demand	<u>499,297</u>	<u>533,246</u>	<u>577,776</u>	<u>627,604</u>	<u>657,452</u>	<u>354,498</u>
Net exports of goods and nonfactor services	64,071	49,303	34,240	21,133	28,645	-14,504
Gross domestic product	<u>563,368</u>	<u>582,549</u>	<u>612,016</u>	<u>648,737</u>	<u>686,097</u>	<u>339,994</u>
(Annual percentage change)						
Consumption	3.6	5.7	8.5	7.5	6.7	7.5
Private	3.4	5.7	8.6	6.8	7.4	8.0
Government	5.2	5.5	7.7	12.8	1.5	3.9
Gross fixed capital formation	3.5	8.1	9.3	9.0	3.7	12.0
Private	2.0	8.6	11.1	9.5	-0.8	...
Government	14.2	5.0	-3.2	5.2	39.8	...
Final domestic demand	3.6	6.4	8.8	7.9	5.8	8.8
Private	3.0	6.5	9.4	7.6	4.9	...
Government	7.9	5.3	4.3	10.6	12.1	...
Total domestic demand	1.3	6.8	8.4	8.6	4.8	9.8
Exports of goods and nonfactor services	9.0	8.4	15.0	18.5	12.7	9.1
Exports of goods	10.6	9.6	17.3	19.8	13.5	9.6
Domestic exports	0.1	-0.5	0.5	0.2	-4.5	-5.7
Re-exports	18.6	16.0	26.5	28.3	19.6	13.9
Exports of nonfactor services	2.3	3.6	4.7	11.6	8.2	6.4
Imports of goods and nonfactor services	8.5	11.5	18.1	20.7	12.2	11.6
Imports of goods	8.9	11.4	19.0	22.2	12.7	12.0
Imports of nonfactor services	5.7	12.1	11.3	9.1	7.8	8.0
Gross domestic product	2.6	3.4	5.1	6.0	5.8	5.5
Memorandum items:						
Contribution to growth:						
From total domestic demand	1.1	6.0	7.6	8.1	4.6	9.8
Of which: From changes in stock	-2.0	0.4	-0.3	0.7	-0.9	1.2
From net exports of goods and nonfactor services	1.4	-2.6	-2.6	-2.1	1.2	-4.3

Sources: Census and Statistics Department, Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994; and Quarterly Estimates of Gross Domestic Product, Second Quarter 1994.

1/ Percentage changes calculated over corresponding year-earlier period

Table 2. Hong Kong: Gross Domestic Product by Expenditure Component
at Current Market Prices, 1989-94

	1989	1990	1991	1992	1993	1994 Jan.-June 1/
(In millions of Hong Kong dollars)						
Consumption	323,930	373,742	442,568	511,745	581,052	316,968
Private	287,677	330,459	391,098	447,917	509,211	276,518
Government	36,253	43,283	51,470	63,828	71,841	40,450
Gross fixed capital formation	136,204	153,776	177,729	213,768	233,723	136,320
Private	118,606	134,006	157,189	191,453	200,782	...
Government	17,598	19,770	20,540	22,315	32,941	...
Final domestic demand	460,134	527,518	620,297	725,513	814,775	453,288
Private	406,283	464,465	548,287	639,370	709,993	...
Government	53,851	63,053	72,010	86,143	104,782	...
Change in stocks	3,463	5,728	4,098	8,187	2,040	11,126
Total domestic demand	<u>463,597</u>	<u>533,246</u>	<u>624,395</u>	<u>733,700</u>	<u>816,815</u>	<u>464,414</u>
Net exports of goods and nonfactor services	<u>60,264</u>	<u>49,303</u>	<u>44,117</u>	<u>45,211</u>	<u>70,799</u>	<u>8,139</u>
Exports of goods and nonfactor services	697,656	782,195	926,973	1,117,396	1,270,140	650,879
Exports of goods	570,509	639,874	765,886	924,952	1,046,250	527,029
Domestic exports	224,104	225,875	231,045	234,124	223,027	98,743
Re-exports	346,405	413,999	534,841	690,829	823,223	428,285
Exports of nonfactor services	127,147	142,321	161,087	192,444	223,890	123,850
Imports of goods and nonfactor services	637,392	732,892	882,856	1,072,185	1,199,341	642,740
Imports of goods	565,219	645,200	782,042	958,462	1,075,710	574,622
Imports of nonfactor services	72,173	87,692	100,814	113,723	123,631	68,116
Gross domestic product	<u>523,861</u>	<u>582,549</u>	<u>668,512</u>	<u>778,911</u>	<u>887,614</u>	<u>472,553</u>
(In percent of GDP)						
Memorandum items:						
Consumption	61.8	64.2	66.2	65.7	65.5	67.1
Gross fixed capital formation	26.0	26.4	26.6	27.4	26.3	28.8
Final domestic demand	87.8	90.6	92.8	93.1	91.8	95.9
Change in stocks	0.7	1.0	0.6	1.1	0.2	2.4
Total domestic demand	88.5	91.5	93.4	94.2	92.0	98.3
Net exports of goods and nonfactor services	11.5	8.5	6.6	5.8	8.0	1.7

Sources: Census and Statistics Department, Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994; and Quarterly Estimates of Gross Domestic Product, Second Quarter 1994.

1/ Percentage changes calculated over corresponding year-earlier period.

Table 3. Hong Kong: Gross Domestic Product by Sector at Current Prices, 1988-92

	1988	1989	1990	1991	1992
(In millions of Hong Kong dollars)					
Agriculture and fishing	1,417	1,386	1,432	1,441	1,468
Mining and quarrying	229	224	210	222	205
Manufacturing	90,035	96,170	98,352	97,223	99,764
Electricity, gas, water	10,199	10,860	12,612	13,521	15,637
Construction	20,658	25,738	30,220	34,659	37,337
Wholesale, retail and export/import trades, restaurants and hotels	109,793	124,749	140,722	163,284	190,694
Transportation, storage, and communications	40,005	44,654	52,927	60,604	70,719
Finance, insurance, real estate and business services	82,813	97,297	113,127	143,296	178,124
Community, social, and personal services	61,002	70,124	81,328	94,293	110,194
Ownership of premises	43,416	51,534	59,257	68,873	77,623
Adjustment for financial services ^{1/}	-21,313	-23,800	-30,741	-45,902	-54,846
Gross domestic product at factor cost	<u>438,255</u>	<u>498,935</u>	<u>559,446</u>	<u>631,514</u>	<u>726,918</u>
Indirect taxes less subsidies	21,450	25,390	29,614	36,323	48,777
Gross domestic product at market prices ^{2/}	<u>459,704</u>	<u>524,326</u>	<u>589,060</u>	<u>667,837</u>	<u>775,694</u>
(In percent of GDP)					
Memorandum items: ^{3/}					
Manufacturing	20.5	19.3	17.6	15.4	13.7
Wholesale, retail and export/import trades, restaurants and hotels	25.1	25.0	25.2	25.9	26.2
Finance, insurance, real estate and business services	18.9	19.5	20.2	22.7	24.5
Transportation, storage, and communications	9.1	8.9	9.5	9.6	9.7
Ownership of premises	9.9	10.3	10.6	10.9	10.7

Source: Census and Statistics Department, Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994.^{1/} An imputed service charge, equal to net interest receipts for the banking sector.^{2/} Production-based estimate. Difference between production-based estimate and expenditure-based estimate reflects statistical discrepancy.^{3/} Measured relative to production-based GDP at factor cost.

Table 4. Hong Kong: Composition of Gross Fixed Capital Formation
at Constant (1990) Market Prices, 1989-93

	1989	1990	1991	1992	Est. 1993
(In millions of Hong Kong dollars)					
Total gross domestic fixed capital formation ^{1/}	142,204	153,776	168,059	183,141	189,826
Private	123,381	134,006	148,914	163,001	161,674
Public	18,823	19,770	19,145	20,140	28,152
Transfer costs of land and buildings	7,766	8,296	11,481	13,126	12,515
Private	7,766	8,296	11,481	13,126	12,515
Public	--	--	--	--	--
Construction	53,088	57,314	57,658	57,650	62,712
Private	35,946	39,172	40,468	39,335	37,054
Public	17,142	18,142	17,190	18,315	25,658
Residential buildings	21,519	23,475	22,576	23,024	22,997
Private	16,065	18,375	17,963	17,770	18,000
Public	5,454	5,100	4,613	5,254	4,997
Non-residential buildings	18,005	20,311	22,034	20,502	19,395
Private	14,287	16,158	18,032	17,084	14,933
Public	3,718	4,153	4,002	3,418	4,462
Other construction	13,564	13,528	13,048	14,124	20,320
Private	5,594	4,639	4,473	4,481	4,121
Public	7,970	8,889	8,575	9,643	16,199
Real estate developers' margin	24,830	28,355	29,034	27,865	25,370
Private	24,830	28,355	29,034	27,865	25,370
Public	--	--	--	--	--
Machinery and equipment	56,520	59,811	69,886	84,500	90,144
Private	54,839	58,183	67,931	82,675	87,650
Public	1,681	1,628	1,955	1,825	2,494
Transportation equipment	8,212	8,468	10,129	12,587	12,709
Private	7,352	8,043	9,676	11,904	12,220
Public	860	425	453	683	489
Machinery and other equipment	48,308	51,343	59,757	71,913	77,435
Private	47,487	50,140	58,255	70,771	75,430
Public	821	1,203	1,502	1,142	2,005
(Percentage change)					
Memorandum items:					
Total gross domestic fixed capital formation	3.5	8.1	9.3	9.0	3.7
Private	2.0	8.6	11.1	9.5	-0.8
Public	14.2	5.0	-3.2	5.2	39.8
Private investment in residential construction	-2.8	14.4	-2.2	-1.1	1.3
Private investment in plant, machinery, and equipment	2.1	5.8	16.8	20.9	6.7

Sources: Census and Statistics Department, Composition of Gross Domestic Fixed Capital Formation by Public/Private Sector, 1966-1993; and staff estimates.

^{1/} Totals for 1993 do not add up, as the disaggregated series has not yet been revised.

Table 5. Hong Kong: Selected Price Indicators, 1988-94

(Percentage change)

	1988	1989	1990	1991	1992	1993	1994 1/		
							Q I	Q II	Q III
CPI (A) 2/	7.4	10.1	9.7	12.0	9.3	8.5	7.3	7.7	8.9
Food - overall	9.6	12.4	9.9	11.4	8.8	7.2	5.6	5.3	8.3
- meals away from home	9.8	15.6	15.5	13.3	10.6	8.7	8.0	7.9	7.6
- excluding meals away from home	9.5	9.4	4.8	9.4	6.9	5.6	2.9	2.4	9.3
Housing	3.5	7.0	8.7	12.6	13.0	12.6	9.8	11.4	11.5
Fuel and light	1.1	3.0	10.9	6.2	5.2	3.8	2.3	2.8	3.3
Alcohol and tobacco	6.5	7.7	17.3	44.2	9.7	10.5	7.8	5.3	4.9
Clothing and footwear	9.1	9.2	7.3	7.3	8.5	7.6	5.8	7.6	9.8
Durable goods	5.9	3.3	3.0	4.4	2.3	2.2	2.4	2.9	3.0
Miscellaneous goods	6.5	7.5	5.3	7.9	6.8	6.8	6.6	6.2	5.6
Transportation and vehicles	4.7	12.1	13.4	13.2	7.2	8.3	10.2	9.5	9.4
Services	9.2	11.4	13.0	14.1	11.8	9.5	10.8	12.1	12.0
Memorandum items.									
CPI (B) 2/	7.4	9.7	9.7	11.7	9.6	8.7	7.7	8.2	9.1
Residential price index	21.5	26.6	11.0	37.8	40.5	11.6	32.9	33.6	18.8
GDP deflator	9.5	12.3	7.5	9.2	9.9	7.8	8.9	8.0	...
Domestic demand deflator	10.9	10.2	7.8	8.1	8.1	6.2	7.4	6.5	...
Export prices - goods deflator	2.4	4.6	2.4	2.0	0.8	-0.3	0.8	0.0	1.4
- services deflator	9.5	12.0	8.0	8.2	7.0	7.5	8.5	6.5	...
Import prices - goods deflator	4.2	3.6	2.5	1.9	0.3	-0.5	1.4	0.6	2.1
- services deflator	3.9	8.7	8.3	3.3	3.4	0.9	-1.8	5.0	...

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; Quarterly Estimates of GDP, Second Quarter 1994; and Financial Services Branch, Third Quarter Economic Report, 1994.

1/ Increase over corresponding year-earlier period

2/ Data for CPI(A) and CPI(B) for 1987-91 use October 1984-September 1985 as the base year. Beginning in 1992, data for CPI(A) and CPI(B) use October 1989-September 1990 as the base year.

Table 6. Hong Kong: Labor Force, Employment, and Unemployment, 1989-94

	1989	1990	1991	1992	1993	1994		
						I	II	III
	(In thousands)							
Labor force <u>1/</u>	2,753	2,748	2,799	2,793	2,873	2,933	2,958	2,974
Employed	2,723	2,711	2,749	2,738	2,816	2,876	2,911	2,907
Unemployed	30	37	50	55	57	57	48	67
	(In percent of total labor force)							
Unemployment rate	1.1	1.3	1.8	2.0	2.0	1.9	1.6	2.3
Labor force participation rate	63.7	63.2	63.4	62.3	62.6	62.3	62.5	62.5
	(In percent of total employed)							
Employment in selected sectors <u>2/</u>								
Manufacturing	29	26	23	21	17	16	15	...
Finance, insurance, and business services	9	10	11	12	12	12	12	...
Trade and tourism <u>3/</u>	28	31	32	33	34	35	36	...
Building and construction	3	3	2	2	2	2	2	...
Community, social, and personal services	9	9	10	10	10	...	...	...
Transportation, storage, and communication	5	5	5	5	5	6	6	...
Civil service	7	7	7	7	6	6	6	...
Other	22	21	23	23	25	...	...	...

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and Financial Services Branch, Third Quarter Economic Report 1994.

1/ Period average.

2/ End of period.

3/ Wholesale, retail, import and export trades, restaurants, and hotels.

Table 7. Hong Kong: Indicators of Wages, Labor Productivity,
and Unit Labor Costs, 1989-94

(Percentage change)

	1989	1990	1991	1992	1993	1994 March 1/
Nominal wages 2/						
Overall economy	13.0	12.7	11.1	9.8	10.8	9.9
Manufacturing sector	11.5	12.2	11.0	9.5	10.7	9.6
Wholesale and retail trade 3/	14.3	11.1	9.9	9.6	9.2	10.2
Business services 4/	19.5	16.6	12.6	11.0	12.2	8.4
Real wages 2/						
Overall economy	2.9	2.5	-1.1	0.2	2.8	1.9
Labor productivity 5/						
Overall economy	2.9	3.7	2.8	5.6	2.6	2.3
Manufacturing sector	6.6	9.7	14.7	13.1	10.3	8.7
Unit labor costs 5/						
Overall economy	10.1	8.6	7.6	4.3	8.0	7.5
Manufacturing sector						
Wage-based	5.1	2.3	-3.7	-2.5	-5.2	0.9

Sources: Census and Statistics Department, Hong Kong Annual Digest of Statistics; Hong Kong Monthly Digest of Statistics; Revised Estimates of Gross Domestic Product, 1961 to First Quarter 1994; Quarterly Estimates of Gross Domestic Product, Second Quarter 1994; and staff estimates.

1/ Data on nominal and real wages are percentage changes over March 1993. Data on labor productivity and unit labor costs are average year-on-year percentage changes for four quarters ending March.

2/ Calculated using averages of semiannual data.

3/ Includes wholesale, retail, import and export trades, restaurants, and hotels.

4/ Includes financing, insurance, real estate, and business services.

5/ Based on employment; data on person-hours are unavailable.

Table 8. Hong Kong: Real Estate Price and Rental Indices, 1989-94 ^{1/}

	1989	1990	1991	1992	1993	1994 ^{2/}		
						I	II	III
(1989 = 100)								
Price indices								
Private domestic premises	100	111	153	215	240	287	310	297
Of which:								
40 - 69.9 square meters	100	111	155	219	246	302	318	302
100 square meters and above	100	105	135	205	253	333	361	345
Private retail premises ^{3/}	100	112	143	200	245	259	265	277
Offices	100	96	97	133	160	198	221	230
Flatted factories	100	106	114	147	173	191	197	208
(Percent change)								
Private domestic premises	26.6	11.0	37.8	40.5	11.6	32.9	33.6	18.8
Of which:								
40 - 69.9 sq. meters	28.2	11.0	39.6	41.3	12.3	37.3	33.6	16.6
100 sq. meters and above	25.0	5.0	27.6	51.9	23.4	54.2	51.7	31.7
Private retail premises ^{3/}	31.6	12.0	27.7	39.9	22.5	11.6	8.6	12.1
Offices	61.3	-4.0	1.0	37.1	20.3	31.1	43.5	42.9
Flatted factories	26.6	6.0	7.5	28.9	17.7	17.2	10.1	15.6
Rental indices								
(1989 = 100)								
Private domestic premises	100	110	119	130	140	153	167	173
Private retail premises ^{3/}	100	112	126	149	165	183	190	193
Offices	100	101	95	101	110	123	132	137
Flatted factories	100	105	109	117	130	130	131	133
(Percent change)								
Private domestic premises	26.6	10.0	8.2	9.2	7.7	14.2	21.9	21.8
Private retail premises ^{3/}	23.5	12.0	12.5	18.3	10.7	13.0	15.9	14.9
Offices	63.9	1.0	-5.9	6.3	8.9	16.0	22.2	22.3
Flatted factories	29.9	5.0	3.8	7.3	11.1	4.0	0.8	1.5

Source: Census and Statistics Department, Hong Kong Monthly Digest of Statistics.

^{1/} Data are period averages.

^{2/} Percentage changes are calculated over corresponding year-earlier periods.

^{3/} From 1989, the indices are in respect of all types of retail premises. They are not strictly comparable with the earlier indices that are in respect of shop premises with street frontage only.

Table 9. Hong Kong: Consolidated Government Account, 1989/90-1994/95 1/

	1989/90	1990/91	1991/92	1992/93	1993/94		1994/95	
					Budget	Actual	Budget	Staff Proj.
<hr/>								
(In millions of Hong Kong dollars)								
General revenue account								
Revenue	74,365	82,674	101,456	120,781	134,006	143,900	147,889	150,000
Expenditure	51,962	62,627	72,851	86,487	99,304	98,540	110,003	109,250
Current	49,077	60,378	70,773	81,593	94,286	93,191	107,750	106,950
Capital	2,885	2,249	2,078	4,894	5,018	5,349	2,253	2,300
Surplus before transfers	22,403	20,047	28,605	34,294	34,702	45,360	37,886	40,750
Transfers to funds	17,700	20,210	20,550	15,538	24,450	22,500	27,100	28,000
Balance after transfers	4,703	-163	8,055	18,756	10,252	22,860	10,786	12,750
Consolidated account funds 2/								
Revenue	8,064	6,849	12,144	12,011	16,029	22,699	28,728	29,800
Capital expenditure	19,404	22,929	19,340	26,845	52,890	47,698	56,659	57,000
Deficit before transfers	-11,340	-16,080	-7,196	-14,834	-36,861	-24,999	-27,931	-27,200
Transfers from general revenue account	17,700	20,210	20,550	15,538	24,450	22,500	27,100	28,000
Balance after transfers	6,360	4,130	13,354	704	-12,411	-2,499	-831	800
Total consolidated account								
Revenue	82,429	89,523	113,600	132,792	150,035	166,599	176,617	179,800
Expenditure	71,366	85,556	92,191	113,332	152,194	146,238	166,662	166,250
Current	49,077	60,378	70,773	81,593	94,286	93,191	107,750	106,950
Capital	22,289	25,178	21,418	31,739	57,908	53,047	58,912	59,300
Balance	11,063	3,967	21,409	19,460	-2,159	20,361	9,955	13,550
Fiscal reserve balance, March 31	72,578	76,545	99,054	121,032	116,230	140,196	143,790	151,446
(In percent of GDP)								
Total consolidated account								
Revenue	15.7	15.4	17.0	17.0	17.7	18.8	18.3	17.7
Expenditure	13.6	14.7	13.8	14.6	18.0	16.5	17.3	16.3
Current	9.4	10.4	10.6	10.5	11.1	10.5	11.2	10.5
Capital	4.3	4.3	3.2	4.1	6.8	6.0	6.1	5.8
Balance	2.1	0.7	3.2	2.5	-0.3	2.3	1.0	1.3
Fiscal reserve balance, March 31	13.9	13.1	14.8	15.5	13.7	15.8	14.9	14.9
(Percentage change)								
Total consolidated account								
Revenue	13.4	8.6	26.9	16.9	13.0	25.5	6.0	7.9
Expenditure	32.7	19.9	7.8	22.9	34.3	29.0	14.0	13.7
Current	18.9	23.0	17.2	15.3	15.6	14.2	15.6	14.8
Capital	77.8	13.0	-14.9	48.2	82.5	67.1	11.1	11.8
Fiscal reserve balance, March 31	12.9	5.5	29.4	22.2	-4.0	15.8	2.6	8.0
(In millions of Hong Kong dollars)								
Memorandum item:								
Net borrowing 3/	...	..	1,098	2,519	-1,200	-1,197	-2,300	-2,300

Sources: Data provided by the Government Secretariat, Finance Branch; and staff projections.

1/ The fiscal year runs from April 1 to March 31.

2/ Consists of the Capital Works Reserve Fund, Development Loan Fund, Mass Transit Fund, Student Loan Fund, and Home Ownership Fund prior to 1990/91; Capital Works Reserve Fund, Capital Investment Fund, and Loan Fund beginning 1990/91, and Disaster Relief Fund beginning 1993/94.

3/ The Government Bond Program was launched in November 1991 in an effort to develop a market in fixed-income securities and facilitate the funding of long-term government infrastructural projects. The bonds are issued before the Government actually requires the funds. The Program limits the size of gross debt outstanding to HK\$5 billion as of June 30, 1997.

Table 10. Hong Kong: Revenue (General Revenue Account), 1989/90-1994/95 ^{1/}

(In millions of Hong Kong dollars)

	1989/90	1990/91	1991/92	1992/93 Actual	1993/94 Budget	1993/94 Actual	1994/95 Budget	1993 April-September	1994
Taxes	54,577	61,914	78,922	96,813	104,096	113,790	116,677	28,540	29,985
Direct taxes	34,039	36,997	45,553	56,086	63,940	66,625	73,785	7,435	9,765
Earnings and profits tax	33,549	36,341	44,870	55,061	63,140	65,439	72,820	6,920	9,015
Estate duty	490	656	683	1,025	800	1,186	965	515	750
Indirect taxes	20,539	24,917	33,369	40,727	40,156	47,165	42,892	21,105	20,220
Duties	4,628	5,729	6,844	7,216	7,739	7,113	7,485	3,131	3,500
General rates	1,663	3,039	3,494	4,423	4,495	4,461	5,050	2,232	2,545
Internal revenue	11,559	13,143	18,406	23,012	21,961	30,020	24,196	13,203	11,144
Bets and sweeps tax	4,830	5,884	7,110	7,818	10,372	10,082	9,900	3,716	3,088
Entertainment tax	129	136	141	15	...	1	--	1	--
Hotel accommodation tax	271	269	266	314	335	375	400	169	208
Stamp duties	5,464	5,939	9,569	13,409	9,670	17,976	13,190	8,528	7,502
Air passengers' departure tax	669	718	1,120	1,255	1,384	1,383	503	687	244
Cross Harbor Tunnel passage tax	196	197	200	201	200	203	203	102	102
Motor vehicles taxes	1,735	2,054	3,437	4,940	4,222	4,192	4,121	1,871	2,248
Royalties and concessions	746	816	886	1,136	1,383	1,379	1,676	668	783
Taxi concessions	208	136	302	--	356	--	364	--	--
Nontax revenue	19,787	20,761	22,535	23,968	29,910	30,110	31,212	15,097	14,803
Fines and penalties	578	652	886	892	942	1,123	1,329	526	678
Properties, investments, and interest	7,279	5,846	4,554	3,588	7,686	5,652	7,200	4,622	3,341
Of which: Interest	4,942	4,505	2,982	1,767	2,970	3,387	3,690	1,497	2,333
Reimbursements and contributions	1,705	2,413	2,863	4,032	4,077	6,447	4,067	1,928	1,984
Utilities	4,857	5,617	6,650	7,174	7,892	7,997	8,403	3,827	4,062
Fees and charges	5,132	5,992	7,170	8,015	9,077	8,627	9,765	4,112	4,601
Land transactions ^{2/}	212	241	412	267	236	264	358	82	137
Other	24	--	--	--	--	--	--	--	--
Total revenue	74,365	82,675	101,457	120,781	134,006	143,900	147,889	43,637	44,788

Source. Data provided by the Government Secretariat, Finance Branch.

^{1/} The fiscal year runs from April 1 to March 31.^{2/} Includes only land transactions completed before the coming into force of the Sino-British Joint Declaration (5/27/85), or land transactions conferring a benefit that expires before June 30, 1997. Revenue from other land transactions is credited to the Suspense Account of the Capital Works Reserve Fund.

Table 11 Hong Kong: Government Expenditure Under the General Revenue Account, 1989/90-1994/95 1/, 2/

(In millions of Hong Kong dollars)

	1989/90	1990/91	1991/92	1992/93 Actual	1993/94 Budget	1993/94 Actual	1994/95 Budget	1993 April-September	1994
Current expenditure	<u>49,077</u>	<u>60,378</u>	<u>70,773</u>	<u>81,593</u>	<u>94,286</u>	<u>93,191</u>	<u>107,750</u>	<u>47,109</u>	<u>52,579</u>
Personal emoluments	18,855	23,443	25,286	25,852	29,063	28,702	32,856	14,254	15,909
Personnel-related expenses	3,752	4,937	6,584	7,711	9,501	8,695	10,854	4,635	5,413
Departmental expenses	3,850	4,552	4,782	4,438	5,143	4,910	5,657	2,095	2,336
Other charges	8,402	9,712	10,939	11,770	13,092	13,904	15,122	6,796	7,495
Subventions	14,218	17,734	23,182	31,822	37,487	36,980	43,261	19,329	21,426
Capital expenditure 3/	<u>20,585</u>	<u>22,459</u>	<u>22,628</u>	<u>20,432</u>	<u>29,468</u>	<u>27,849</u>	<u>29,353</u>	<u>15,368</u>	<u>15,081</u>
Plant, equipment, and works	643	776	758	641	650	466	698	159	147
Other nonrecurrent	2,029	1,091	904	3,431	3,788	3,767	859	3,072	279
Subventions	213	382	416	822	580	1,116	696	514	256
Transfers to funds	17,700	20,210	20,550	15,538	24,450	22,500	27,100	11,623	14,399
Capital Works Reserve Fund/Public Works	8,800	15,200	15,000	12,198	13,650	13,650	15,500	6,223	7,809
Development Loan Fund	8,900	--	--	--	--	--	--	--	--
Mass Transit Fund	--	--	--	--	--	--	--	--	--
Capital Investment Fund	--	4,100	3,900	3,340	10,500	8,500	9,500	5,250	4,740
Loan Fund	--	910	1,650	--	300	300	2,100	150	1,850
Disaster Relief Fund	--	--	--	--	--	50	--	--	--
Other	--	--	--	--	--	--	--	--	--
Total expenditure	<u>69,662</u>	<u>82,837</u>	<u>93,401</u>	<u>102,025</u>	<u>123,754</u>	<u>121,040</u>	<u>137,103</u>	<u>62,477</u>	<u>67,660</u>

Source: Data provided by the Government Secretariat, Finance Branch.

1/ The fiscal year runs from April 1 to March 31.

2/ Expenditure of the funds established under the Public Finance Ordinance, and expenditure of the Urban Council, Regional Council, and Housing Authority are not included.

3/ Includes capital expenditure financed directly from the General Revenue Account (GRA) and from transfers from the GRA to Consolidated Account Funds.

Table 12. Hong Kong: Public Expenditure by Function, 1990/91-1994/95 1/, 2/

(In millions of Hong Kong dollars)

	1990/91		1991/92		1992/93		1993/94 Budget		1993/94 Actual		1994/95 Budget	
	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital	Recurrent	Capital
Economic	4,030	1,130	4,648	1,126	5,318	2,160	5,995	2,459	5,952	6,451	6,677	1,710
Security	12,224	1,620	13,497	1,401	15,173	1,113	16,345	1,789	16,591	660	18,152	957
Internal security	10,132	1,431	11,059	1,294	12,451	1,037	13,678	1,705	13,594	603	14,801	874
Immigration	923	93	1,049	84	1,165	42	1,283	61	1,318	38	1,430	62
Other	1,169	96	1,389	23	1,557	34	1,384	32	1,679	19	1,921	21
Social services	12,849	2,189	16,296	1,716	19,901	1,572	23,786	2,920	23,852	4,337	28,328	3,030
Social welfare	5,285	523	6,589	320	7,561	275	9,003	523	9,333	400	11,259	624
Health	7,564	1,666	9,707	1,396	12,340	1,297	14,783	2,397	14,519	3,937	17,069	2,406
Education	14,249	1,803	16,112	2,762	18,876	2,744	22,221	3,144	21,977	2,815	25,824	3,106
Environment	663	1,362	633	2,042	788	2,340	1,288	2,759	1,276	1,868	1,641	3,593
Community and external affairs	4,816	1,775	5,323	1,431	5,866	1,107	6,989	2,330	6,694	1,702	8,038	2,383
Recreation, culture, and amenities	3,910	1,725	4,346	1,394	4,858	1,071	5,909	2,296	5,540	1,664	6,723	2,354
District and community relations	617	25	680	16	717	16	756	20	802	20	922	21
Other	289	25	297	21	291	20	324	14	352	18	393	8
Infrastructure	4,726	7,216	5,492	8,787	6,030	11,454	6,633	18,095	6,804	16,819	7,556	22,803
Transportation	1,138	3,335	1,270	2,503	1,413	4,514	1,527	8,062	1,562	7,472	1,607	9,104
Land and buildings	1,332	3,092	1,893	5,203	2,106	5,827	2,324	8,773	2,418	7,878	2,826	11,822
Water supply	2,256	789	2,329	1,081	2,511	1,113	2,782	1,260	2,824	1,469	3,123	1,877
Civil service support services	10,037	2,030	12,789	1,715	14,140	1,894	16,870	4,985	15,611	5,777	18,685	4,367
Housing	3,994	8,422	5,123	7,454	5,082	7,850	6,861	11,132	6,498	9,524	8,493	9,096
Total public expenditure	<u>67,588</u>	<u>27,547</u>	<u>79,913</u>	<u>28,434</u>	<u>91,174</u>	<u>32,234</u>	<u>106,988</u>	<u>49,622</u>	<u>105,255</u>	<u>49,953</u>	<u>123,394</u>	<u>51,045</u>

Source. Data provided by the Government Secretariat, Finance Branch.

1/ Public expenditure comprises expenditure by the Housing Authority, the Urban Council, the Regional Council, expenditure financed by the Government's statutory funds, and all expenditure charged to the General Revenue Account. Expenditure by institutions in the private or quasi-private sector is included to the extent of their subventions. The activities of government departments that are partly financed by charges raised on a commercial basis are also included (e.g., airport, waterworks). Excluded is expenditure by those organizations in which the Government has only an equity position, including statutory organizations such as the Mass Transit Railway Corporation and the Kowloon-Canton Railway Corporation. Similarly, debt repayments and equity payments are excluded, as they represent financing items.

2/ Owing to the reclassification of public expenditure by function, figures for 1990/91-1992/93 have been revised accordingly and expenditure by the Monetary Authority has been excluded.

Table 13. Hong Kong: Monetary Indicators, 1989-94 ^{1/}

	1989	1990	1991	1992	1993	1994 2/			
						March	June	Sept.	Nov.
<u>(Percentage change)</u>									
M1	6.8	13.3	19.5	21.1	20.6	20.9	6.1	6.3	2.4
M2	19.9	22.4	13.3	10.8	16.0	11.0	12.7	15.4	4.1
M3	18.7	21.5	11.6	9.5	15.6	10.9	13.3	16.5	5.2
Hong Kong dollars 3/	15.0	14.8	15.6	13.7	25.2	29.4	25.8	25.7	1.8
Foreign currency 4/	22.2	27.4	8.4	6.0	6.9	-6.7	1.5	7.5	9.4
Total credit	27.3	36.4	26.3	9.7	15.4	15.3	15.7	14.4	10.5
Hong Kong dollars	27.6	16.9	18.9	12.7	20.4	20.1	22.5	21.1	6.2
Foreign currency	27.2	48.5	30.0	8.4	13.0	13.1	12.5	11.3	12.8
Of which:									
Total loans	32.2	40.6	25.4	10.1	15.7	15.3	14.7	12.1	8.7
Hong Kong dollars	29.8	15.6	19.2	12.2	17.9	17.3	18.7	17.2	2.3
Foreign currency	33.9	58.3	28.6	9.0	14.6	14.3	12.8	9.7	12.4
<u>(Percent of total)</u>									
Currency composition									
M1									
Hong Kong dollars 3/	89.8	85.4	87.0	89.7	89.8	90.0	89.5	90.8	91.0
Foreign currency 4/	10.2	14.6	13.0	10.3	10.2	10.0	10.5	9.2	9.0
M3									
Hong Kong dollars 3/	46.9	44.3	45.9	47.7	51.6	56.8	53.8	53.7	53.4
Foreign currency 4/	53.1	55.7	54.1	52.3	48.4	43.2	46.2	46.3	46.6
Velocity									
M2	0.53	0.48	0.49	0.51	0.50	0.51	0.51	0.51	...
M3	0.49	0.45	0.47	0.49	0.49	0.50	0.50	0.49	...
Memorandum items:									
Nominal GDP (HK\$ billions)	523.9	582.5	668.5	778.9	887.6	918.2 5/	947.4 5/	982.0 5/	...
Nominal growth of GDP (percent)	15.1	11.2	14.8	16.5	14.0	15.2	13.8	14.7	...

Sources: Hong Kong Monetary Authority, Monthly Statistical Bulletin; Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and staff estimates.

- ^{1/} Twelve-month change in monetary stocks at end of period; unadjusted for valuation changes in foreign currency-denominated deposits.
- ^{2/} Percentage changes calculated over corresponding year-earlier periods.
- ^{3/} Adjusted to include foreign currency swap deposits.
- ^{4/} Adjusted to exclude foreign currency swap deposits.
- ^{5/} Nominal GDP for four preceding quarters.

Table 14. Hong Kong: Loans for Use in Hong Kong, 1989-94 ^{1/}

(Twelve-month percentage change)

	1989	1990	1991	1992	1993	1994		
						March	June	Sept.
Loans for use in Hong Kong	28.1	17.9	18.5	11.4	18.2	17.7	19.2	16.3
Of which:								
Manufacturing	18.6	6.6	10.6	16.9	15.7	14.3	16.2	16.4
Transportation and equipment	59.0	10.9	24.3	13.3	7.2	8.3	8.0	8.0
Building, construction, and property development	63.6	12.3	16.3	13.1	27.9	31.1	27.4	23.8
Wholesale and retail trade	4.9	19.1	7.8	9.5	12.6	16.1	14.8	16.0
Miscellaneous	24.2	20.9	21.5	10.8	17.8	15.2	18.2	13.8
Of which:								
To purchase flats in the Home Ownership Scheme and Private Sector Participation Scheme	22.5	28.8	39.6	13.4	60.6	45.1	44.5	24.9
To purchase other residential property	28.6	32.8	34.9	13.6	16.6	18.8	17.6	12.4
To financial concerns	60.6	23.0	8.6	10.1	24.7	13.8	17.3	22.3
To stockbrokers	6.6	-19.2	38.6	0.7	59.2	-20.4	152.7	5.5

Sources: Hong Kong Monetary Authority, Monthly Statistical Bulletin; and Census and Statistics Department, Hong Kong Monthly Digest of Statistics.

^{1/} Based on outstanding loans at end of period.

Table 15. Hong Kong: Interest Rate Differentials, 1990-94

	Interbank Rates 1/			Deposit Rates 2/			Lending Rates 3/,4/		
	HIBOR 5/	LIBOR 6/	Differential	Hong Kong dollars	U.S. dollars	Differential	HSBC's BLR	U.S. Prime Rate	Differential
1990									
January	8.5	8.3	0.2	6.5	8.2	-1.7	10.0	10.1	-0.1
February	8.9	8.3	0.6	6.5	8.2	-1.7	10.0	10.0	--
March	9.2	8.4	0.8	6.7	8.4	-1.7	10.0	10.0	--
April	9.9	8.6	1.3	7.7	8.4	-0.7	11.0	10.0	1.0
May	9.5	8.3	1.2	7.8	8.3	-0.6	11.0	10.0	1.0
June	8.8	8.3	0.4	7.8	8.2	-0.4	11.0	10.0	1.0
July	8.6	7.9	0.7	7.8	8.1	-0.3	11.0	10.0	1.0
August	8.2	8.0	0.2	7.4	8.0	-0.6	10.7	10.0	0.7
September	8.6	8.3	0.3	7.3	8.1	-0.8	10.5	10.0	0.5
October	8.0	8.0	--	7.1	8.1	-1.0	10.3	10.0	-0.3
November	8.4	8.3	0.1	6.8	8.0	-1.3	10.0	10.0	--
December	7.9	7.5	0.4	6.8	7.8	-1.0	10.0	10.0	--
1991									
January	6.9	7.0	-0.1	6.7	7.2	-0.5	9.9	9.5	0.4
February	7.1	6.8	0.3	6.3	6.5	-0.3	9.5	9.0	0.5
March	7.1	6.3	0.8	6.3	6.4	-0.2	9.5	9.0	0.5
April	6.6	6.0	0.6	6.3	6.1	0.2	9.5	9.0	0.5
May	8.3	6.0	2.3	6.4	5.9	0.5	9.7	8.5	1.2
June	7.6	6.3	1.3	7.3	6.1	1.2	10.5	8.5	2.0
July	6.4	6.0	0.4	6.3	6.0	0.3	9.5	8.5	1.0
August	5.9	5.6	0.3	5.9	5.7	0.2	9.5	8.5	1.0
September	5.3	5.6	-0.3	5.5	5.5	--	9.3	8.2	1.1
October	5.2	5.2	--	5.3	5.3	--	9.0	8.0	1.0
November	4.4	4.9	-0.6	4.8	4.9	-0.1	8.6	7.6	1.0
December	4.0	4.2	-0.2	4.8	4.5	0.3	8.5	7.2	1.3
1992									
January	4.5	4.1	0.4	4.8	4.1	0.7	8.5	6.5	2.0
February	4.6	4.2	0.4	4.8	4.1	0.7	8.5	6.5	2.0
March	4.8	4.3	0.6	4.8	4.2	0.5	8.5	6.5	2.0
April	4.3	4.0	0.3	4.8	4.0	0.8	8.5	6.5	2.0
May	3.7	4.0	-0.3	4.1	3.8	0.3	7.8	6.5	1.3
June	3.8	3.8	-0.1	3.3	3.9	-0.6	7.0	6.5	0.5
July	3.3	3.4	-0.1	2.8	3.4	-0.6	6.6	6.0	0.6
August	3.2	3.4	-0.3	2.8	3.3	-0.5	6.5	6.0	0.5
September	3.0	3.2	-0.2	2.8	3.1	-0.4	6.5	6.0	0.5
October	3.8	3.5	0.3	2.8	3.3	-0.5	6.5	6.0	0.5
November	4.8	4.0	0.8	2.8	3.6	-0.9	6.5	6.0	0.5
December	4.2	3.4	0.8	2.8	3.5	-0.7	6.5	6.0	0.5
1993									
January	3.6	3.2	0.4	2.8	3.2	-0.4	6.5	6.0	0.5
February	3.3	3.1	0.2	2.8	3.1	-0.4	6.5	6.0	0.5
March	3.3	3.2	0.1	2.8	3.1	-0.4	6.5	6.0	0.5
April	3.1	3.1	--	2.8	3.1	-0.3	6.5	6.0	0.5
May	3.3	3.3	--	2.8	3.1	-0.4	6.5	6.0	0.5
June	3.9	3.3	0.6	2.8	3.2	-0.5	6.5	6.0	0.5
July	3.4	3.3	0.1	2.8	3.2	-0.4	6.5	6.0	0.5
August	3.4	3.2	0.2	2.8	3.1	-0.3	6.5	6.0	0.5
September	3.3	3.3	--	2.8	3.1	-0.3	6.5	6.0	0.5
October	3.3	3.4	-0.1	2.8	3.2	-0.4	6.5	6.0	0.5
November	3.5	3.5	--	2.8	3.4	-0.6	6.5	6.0	0.5
December	3.6	3.4	0.2	2.8	3.3	-0.5	6.5	6.0	0.5
1994									
January	3.5	3.3	0.2	2.8	3.2	-0.4	6.8	6.0	0.8
February	4.1	3.5	0.5	2.8	3.4	-0.7	6.8	6.0	0.8
March	4.3	3.9	0.4	3.5	3.8	-0.3	6.8	6.1	0.7
April	4.4	4.1	0.3	3.5	4.0	-0.5	6.8	6.5	0.3
May	4.6	4.7	--	4.3	4.5	-0.3	7.3	7.0	0.3
June	4.9	4.6	0.3	4.3	4.5	-0.3	7.3	7.3	--
July	4.8	4.9	-0.1	4.3	4.7	-0.5	7.3	7.3	--
August	4.9	4.9	--	4.8	4.8	-0.1	7.8	7.5	0.2
September	5.2	5.1	0.1	4.8	5.0	-0.3	7.8	7.8	--
October	5.4	5.6	-0.2	5.4	5.5	-0.2	7.8	7.8	--
November	6.2	6.2	--	6.0	5.8	0.2	8.0	8.2	-0.2

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; IMF, International Financial Statistics; and the Hong Kong Monetary Authority.

1/ Three-month end-of-period rates.

2/ Three-month period average rates.

3/ Monthly period average.

4/ U.S. prime lending rates and Hong Kong and Shanghai Banking Corporation's quoted Best Lending Rates.

5/ Hong Kong interbank offered rate.

6/ London interbank offered rate.

Table 16. Hong Kong: Exchange Fund Balance Sheet, 1988-93

(In millions of Hong Kong dollars; end of year)

	1988	1989	1990	1991	1992	1993
Assets						
Foreign currency	127,089	149,142	192,323	225,333	274,948	335,421
Hong Kong dollar	5,962	9,625	3,874	10,788	12,546	12,973
Total	133,051	158,777	196,197	236,121	287,494	348,394
Liabilities						
Certificates of indebtedness ^{1/}	31,731	37,191	40,791	46,410	58,130	68,801
Transfers of fiscal reserves ^{2/}	38,269	52,546	63,226	69,802	96,145	115,683
Coins in circulation	1,890	2,012	2,003	2,299	2,559	2,604
Exchange Fund bills	--	--	6,671	13,624	19,324	25,168
Other ^{3/}	2,554	1,603	391	4,834	3,220	1,385
Balance of banking system ^{4/}	860	978	480	500	1,480	7,135
Total	75,304	94,330	113,562	137,469	180,858	220,776
Accumulated earnings	57,747	64,447	82,635	98,652	106,636	127,618

Source: Hong Kong Monetary Authority, Monthly Statistical Bulletin.

^{1/} As backing for their bank note issues, the three note-issuing banks are required to hold non-interest-bearing certificates of indebtedness issued by the Exchange Fund. Since October 17, 1983 these certificates have been issued to or redeemed from the note-issuing banks against payment in U.S. dollars at a fixed rate of HK\$7.80=US\$1.00.

^{2/} Fiscal reserves that have been transferred from the General Revenue Account, Capital Investment Fund, Loan Fund, and Capital Works Reserve Fund to the Exchange Fund on an interest-bearing basis.

^{3/} Other liabilities comprise expenses accrued at the year's end, primarily interest due on fiscal reserve transfers, contingency reserves for bank rescue operations, and any other borrowings.

^{4/} In accordance with the Accounting Arrangements introduced in July 1988, the Hongkong and Shanghai Banking Corporation Ltd., as the Management Bank of the Clearing House of the Hong Kong Association of Banks, is required to maintain a Clearing Account with the Exchange Fund. The balance in the Account, which represents the level of liquidity in the interbank market, can only be altered by the Exchange Fund.

Table 17. Hong Kong: Exchange Rate Indices, 1990-94 1/, 2/

	Real Effective Exchange Rate Index	Nominal Effective Exchange Rate Index	Nominal Exchange Rate Index (US\$ per HK\$1)
1990			
January	93.8	68.0	63.7
February	93.4	67.8	63.7
March	95.9	69.1	63.7
April	96.7	69.6	63.8
May	96.4	68.9	63.9
June	97.1	69.0	63.9
July	96.3	68.0	64.0
August	94.9	66.9	64.0
September	94.2	66.2	64.1
October	92.4	64.5	64.0
November	92.8	64.3	63.8
December	94.9	65.4	63.8
1991			
January	95.5	65.6	63.8
February	95.1	64.9	63.8
March	99.4	67.1	63.9
April	101.9	68.1	63.8
May	102.7	68.6	63.9
June	105.0	70.1	64.3
July	104.9	69.7	64.1
August	104.5	69.0	64.1
September	103.6	68.3	64.2
October	103.4	67.9	64.2
November	102.3	67.0	64.1
December	101.5	66.1	64.0
1992			
January	102.0	65.9	64.1
February	104.0	66.7	64.1
March	106.7	68.1	64.2
April	106.9	68.1	64.3
May	105.7	67.2	64.2
June	105.1	66.3	64.3
July	104.0	65.2	64.3
August	104.2	65.0	64.3
September	105.0	65.0	64.4
October	107.0	66.0	64.4
November	110.4	67.9	64.3
December	111.4	68.1	64.3
1993			
January	113.5	68.6	64.3
February	113.3	69.0	64.3
March	112.4	68.5	64.3
April	110.3	67.0	64.4
May	110.3	66.7	64.4
June	110.7	66.7	64.3
July	112.1	67.3	64.1
August	112.0	67.0	64.2
September	112.2	66.7	64.3
October	114.3	67.3	64.4
November	115.5	68.0	64.4
December	116.0	68.2	64.4
1994			
January	121.9	72.0	64.4
February	120.7	71.1	64.3
March	120.1	70.7	64.4
April	120.4	70.5	64.4
May	120.6	70.2	64.4
June	120.0	69.7	64.4
July	118.4	68.4	64.4
August	119.5	68.5	64.4
September	118.7	68.2	64.4
October	118.6	67.7	64.4

Source: IMF, Information Notice System.

1/ Base year, 1980=100

2/ Increase indicates appreciation.

Table 18. Hong Kong: Equity Price Developments, 1987-94

	1987	1988	1989	1990	1991	1992	1993	1994 ^{1/}
<u>(Index of share prices)</u>								
Hang Seng Index								
End of year	2,302.8	2,687.4	2,836.6	3,024.5	4,297.3	5,512.4	11,888.4	8,466.3
Average of end of month	2,884.9	2,556.7	2,781.0	3,027.5	3,471.5	5,546.0	7,695.8	9,568.3
Sector indices								
(Average of end of month)								
Finance	1,933.4	1,625.7	1,808.1	1,906.9	2,304.4	4,643.6	7,142.1	8,043.3
Utilities	3,594.4	3,486.6	3,198.7	3,840.6	4,448.9	6,689.1	9,032.0	10,798.9
Property	4257.1	3,847.9	4,535.2	4,874.5	5,843.3	9,215.7	12,490.5	16,832.3
Commerce and industry	2536.9	2,318.0	2,687.0	2,797.0	2,981.1	4,379.3	5,782.7	7,429.8
<u>(Percentage change)</u>								
Hang Seng Index								
End of year	40.5	16.7	5.6	6.6	42.1	28.3	115.7	-28.8
Average of end of month	47.2	-11.4	8.8	8.9	14.7	59.8	38.8	24.3
Sector indices								
Finance	40.0	-16.0	11.2	5.5	20.8	101.5	53.9	12.6
Utilities	35.1	-3.0	-8.3	20.1	15.8	50.4	35.0	19.6
Property	74.8	-9.6	17.9	7.5	19.9	57.7	35.5	34.8
Commerce and industry	44.2	-8.6	15.9	4.1	6.6	46.9	32.0	28.5

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and the Asian Wall Street Journal.

^{1/} Data for 1994 are either end of November, or average of end of month for January-November, as appropriate. The percentage change for 1994 is relative to the year 1993.

Table 19. Hong Kong: Balance of Trade in Goods and Nonfactor Services, 1989-94 ^{1/}

	1989	1990	1991	1992	1993	1994 Jan.-June ^{2/}
(In billions of Hong Kong dollars)						
Trade balance	5.3	-5.3	-16.2	-33.5	-29.5	-47.6
Exports of goods	570.5	639.9	765.9	925.0	1,046.3	527.0
Domestic exports of goods	224.1	225.9	231.0	234.1	223.0	98.7
Re-exports	346.4	414.0	534.8	690.8	823.2	428.3
Imports of goods	565.2	645.2	782.0	958.5	1,075.7	574.6
Of which: Retained imports	254.2	289.9	329.4	383.3	400.0	224.7
Net balance on nonfactor services	55.0	54.6	60.3	78.7	100.3	55.7
Exports of nonfactor services	127.1	421.3	161.1	192.4	223.9	123.9
of which: Transportation	46.7	54.5	64.7	73.6	...	...
Travel	38.7	41.5	42.7	53.2	...	...
Imports of nonfactor services	72.2	87.7	100.8	113.7	123.6	68.1
of which: Transportation	22.4	25.8	28.0	32.2	...	...
Travel	29.4	37.1	43.7	46.7	...	...
Net balance of trade on goods and nonfactor services	60.3	49.3	44.1	45.2	70.8	8.1
(In percent of GDP)						
Trade balance	1.0	-0.9	-2.4	-4.3	-3.3	-10.1
Exports of goods	108.9	109.8	114.6	118.7	117.9	111.5
Domestic exports of goods	42.8	38.8	34.6	30.1	25.1	20.9
Re-exports	66.1	71.1	80.0	88.7	92.7	90.6
Imports of goods	107.9	110.8	117.0	123.1	121.2	121.6
Of which: Retained imports	48.5	49.8	49.3	49.2	45.1	42.6
Net balance on nonfactor services	10.5	9.4	9.0	10.1	11.3	11.8
Exports of nonfactor services	24.3	24.4	24.1	24.7	25.2	26.2
Imports of nonfactor services	13.8	15.1	15.1	14.6	13.9	14.4
Net balance of trade on goods and nonfactor services	11.5	8.5	6.6	5.8	8.0	1.7
(Percentage change)						
Trade balance	-165.3	-200.7	203.3	107.4	-12.1	62.5
Exports of goods	15.7	12.2	19.7	20.8	13.1	10.0
Domestic exports of goods	3.0	0.8	2.3	1.3	-4.7	-4.3
Re-exports	25.8	19.5	29.2	29.2	19.2	14.0
Imports	12.8	14.2	21.2	22.6	12.2	13.1
Of which: Retained imports	--	14.1	13.6	16.4	4.4	--
Net balance on nonfactor services	14.1	-0.6	10.3	30.6	27.4	15.4
Exports of nonfactor services	14.6	11.9	13.2	19.5	16.3	14.0
Imports of nonfactor services	14.9	21.5	15.0	12.8	8.7	12.9
Net balance of trade on goods and nonfactor services	50.4	-18.2	-10.5	2.5	56.6	-57.2

Sources: Census and Statistics Department, Hong Kong Annual Digest of Statistics: Revised Estimates of Gross Domestic Product, 1961 to First Quarter, 1994; and Quarterly Estimates of Gross Domestic Product, Second Quarter, 1994.

^{1/} National accounts basis.

^{2/} Percentage changes are calculated over the corresponding year-earlier period

Table 20. Hong Kong: Imports, Re-Exports, and Retained Imports, 1989-94

	1989	1990	1991	1992	1993	1994 Jan. - June
(In billions of Hong Kong dollars)						
Raw materials and semimanufactures						
Imports	230.5	248.7	293.1	329.9	355.1	200.5
Re-exports	119.5	127.2	155.3	187.3	214.9	120.9
Retained imports	121.3	133.0	150.7	157.4	153.3	86.9
Consumer goods						
Imports	201.5	247.7	306.4	394.5	454.8	232.8
Re-exports	166.1	219.3	290.7	376.8	447.4	222.6
Retained imports	55.4	69.2	77.5	104.0	117.4	65.0
Capital goods						
Imports	84.4	94.6	122.7	167.8	199.4	104.6
Re-exports	46.6	53.5	72.1	108.1	140.9	73.7
Retained imports	43.9	48.8	59.5	76.1	83.8	44.2
Foodstuffs						
Imports	34.0	37.0	41.4	45.4	45.0	24.4
Re-exports	11.4	11.4	13.2	14.4	13.8	7.8
Retained imports	23.5	26.6	29.6	32.5	32.8	17.5
Fuels						
Imports	12.5	14.5	15.3	17.7	18.3	10.6
Re-exports	2.8	2.5	3.5	4.3	6.1	3.3
Retained imports	10.0	12.3	12.1	13.7	12.6	7.5
Total imports ^{1/}	565.2	645.2	782.0	958.5	1,075.7	574.6
Total re-exports ^{1/}	346.4	414.0	534.8	690.8	823.2	428.3
Total retained imports ^{1/}	254.2	289.9	329.4	383.3	400.0	224.7
(In percent of GDP)						
Raw materials and semimanufactures						
Imports	44.0	42.7	43.8	42.4	40.0	42.4
Re-exports	22.8	21.8	23.2	24.0	24.2	25.6
Retained imports	23.2	22.8	22.5	20.2	17.3	18.4
Consumer goods						
Imports	38.5	42.5	45.8	50.7	51.2	49.3
Re-exports	31.7	37.6	43.5	48.4	50.4	47.1
Retained imports	10.6	11.9	11.6	13.4	13.2	13.8
Capital goods						
Imports	16.1	16.2	18.4	21.5	22.5	22.1
Re-exports	8.9	9.2	10.8	13.9	15.9	15.6
Retained imports	8.4	8.4	8.9	9.8	9.4	9.3
Foodstuffs						
Imports	6.5	6.3	6.2	5.8	5.1	5.2
Re-exports	2.2	2.0	2.0	1.8	1.6	1.6
Retained imports	4.5	4.6	4.4	4.2	3.7	3.7
Fuels						
Imports	2.4	2.5	2.3	2.3	2.1	2.2
Re-exports	0.5	0.4	0.5	0.5	0.7	0.7
Retained imports	1.9	2.1	1.8	1.8	1.4	1.6
Total imports ^{1/}	107.9	110.8	117.0	123.1	121.2	121.6
Total re-exports ^{1/}	66.1	71.1	80.0	88.7	92.7	90.6
Total retained imports ^{1/}	48.5	49.8	49.3	49.2	45.1	47.6

Sources: Census and Statistics Department, Trade Analysis Section; and staff estimates.

^{1/} Components do not necessarily add up to totals, as the disaggregated series have not yet been revised.

Table 21. Hong Kong: Merchandise Trade Developments, 1989-94

(Percentage change)

	1989	1990	1991	1992	1993	<u>1994</u> Jan.-Sept. <u>1/</u>
Total exports						
Value	15.7	12.2	19.7	20.8	13.1	11.0
Unit value	5.1	2.7	2.6	0.9	-0.4	0.8
Quantity	10.7	9.6	17.3	19.8	13.5	10.1
Domestic exports						
Value	3.0	0.8	2.3	1.3	-4.7	-2.1
Unit value	2.8	1.3	1.9	1.0	0.3	1.4
Quantity	0.1	-0.5	0.5	0.2	-4.5	-3.5
Re-exports						
Value	25.8	19.5	29.2	29.2	19.2	14.6
Unit value	6.1	3.0	2.2	0.8	-0.6	0.8
Quantity	18.6	16.0	26.5	28.3	19.6	13.7
Imports						
Value	12.8	14.2	21.2	22.6	12.2	14.5
Unit value	3.6	2.5	1.9	0.2	-0.6	1.2
Quantity	8.9	11.4	19.0	22.2	12.7	13.1
Terms of trade	1.3	0.3	0.7	0.7	0.2	-0.4

Sources: Census and Statistics Department, Revised Estimates of Gross Domestic Product 1961 to First Quarter 1994 and Quarterly Estimates of Gross Domestic Product, Second Quarter 1994; and Financial Services Branch, Third Quarter Economic Report 1994.

1/ Percentage change from year-earlier period.

Table 22. Hong Kong: Direction of Trade by Area and Major Partners, 1989-94

(Percent of total)

	1989	1990	1991	1992	1993	1994 Jan.-Aug.
Imports	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
North America	8.7	8.5	8.0	7.8	7.9	7.8
Of which:						
United States	8.2	8.1	7.6	7.4	7.4	7.2
Western Europe	12.5	12.3	11.2	11.4	11.4	11.6
Asia	74.5	75.7	77.5	77.4	77.1	77.0
Of which:						
China	34.9	36.8	37.7	37.1	37.5	37.3
Japan	16.6	16.1	16.4	17.4	16.6	15.7
Taiwan Province of China	9.2	9.0	9.6	9.1	8.8	8.6
Korea	4.5	4.4	4.5	4.6	4.5	4.7
Other	4.3	3.5	3.3	3.4	3.5	3.6
Domestic exports	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
North America	35.0	31.8	29.4	29.7	29.2	28.6
Of which:						
United States	32.2	29.4	27.2	27.6	27.0	26.7
Western Europe	23.8	24.3	24.3	21.0	18.7	18.0
Of which:						
Germany 1/	7.0	8.0	8.4	6.8	6.3	5.9
United Kingdom	6.5	6.0	5.9	5.4	4.8	4.7
Asia	34.9	37.9	40.6	44.2	47.1	48.3
Of which:						
China	19.3	21.0	23.5	26.5	28.4	28.2
Japan	5.8	5.3	5.0	4.7	4.3	4.6
Other	6.3	6.0	5.7	5.1	5.0	8.0
Re-exports (destination)	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
China	29.9	26.8	28.7	30.7	33.4	34.5
United States	20.8	21.2	20.7	21.5	21.9	22.1
Germany 1/	3.9	5.7	6.0	4.8	5.0	5.5
Japan	6.4	5.9	5.5	5.4	5.4	4.5
Taiwan Province of China	4.8	5.1	4.6	3.8	2.7	2.9
United Kingdom	2.6	2.9	2.7	3.0	3.0	2.4
Korea	3.8	3.1	2.7	2.0	1.9	2.1
Other	27.8	29.3	29.1	28.8	26.9	26.1
Memorandum items:						
Re-exports (origin)	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
China	54.3	58.1	59.0	58.4	57.6	57.0
Japan	11.3	10.2	10.7	12.3	13.4	13.3
Taiwan Province of China	7.8	7.3	7.8	7.9	7.9	7.7
United States	6.4	5.9	5.0	4.6	4.5	4.7
Korea	3.3	2.8	2.8	2.8	2.6	2.9
Germany 1/	1.4	1.3	1.3	1.3	1.7	1.7
United Kingdom	1.1	1.1	1.1	1.1	1.0	1.0
Other	14.4	13.3	12.3	11.6	11.3	11.8

Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and staff estimates.

1/ Data prior to October 1990 have been adjusted to include trade figures from the former German Democratic Republic, so as to ensure comparability of these trade figures with those after German reunification.

Table 23. Hong Kong. Structure of Trade with China, 1984-94

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 Jan. - June
(In billions of Hong Kong dollars)											
Trade with China											
Balance	-16.4	2.2	-22.7	-29.3	-22.7	-49.9	-77.8	-85.6	-80.3	-64.2	-28.9
Total exports	39.3	61.2	58.9	88.0	132.9	146.8	158.4	207.7	274.1	337.9	179.8
Domestic exports	11.3	15.2	18.0	27.9	38.0	43.3	47.5	54.4	62.0	63.4	28.5
Re-exports (to China)	28.1	46.0	40.9	60.2	94.9	103.5	110.9	153.3	212.1	274.6	151.3
Total imports	55.8	59.0	81.6	117.4	155.6	196.7	236.1	293.4	354.3	402.2	208.7
Of which: Re-exports (from China)	28.1	34.6	51.6	84.3	131.5	188.3	240.4	315.7	403.8	474.0	238.6
(Percent of GDP)											
Trade with China											
Balance	-6.6	0.8	-7.3	-7.6	-5.0	-9.5	-13.3	-12.8	-10.3	-7.2	-6.1
Total exports	15.9	22.5	18.8	22.9	29.2	28.0	27.2	31.1	35.2	38.1	38.0
Domestic exports	4.6	5.6	5.8	7.2	8.4	8.3	8.1	8.1	8.0	7.1	6.0
Re-exports (to China)	11.3	16.9	13.1	15.6	20.9	19.8	19.0	22.9	27.2	30.9	32.0
Total imports	22.5	21.7	26.1	30.5	34.2	37.5	40.5	43.9	45.5	45.3	44.2
Of which: Re-exports (from China)	11.3	12.7	16.5	21.9	28.9	35.9	41.3	47.2	51.8	53.4	50.5

Sources: Census and Statistics Department, Monthly Digest of Statistics; Revised Estimates of Gross Domestic Product, 1961 to First Quarter, 1994; Quarterly Estimates of Gross Domestic Product, Second Quarter, 1994; and staff estimates