

Hong Kong, China in Transition

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Hong Kong, China's transparent and rules-based approach to economic policymaking has encouraged its rapid growth over the past decade and a half. How has this approach been applied in practice, and how can Hong Kong maintain its impressive performance?

OVER THE past 15 years, Hong Kong, China, has seen dramatic structural change and exceptionally strong growth—real GDP growth averaged almost 7 percent annually, and per capita income increased fourfold, to \$22,770 in 1995. Hong Kong's economy is among the most open in the world; exports represent about 200 percent of GDP.

The secret to Hong Kong's success has been sound economic policies, consisting of an exchange rate linked to the US dollar, prudent fiscal policy, and a general noninterventionist approach to economic

policymaking. Over the medium term, keeping this approach will help maintain Hong Kong's economic stability and market flexibility. Its position as an international financial center will be further enhanced if it maintains strong banking supervision and continues to liberalize the nontradable sectors of the economy.

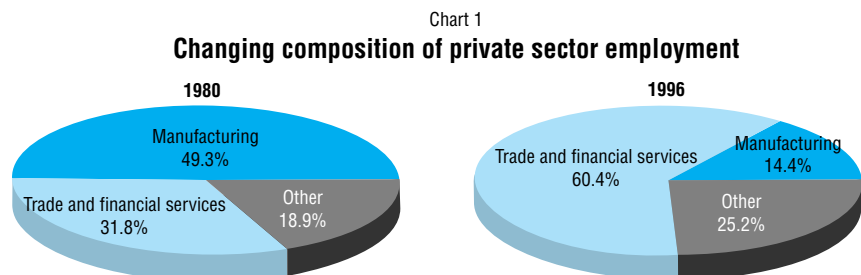
Structural transformation

During the 1960s and 1970s, an abundant supply of inexpensive labor supported the rapid growth of Hong Kong's manufacturing sector. By the late 1970s, however, Hong Kong's competitiveness in manufacturing had started to erode as land and labor costs rose. When China began its policy of economic reform in 1978, manufactur-

ing started to relocate from Hong Kong to southern China, where labor and facility costs were much lower. By the mid-1990s, according to private estimates, about 25,000 Hong Kong firms were operating plants, employing a total of 4–5 million workers, in southern China.

The extensive transfer of manufacturing operations and the sustained rapid increase in China's export activity boosted the development of supporting service industries in

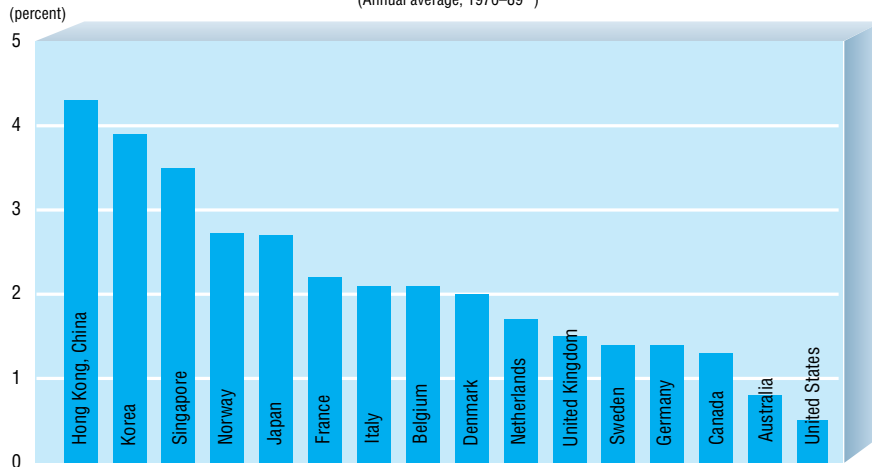
On July 1, 1997, Hong Kong, which had previously been administered by the United Kingdom, became a special administrative region of the People's Republic of China.



Source: Hong Kong, China, *Annual Digest of Statistics*.

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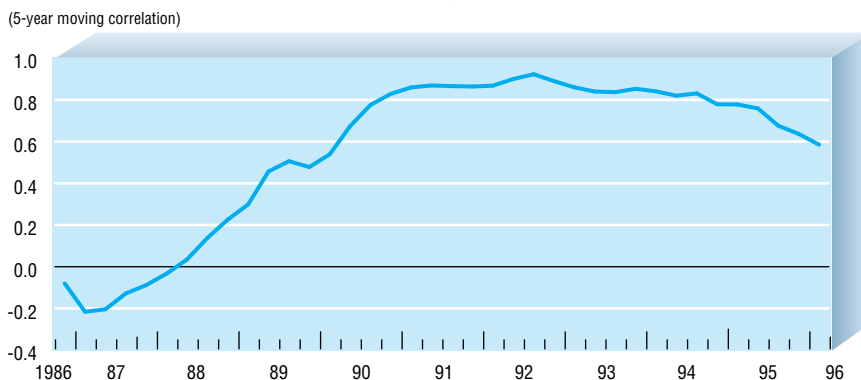
Chart 2
Hong Kong, China is a world leader in total factor productivity growth
 (Annual average, 1970–89¹)



Sources: Organization for Economic Cooperation and Development, International Sectoral Database; Australia, Economic Planning and Advisory Council estimates; Hong Kong Monetary Authority, *Quarterly Bulletin* (August 1995); Hong Kong, China, *Annual Digest of Statistics*; and IMF staff estimates.

¹ Data for Hong Kong, China; Korea; and Singapore are for 1965–90.

Chart 3
Correlation of cyclical components of Hong Kong, China's real GDP and China's industrial production, 1986–96



Sources: Hong Kong, China, *Monthly Digest of Statistics*; IMF, *International Financial Statistics*; and IMF staff estimates.

Hong Kong, most notably in trade and financial services. As a result, a dramatic structural shift of Hong Kong's economy took place during the 1980s and early 1990s, and was reflected in a reduction in the manufacturing sector's share in GDP and employment (Chart 1).

The composition of exports also changed substantially, with a decline in domestic merchandise exports more than offset by rapid growth in reexports (which are closely related to export activity and industrial production in China) and exports of services.

The structural shift from manufacturing to services took place without significantly

slowing the pace of economic activity or increasing unemployment. Indeed, the growth of real GDP and labor productivity remained strong throughout the period. Although the initial structural shift and heightened immigration from China led to temporarily higher unemployment in the early 1980s, much of the 1980s and the 1990s have been characterized by a shortage of labor, with the unemployment rate remaining around 2 percent. During the 1970s and 1980s, total factor productivity—the increase in productivity that is the result of greater efficiency—in Hong Kong is estimated to have increased at a rate well above the pace experienced by most

OECD countries during the same period (Chart 2) and considerably faster than in other Asian countries (Hawkins, 1995; and Young, 1994).

During this process of structural change, Hong Kong has grown to become an important international financial center, with financial and business services accounting for one-fourth of GDP. Hong Kong has more than 500 banking institutions, whose parent institutions include 80 of the 100 largest banks in the world. The external assets held by banks and deposit-taking institutions exceed \$600 billion, making Hong Kong one of the largest banking centers in the world. About 70 percent of its banking business is denominated in foreign currencies, and Hong Kong ranks fifth in the world in terms of foreign exchange market turnover. Its stock market is the seventh largest in the world, and the second largest in Asia, in terms of market capitalization.

Integration with China

With the relocation of manufacturing operations to China and the development of supporting services industries in Hong Kong, the two economies have become more closely linked. The correlation between the cyclical components of Hong Kong's GDP and industrial production in China rose sharply in the late 1980s and has remained high during the 1990s (Chart 3). In part, this is explained by the expansion of bilateral trade flows between Hong Kong and China. The share of Hong Kong's total exports going to China rose from 6 percent in 1980 to one-third in 1996.

Hong Kong has also developed in its role as a financial intermediary for China, although direct banking links between the two economies remain limited. However, about one-quarter of all Hong Kong dollar banknotes in circulation are circulating in southern China and most syndicated loans for use in China are arranged in Hong Kong. The Hong Kong Stock Exchange has a capitalization around four times that of the Shanghai and Shenzhen stock markets combined and, since 1993, Chinese enterprises have been able to raise capital by issuing shares traded in Hong Kong. Investors from China have also accumulated significant property and equity assets in Hong Kong.

Economic policies

Hong Kong's approach to economic policymaking provided an environment that encouraged market forces and helped maintain business confidence during the run-up to the return to Chinese sovereignty in 1997.

Noninterventionist approach and competition policy. An important part of Hong Kong's approach has been its non-intervention in markets. Hong Kong has maintained its status as a free port and tariff-free zone with complete freedom from foreign exchange controls. The Hong Kong government does not have an industrial policy and has refrained from using fiscal subsidies or preferential tax treatment to promote particular sectors or industries. In addition, social welfare benefits have been narrowly targeted and labor market policies have focused on providing retraining assistance rather than unemployment insurance. The absence of policy distortions has helped promote flexible markets and ensure that factors of production move smoothly across sectors in response to changes in market conditions.

In recent years, as the economy has become increasingly services-based, the role of domestic competition policy in encouraging the efficient allocation of resources has become more important. In this connection, Hong Kong's government recently commissioned a number of sectoral studies reviewing the state of competition and, on the basis of these, it is taking steps to liberalize the nontradables sectors. While the studies generally found that Hong Kong's nontraded services sectors were competitive in terms of both price and quality, they concluded that some scope remained for greater efficiency and competition in a number of sectors, including telecommunications, broadcasting, accounting and legal services, and medical and educational services.

Linked exchange rate. Following a period of sustained exchange rate depreciation in the late 1970s and early 1980s, which accelerated sharply because of uncertainties created by negotiations between China and the United Kingdom regarding the status of Hong Kong, a linked exchange rate system was adopted in October 1983. Under the linked rate system (which is based on a form of currency board arrangement), the overriding objective of monetary policy is to maintain a stable exchange rate between the Hong Kong and US dollars. The link, together with the freedom from controls on capital flows, implies that Hong Kong's interest rates are essentially determined by US monetary conditions. While the Hong Kong Monetary Authority (HKMA) has some limited tools available to influence interbank liquidity and thereby affect local short-term interest

rates, these have been used sparingly, mainly to smooth temporary fluctuations. The HKMA considers such smoothing to be of secondary importance compared with the attainment of its primary goal of defending the exchange rate link.

Hong Kong's external competitiveness has been preserved through the flexibility of markets and prices. With substantial gains made in labor productivity in the tradables sector, along with strong demand for property and land, there has been a long-term trend toward higher relative prices for nontradable goods. In the context of the linked exchange rate system, these underlying productivity developments have required an appreciation of the real effective exchange rate, which has taken place primarily through higher inflation in Hong Kong than in its trading partners. Since the

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end of 1987, the inflation differential, reinforced by an appreciation in nominal effective terms, has resulted in a real effective exchange rate appreciation of about 60 percent.

Prudential supervision. In support of the exchange rate link, the HKMA has accumulated substantial international reserves and placed high priority on maintaining a high-quality system of banking supervision in line with international prudential standards. The strategy has been to supplement on-site bank examinations with off-site review and analysis and to promote a freer flow of information about the financial sector by enhancing banks' disclosure requirements. In addition, increased emphasis has been placed on ensuring that banks' internal risk management systems are functioning well.

The banking system has, in fact, been highly profitable, and loan-loss provisioning rates are below those in most industrial countries. Overall asset quality is strong. The use of conservative loan-to-value ratios and variable rate mortgages has kept loan default rates for property lending, which

accounts for a substantial proportion of bank loans, quite low. Banking sector assets and liabilities are repriced quickly, so that changes in interest rates generally have small and short-lived impacts on spreads between lending and deposit interest rates.

Providing financial infrastructure. The government has played a limited, hands-off role in developing the financial sector, concentrating on providing financial infrastructure and leaving the development of financial products to the market. In this context, recent initiatives have included the extension of the benchmark yield curve of Exchange Fund notes to 10 years; helping to standardize mortgage-backed securities by establishing the Mortgage Corporation; and bringing interbank clearing into the Hong Kong Monetary Authority through the introduction of a real-time gross settlement (RTGS) system. This last initiative should improve the efficiency of the payment system, reduce settlement risk, and improve the authorities' control over interbank liquidity.

Fiscal policy. A critical ingredient in the rules-based policy framework has been a prudent fiscal policy aimed at keeping government small, avoiding deficits, and not pursuing counter-cyclical stabilization policies. By and large, the approach has been that, despite the constraints on monetary policy, the fiscal stance should be broadly neutral. Budgetary strategy has been guided by four broad principles: to maintain a simple and stable tax system with low tax rates; keep current spending in line with GDP growth; provide funding for key infrastructure projects; and maintain an adequate level of fiscal reserves. Although balanced budgets have generally been projected, conservative revenue projections and shortfalls in capital spending have tended to result in fiscal surpluses. Indeed, the budget deficit recorded in 1995, primarily as a result of spending on Hong Kong's new airport, was the first since 1983.

The basic approach to taxation has been to derive revenue from a limited number of sources and maintain both low tax rates and a simple tax structure. On the expenditure side, the guiding principle has been to provide a relatively narrow range of public goods for which government supply is deemed efficient. As a result, total public spending relative to GDP has been low in Hong Kong, compared with OECD

Institutional arrangements for Hong Kong after June 1997

The constitutional framework for the Hong Kong Special Administrative Region (HKSAR) following the transition of sovereignty on July 1, 1997 is set out in the Sino-British Joint Declaration (1984) and the Basic Law of the HKSAR of the People's Republic of China (1990). The framework stipulates that the HKSAR's capitalist system and way of life shall remain unchanged for 50 years after July 1. During this period, the HKSAR is to remain autonomous in all but two areas: foreign affairs and defense. Key provisions of the constitutional framework with respect to the economic and legal system are:

- The rights of private ownership of property and investment shall be protected by the law;
- The HKSAR will enjoy freedom from taxation by the central gov-

ernment of China and will have an independent tax system and its own tax laws;

- The monetary relationship between China and Hong Kong has been defined under the concept of "one country, two systems" as one country with two currencies, two monetary systems, and two monetary authorities which are mutually independent;
- The Hong Kong dollar will remain the legal tender and a freely convertible currency fully backed by foreign exchange; and
- The HKSAR shall also maintain autonomy in its external economic relations, including the status of a free port and a tariff-free zone, separate customs territory, and participation—in an appropriate capacity—in international organizations.

countries. Within the overall conservative expenditure structure, however, spending priorities have shifted somewhat in recent years. Expenditures on social welfare, health, and the environment have expanded, and infrastructure spending has been boosted by the implementation of the Airport Core Program starting in 1991. Relatively less spending has been directed toward security, housing, and community and external affairs.

Future prospects

Uncertainties over the implications of Hong Kong's return to Chinese sovereignty have gradually diminished during the transition. In economic management, the fundamental elements of Hong Kong's approach to economic policymaking—namely, openness, freedom from foreign exchange and trade controls, small government, and the avoidance of budget deficits—are embedded in the Joint Declaration and the Basic Law (see box). Policymakers are expected to retain considerable independence and autonomy. Under the Basic Law, budgets are to be independently set by Hong Kong policymakers. China and Hong Kong will continue to have two separate monetary systems, two currencies, and two independent monetary authorities. Hong Kong will also continue to participate in international organizations and subscribe to international treaties. For example, the Hong Kong Monetary Authority is a participant in the IMF's New Arrangements to Borrow.

Continuation of the rules-based approach that has contributed to Hong Kong's past success augurs well for maintaining confidence and stability in the coming years. Indeed, maintenance of its reliable legal system and transparent economic policies is essential for Hong Kong's continued

success. In fiscal policy, budget surpluses are expected to continue over the medium term. While some concerns have been expressed that these surpluses, along with the high level of fiscal reserves, will intensify political pressures for more interventionist policies, the tradition of small government appears well entrenched in Hong Kong and continued moderate budget surpluses should be considered an appropriate component of macroeconomic policy.

Continuity of the exchange rate link will also be important for maintaining confidence. It is well recognized that Hong Kong's closer integration with China will increase the possibility of conflict between the former's business cycle and monetary conditions imported from the United States. Past experience suggests, however, that even during a period of massive structural change, the adaptability of Hong Kong's firms and the flexibility of factor and commodity prices are sufficient to preserve competitiveness and continued strong macroeconomic performance.

Within the context of a sound economic policy framework, Hong Kong's medium-term prospects appear highly favorable. On the domestic side, recent public infrastructure investment and massive imports of capital goods have raised the productive capacity of the economy. In addition, with many emigrants returning to Hong Kong, labor has become more abundant after a decade of shortages.

On the external side, the recent "soft landing" of the Chinese economy suggests that China will be able to sustain solid and more stable growth during the coming years, which will be highly beneficial for Hong Kong. In addition, Hong Kong has strong potential to develop further as an international financial center. As China

liberalizes its controls on capital account transactions, Hong Kong will be able to play a central role in the subsequent increase in financial flows into and out of China. More generally, Hong Kong can benefit by serving as an intermediary for savings and investment flows within Asia, since these are, to a large extent, presently intermediated outside the region. Thus, while its growth is unlikely to reach the levels of the 1980s, Hong Kong appears to be well positioned to mature further as a services-based economy by strengthening its trading and financial links to both the rest of China and the rest of the world. **[F&D]**

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