



The Economy

Output grew strongly in Hong Kong in 1994 notwithstanding corrections in the stock and property markets. Measures to increase land supply and continued fiscal discipline, along with rising interest rates, led to some moderation in inflation. The economy is likely to maintain its strong growth with slightly higher inflation in 1995.

Overview

The Hong Kong economy continued its strong performance in 1994 despite the consolidation in the stock and property markets. Strong economic fundamentals, a high degree of flexibility in the labour market and a sound policy framework including the linked exchange rate system, prudent fiscal policy and an appropriate regulatory framework for the financial system have helped maintain overall stability. Real GDP in 1994 grew by 5.5%, slightly below the

rate of 5.8% in 1993. On the external trade front, re-exports rose by 15% and the performance of domestic exports improved somewhat from a fall of 4.7% in 1993 to a modest decrease in 1994. The improvement in domestic export performance in the second half of the year was due to an increase in external demand, especially from the US and Japan, and the trend is likely to continue in 1995 given the momentum of growth in the global economy.

The strong inflationary pressures evident in 1993 continued into the early part of 1994 but were eased by rising interest rates and measures adopted by the Government in the first half to increase land supply (see box below). The growth in the CPI(A) moderated from 8.5% in 1993 to 8.1% in 1994. On the fiscal side, despite higher spending on the new airport related projects, the budget registered a surplus of HK\$7.7 bn in the 1994/95 financial year, equivalent to 0.8% of GDP. The continued

Government Measures to Increase Land Supply and Stabilise the Property Market

Measures announced on 2 March 1994:

1. Change in town planning rules:
 - zoning/re-zoning of land for commercial purposes;
 - more flexible guidelines on industrial-office buildings allowing a considerable expansion of office accommodation in such buildings;
 - approval of smaller office buildings in other land-use zones.
2. Directly increasing the supply of new sites.
3. Accelerating the processing of new land grants, land exchanges and lease modifications.
4. Facilitating the redevelopment of existing sites by allowing private developers to apply for land resumptions.
5. Involvement of the private sector in supplying the requisite infrastructure for major private sector projects.

Further measures announced on 8 June 1994:

1. Measures to increase housing and land supply:
 - increasing the supply of new flats by 45,000 to 60,000 units by 2001;
 - increasing the supply of residential land by up to 120 hectares before 1997/98;
 - accelerating the processing of land transactions and building applications;
 - speeding up the redevelopment of old buildings and under-utilised sites.
2. Measures to dampen speculative activities:
 - lowering the quota for internal sales of pre-completion flats from 50% to 10%;
 - restricting pre-completion sales to a timing of not more than nine months before the date of assignment;
 - increasing the initial deposit from 5% to 10% of the purchase price and raising the amount of forfeiture upon default of purchase from 3% to 5% of the purchase price.

financial discipline on the part of the Government also helped rein in demand pressures in the economy.

Inflationary pressures

Inflationary pressures, which had been building up during 1993, were mostly felt in early 1994 in such sectors as housing rental, transport and other miscellaneous services that are provided domestically and cannot be substituted by imports (Chart 1). During 1994, high food prices, largely as a result of floods in southern China, also exerted upward pressure on inflation (Chart 2).

Continued international interest in Hong Kong as a gateway to China spilled over to early 1994, adding to higher equity and property prices, which further spurred consumption and added to the inflationary pressures.

The Hang Seng Index rose to a record high of 12201 in early January and hovered around 10000 to 12000 for the rest of the month. The average daily turnover in the stock exchange topped HK\$10 bn in January, more than double the average volume of HK\$4.9 bn in 1993. Real interest rates remained negative in the first quarter, with the BLR at a low of 6.5%, two percentage points below the annual growth of CPI(A) in 1993. HK dollar loans grew 17% at end-March 1994 from a year ago while nominal GDP grew 15% during the March quarter from a year-earlier period.

Chart 1: Growth Rates of CPI(A) Components in March Quarter 1994

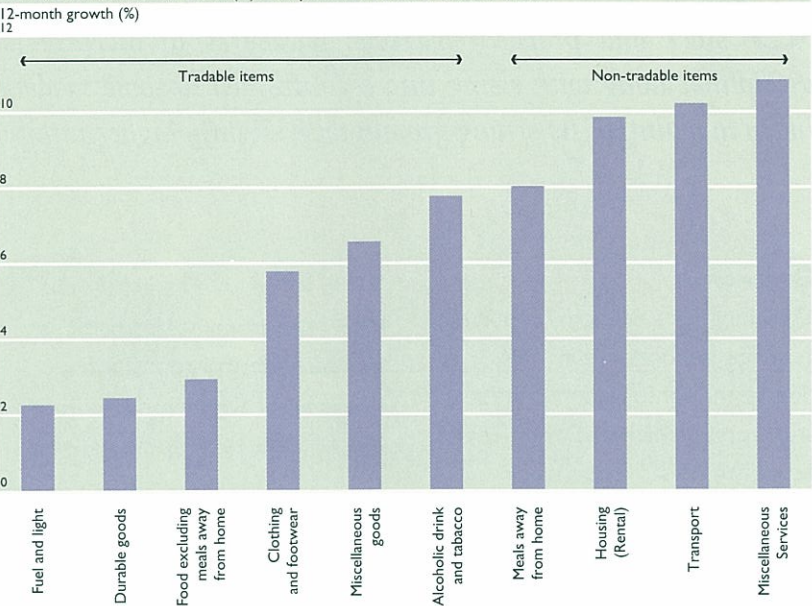
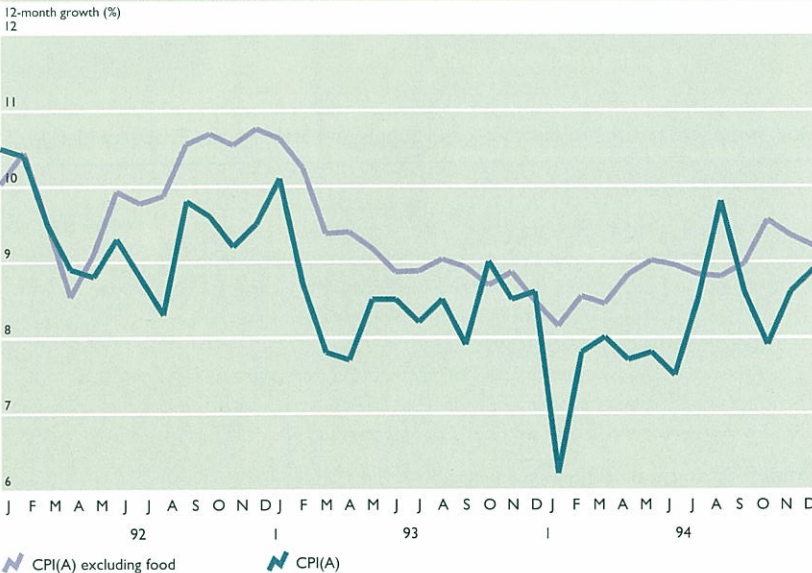


Chart 2: Growth Rates of CPI(A)



Property prices surged sharply in the March quarter, with some residential developments rising as much as 30%. The overall prices of private residential and commercial property rose by 15% and 21% respectively in the March quarter and by 5% and 13% in the following quarter. Such high prices were translated into higher rentals (Chart 3), contributing to inflation.

The buoyant conditions with low interest rates led to robust consumption demand. Retail sales volume in the March quarter grew 12% from the year-earlier period, with consumer durables and such luxury items as jewellery and watches registering the sharpest gains. Spending in restaurants also recorded an appreciable growth of 6% in volume terms during the same period.

To alleviate inflationary pressures, the Government implemented in March and June a series of measures that aimed at increasing land supply, improving flexibility of land use and curbing speculative activities in the residential property market.

Monetary tightening from late March

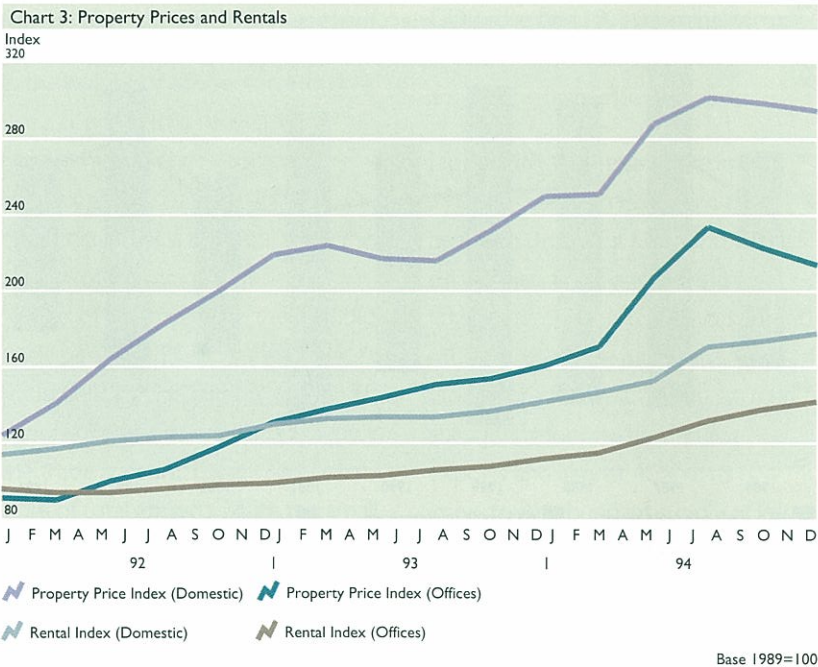
Around the same time as these measures were adopted, the monetary situation started to tighten. This led to a dampening in domestic demand and major corrections in the asset markets. Inflation moderated as a result.

Under the linked exchange rate system that Hong Kong has adopted since 1983, the domestic interest rates track closely movements of those in the US. Since late March, HK dollar interest rates had risen in line with increases in the US interest rates. The ceiling on HKAB savings deposit rate were raised by 225 bp during the year. The BLR also rose by 200 bp to 8.5% in late November.

As property and equity prices moderated with the increase in interest rates, domestic credit expansion slowed down during 1994. Growth in Hong Kong dollar loans slowed from an average monthly rate of 1.9% in the first six months of 1994 to 0.9% in the second half. Annual loan growth fell slightly from 18% in 1993 to 17% in 1994. At the same

time, the annual growth in broad money supply, HK\$M3, also slowed to 18% in 1994, substantially lower than the 25% growth in 1993 (Chart 4).

Higher interest rates dampened domestic demand through the following channels. *First*, the public began to save more and spend less. This was reflected in the shifting of money balances from current and savings accounts into time deposits. Since February, there had been a steady rise in the share of time deposits in HK\$M3, with the share growing to 58% by end-December, up seven percentage points from end-February. The deregulation in October of HKAB's IRR for time deposits fixed for more than one month also contributed to a more



rapid growth in time deposits. *Second*, higher interest rates increased the repayment burden of some borrowers and mortgagors, dampening their consumption power. *Third*, higher interest rates contributed to a reduction in asset prices and hence, a moderation in consumption.

The asset markets underwent major corrections. The Hang Seng Index closed the year at 8191, down 31% from end-1993 although it was still up 15% from the level in mid-1993. At the same time, the Government's measures to curb property speculation and increase land supply coupled with rising interest rates had brought residential property prices down since the June quarter.

Speculation in the property market had largely subsided.

The dampening effect on consumption was apparent in the retail market. Retail sales volume increased by 6% during 1994, compared with a growth of 12% in the March quarter from a year-earlier period. Private consumption expenditure grew 7.2% and 5.7% in June and September quarters compared with respective year-earlier periods, representing a slowdown from the 12.2% growth in the March quarter.

As demand in both goods and asset markets was dampened, inflationary pressures were eased. Core prices stopped accelerating between May

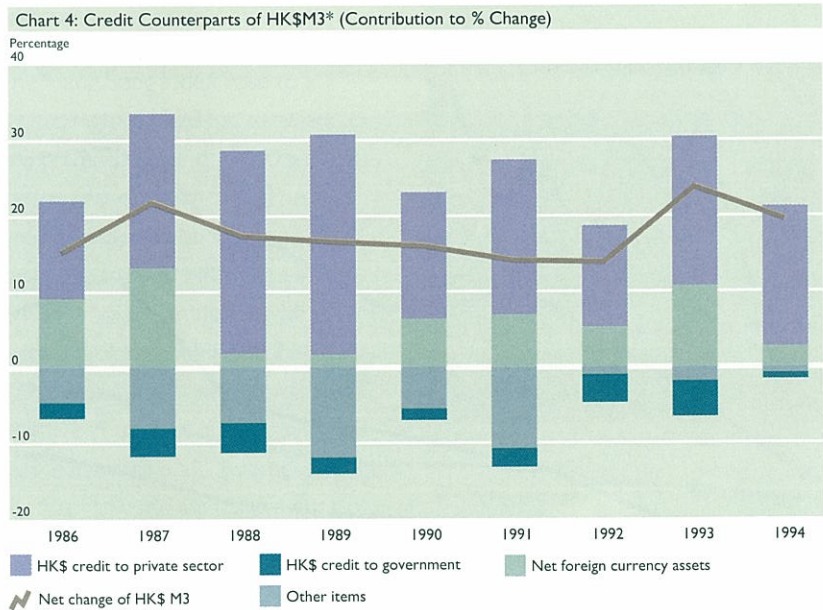
and September (Chart 2). The acceleration in October was mainly due to the increase in the prices of clothing and footwear, partly caused by the weakening of the HK dollar exchange rate against non-US currencies. The growth of CPI(A) for the year as a whole moderated to 8.1%, slightly below the 8.5% reached in 1993.

External sector

In 1994, there was a sharp widening in the merchandise trade deficit as imports surged rapidly while exports maintained a steady growth. This deficit was however offset by surplus in the invisible trade sector, resulting in a small overall surplus in the trade account.

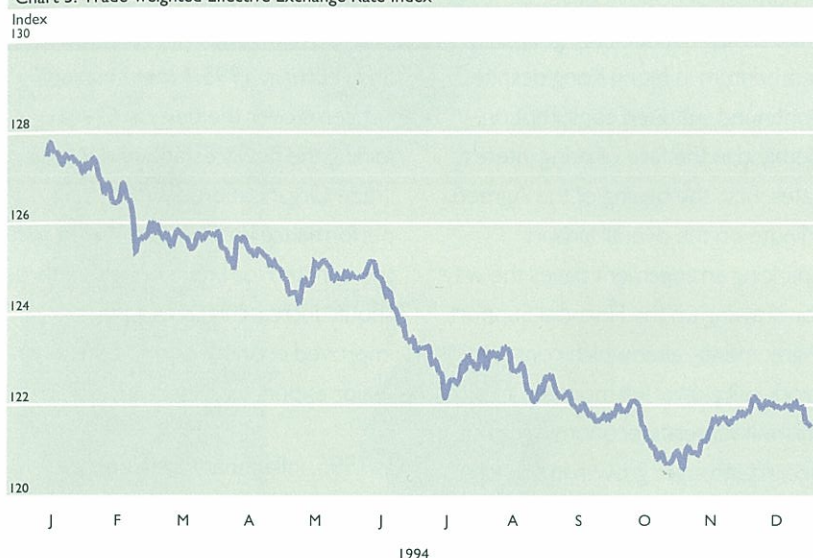
Tracking the movements of the US dollar to which the HK dollar is linked, the local currency depreciated against foreign currencies other than the US dollar, especially against the Yen. The trade-weighted EERI closed the year at 121.4, down from 127.5 at the beginning of the year (Chart 5).

The weakening of Hong Kong's trade-weighted exchange rate has improved the price competitiveness of Hong Kong's exports while the currencies of other East Asian economies have been strengthening. Total exports registered a growth of 12% in 1994. Domestic exports which recorded a 4.7% fall in 1993, fell only slightly last year. Exports to the US and Japan had picked up



* HK\$ M3 has been adjusted to include foreign currency swap deposits and to exclude government deposits and Exchange Fund deposits with licensed banks.

Chart 5: Trade-weighted Effective Exchange Rate Index



notably since the June quarter and the trend is likely to continue in 1995.

The growth of re-exports moderated somewhat but nevertheless achieved an appreciable 15% in 1994.

Total imports surged by 17% in 1994, compared with 12% in 1993. The increase in imports was attributable to *first*, the construction of the new airport and the related works that required a substantial amount of imports; *second*, the rising need for raw materials and capital goods to meet the increase in production orders for exports; and *third*, the increase in retained imports of consumer goods for stock replenishment. The first two developments should help improve the productive capacity of the economy in the future.

The rapid rise in imports had led to a sharp widening in the merchandise

trade deficit. At the end of 1994, the domestic exports versus retained imports deficit reached HK\$254 bn, up from HK\$177 bn in 1993. On the other hand, the re-exports versus imports for re-export surplus rose at a more moderate rate to HK\$173 bn from HK\$151 bn in 1993.

In the invisible trade sector, Hong Kong continued to record a handsome surplus. Exports of services grew by 14% in 1994, notwithstanding a moderation in the growth of the tourism trade. A surplus of HK\$103 bn in the invisible trade balance offset the merchandise trade deficit of HK\$84 bn, resulting in a small overall surplus of HK\$19 bn in the trade account, roughly equal to 1.5% of total imports. With this small overall surplus, together with the income generated from investments abroad and transfers, and capital account items, foreign currency

reserves at the Exchange Fund increased by HK\$49 bn to HK\$384 bn at end-1994.

Labour market and incomes

The flexibility of the labour market has always been Hong Kong's strength. This explains the low level of unemployment of around 2% even while the economy is undergoing a structural shift from its manufacturing base to become a financial and services centre in the last few years. In 1994, growth of the labour force accelerated to 3.5%, compared with 2.9% in 1993, partly due to a growing population of returning migrants. Nevertheless, the labour market remained tight, with unemployment and underemployment remaining at the low levels of 1.9% and 1.4% respectively in 1994, similar to those in 1993. Workers' wages rose by 0.7% in real terms. The per capita GDP rose by 1.1% in nominal terms to reach HK\$168,000, which is among the highest in the world.

Links with Chinese economy

With increasing interdependence between the Hong Kong and China economies, trade and investment flows between the two places surged substantially in the past years. China is Hong Kong's largest trading partner, accounting for one third of its exports and almost 40% of its imports. An abundant supply of low cost land and labour has prompted manufacturers in Hong Kong to relocate their production bases across the border resulting in a rapid

surge in outward processing arrangements in China. Despite a slowdown in imports into China owing to its austerity measures to stabilise its economy, outward processing arrangements continued to flourish. In 1994, roughly 74% of Hong Kong's domestic exports involved components processed in China. Also, 42% of Hong Kong's re-exports to China were for use at outward processing factories. These arrangements have helped maintain the price competitiveness of Hong Kong's products and facilitate the transformation of Hong Kong into a more service-oriented economy.

Direct investments in both directions between Hong Kong and China have further tied the two economies together. As at end-1994, the cumulative value of realised Hong Kong direct investments in China was estimated to reach US\$60 bn. On the other hand, China's direct investments in Hong Kong reached US\$25 bn with over 1 600 mainland funded enterprises operating in the territory.

Outlook

In 1995, the Hong Kong economy is likely to maintain its strong growth with slightly higher inflation.

A number of positive developments should help maintain the growth momentum in Hong Kong despite continued subdued consumption demand in the face of rising interest rates. *First*, the signing of the Agreed Minute on the overall airport financing arrangement paves the way for drawing up the Financial Support Agreements, after which construction work will gather full momentum and this will stimulate economic growth. *Second*, stronger growth in services exports in 1995 is expected, especially in the tourism industry as tourist arrivals have picked up since end-1994. *Third*, strong investment demand in 1994 is likely to continue in 1995. The 15% growth in building and construction in 1994 was supported by public works programmes including the new airport at Chek Lap Kok. Spending on machinery also picked up from a modest growth of 5.2% in 1993 to 14.3% in real terms during 1994. *Fourth*, the unconditional renewal of China's Most Favoured Nation Status by the US and the successful conclusion of the Uruguay Round of GATT removed a lot of uncertainties on the trade front. *Fifth*, the tension over the protection of intellectual

property rights between China and the US was successfully resolved in late February 1995. Notwithstanding concerns over the delay in China joining the newly established World Trade Organisation, export performance is still looking bright as the demand for Hong Kong's exports should increase in light of the improved economic conditions in its major export markets.

In 1995, inflationary pressures are expected to remain due to both supply and demand factors. On the supply side, the Government's measures to increase land supply would help relieve shortages. Nevertheless, there is some spillover of high prices into rents. Expansion of the labour import quota for the airport project, and possibly continued increase in the number of returning migrants, should help relax pressures in the tight labour market. On the demand side, the consolidation in property prices and modest consumption growth are all pointing to lower inflation. However, the depreciation of the US dollar, high inflation in China and possible rises in commodity prices may exert some pressures on the prices of imports.



Silver 50 cent coin bearing the portrait of King Edward VII, 1902. In 1935, the Government began to withdraw all silver coins from circulation when it abandoned the silver standard following surges in silver prices.

Bronze one cent coin bearing the portrait of King George V, 1919.

Street Scene of Hong Kong in 1920s.