2-2007

# The economy

Lok Sang HO
lsho@ln.edu.hk

Working Paper Series

Centre for Public Policy Studies
Institute of Humanities and Social Sciences

No. 180 (Feb 07) CPPS/CAPS

# The Economy

Lok Sang Ho

Lingnan University
Hong Kong

# The Economy

Lok Sang Ho

February 2007

Professor Lok Sang Ho is Professor of Economics and Director of Centre for Public Policy Studies, Lingnan University, Hong Kong.

Centre for Public Policy Studies
Lingnan University
Tuen Mun
Hong Kong
Tel: (852) 2616 7182
Fax: (852) 2591 0690
Email: cpps@LN.edu.hk
http://www.LN.edu.hk/cpps/

# The Economy

**Lok-sang Ho***

*Abstract*

This paper reviews the economic policy since the handover. Evidence is presented and the case is argued that the serious recession and fiscal problems in 1998 were essentially a result of misguided housing policy. Hong Kong's subsequent recovery and return to fiscal health, too, were essentially a result of a bold effort to reverse that misguided policy in late 2002. The paper commends the SAR government for its pragmatism and courage in the "incursion" in the stock market in the summer of 1998. CEPA was of course a great achievement for both Hong Kong and the Mainland, and Hong Kong's future definitely is closely tied to the future course of the Mainland economy. Tighter integration with the Mainland is therefore both necessary and logical. However, CEPA played only a minor role in the recovery. The many "structural problems" often alluded to by commentators similarly had little to do with Hong Kong's difficulties from 1998 to 2003. The best proof is that Hong Kong has managed to recover without a major surgery to its economic policy. Still, with widening income disparity and many Hong Kong people in dire poverty, Hong Kong does need a major rethinking of its economic policy if the prosperity and stability of the society are to be sustained.

*Introduction*

To discuss the Hong Kong economy after the handover, it is fitting to refer first to the *Fortune Magazine* story in 1995 foretelling "the death of Hong Kong." For a few years, it did look as if these dire predictions were vindicated. Yet Hong Kong bounced back dramatically after hitting trough during the SARS episode in 2003 at a pace that few analysts believed was possible. Although the government had always found the credit rating companies far too pessimistic, even its officials had always thought that balancing the fiscal budget was out of the question before 2008/2009. Yet the government managed to come up with a real fiscal

---

* Professor of Economics, Director of Centre for Public Policy Studies, Lingnan University.

surplus as early as 2005/2006,[1] and by 2006/2007 the fiscal surplus had become rather sizable.

Just as the return to black ink came unexpected, so the red ink that began in 1998/99 had come as a surprise. In fiscal 1997-98, the operational surplus was $86.9 billion. At that time, emotions were high, and Mr. Tung Chee-hwa, the first Chief Executive of the SAR government, became over confident because the overall situation appeared superb and the prospects were extremely rosy. Most important of all, he had plenty of fiscal room to maneuver, certainly much more than any of the governors during colonial times. At the time, however, I wrote:

> Hong Kong's fiscal strength can be attributed to strength in the property and stock markets, while Hong Kong's apparent fiscal restraint is to a certain extent an accounting illusion. If the property market and the stock market should fail to perform, Hong Kong would immediately run into fiscal trouble. To the extent that the property market is considered having run ahead of economic fundamentals, Hong Kong's fiscal problems cannot be too far away.(Ho, 1997a, p.90)

Unfortunately, Tung was too overjoyed at the handover to take heed. He announced his ambitious plan to raise the homeownership rate to 70 per cent in ten years, and a scheme to turn public rental housing into ownership units called the Tenants Purchase Scheme (TPS) became a key component of his strategy. The TPS was welcomed by all political parties alike and was particularly popular among public housing tenants, but it proved to be a disaster for the homeowner middle class (Ho, 1998b, 1998c, 1998d, 1998e, 2003, 2006.) By severing the homeownership ladder, the housing market collapsed through a domino mechanism, bringing the Hong Kong economy to a deep recession that is more appropriately called a small depression in 1998. Yet my analysis then was met with disbelief and even ridicule (Miller, 1998, Mondejar and Boardman, 1998). The SAR government simply ignored my plea to change its misguided housing policy.

[1] Actually as early as 2004/2005 already there was a measured fiscal "surplus" when the revenue of a modest $5 billion bond flotation was counted.

The rapidity and the extent of the decline of the economy took virtually all observers by surprise. But the economic decline seemed to have vindicated the Fortune Magazine article's argument. Many regarded it as symptomatic of more serious structural problems that had been obscured by a superficial economic bloom leading to the handover. To see the general thrust of such lines of thinking, consider Sin-ming Shaw's article in the Time Magazine, 3 September 2001. There he wrote:

> "Hong Kong is having trouble competing, not only with a rising China, but against a world built on brains, not asset trading. As the mainland maintains its rapid growth rates, Hong Kong is barely above water after three years of stagnation....
>
> "Hong Kong… is too expensive, in terms of both wages and real estate, and its government is too big. University graduates have poor skills not only in English but in Chinese, too. Corporations are hiring in the mainland, and firing in Hong Kong. Premier Zhu Rongji, a former Shanghai mayor, allowed the mainland property bubble to burst in the mid-'90s without intervention. Now, Shanghai and other Chinese cities are bursting with new businesses in part because both wages and asset prices are but a fraction of Hong Kong's."

Again, in a report by a team of academics from the Hong Kong University of Science and Technology (HKUST Forum on the Future Development of Hong Kong May-July 2002), the following "structural problems" are cited:

1. Over-dependence on land sales and the property sector for revenue. Once the property sector declined, decrease in revenues was inevitable.
2. When Hong Kong manufacturers decided to move their production base to the Chinese hinterland, rather than upgrade their capabilities in Hong Kong, they created an economy over-reliant on the service sector, which now accounts for 86% of Hong Kong's GDP.
3. Industrial policy-making has traditionally been limited in Hong Kong. The lack of coordinated preparation for the high-tech economy, in terms of education, training and manpower, R&D

investment, and identification of core industries, has left Hong Kong far behind other economies.

4. The Government has abrogated responsibility for nurturing competitiveness because of local politics before and after the handover. The lack of interest in innovation and technology may have led to an over-indulgence of older businesses and not enough encouragement of new and emerging businesses.

I cannot agree with any of these views. In particular, I cannot agree with the view that Hong Kong's economic difficulties from 1997-2003 were structural. Structural problems do not suddenly surface and suddenly disappear. Although there are indeed some structural problems in Hong Kong, the same can be said of most economies. One can easily discover various forms of structural problems in the U.S., in Japan, in Thailand, in mainland China, in Taiwan, and so on. It is true that some costs in Hong Kong are very high, particularly land costs, and that this is making life difficult for some businesses. It is true that some university graduates do not have the necessary skills and attitudes to compete effectively in the market. It is also true that some businesses were not innovative enough, and that they under-invest in R&D. It is also true that Hong Kong's fiscal revenues are quite dependent on the land market, and that if the land market goes sour, Hong Kong will most likely run a fiscal deficit. But to say that therefore the government needs a more active industrial policy, to discover new industries and to support the development of tech industries, to reduce the dependence on services, to clamp down its land costs, and to steer itself away from a dependence on land as a major source of fiscal revenue would be wrong.

*To understand Hong Kong, one must understand the market*

Unfortunately for Hong Kong, too few people understand the market. By this I mean the strengths and the weaknesses of the free market. We need to have full understanding of the nature of the free market, so we can harness its strengths and overcome its weaknesses. Only when we understand the market can we effectively implement the policy of "positive non-interventionism," a term coined by the late and former Financial Secretary Haddon-Cave. The term means that when the government chooses not to intervene in the market, it is for a good reason and as a result the non-intervention is positive for the economy. The corollary of the term is that when the government chooses to intervene, there has to be a good reason for it to do so.

The first important understanding about the market is that free market prices are always *the right prices for resource allocation purposes* unless there are technological externalities such as pollution (a negative externality) or public health benefits (a positive externality), excessive concentration of market power, or evidence of herd behavior.

The second important understanding about the market is that free market prices do not always reward people fairly in the sense of rewarding them according to the total contributions that they make to the economy. This means, for example, that a group of people may make much greater contribution to the economy this year than last year and yet they are rewarded less than last year. The classical example is the case of agriculture. If farmers have a fantastic bumper crop, their collective revenue may actually decline dramatically so that each farmer will collect much less than last year. One free market rule is that abundance benefits consumers and hurts producers.

On the other hand, if someone owns a special talent, or owns a prime site, he can collect very large earnings when the competition for such talent or the location increases.

This means that market prices may be *wrong prices for distributive purposes*. This implies that while we should let the market dictate the prices in order to achieve economic efficiency, we may have to adopt some redistributive measures to achieve fairness and maintain social harmony.

The third important understanding about the market is that in the event of technological externalities, economic agents should be asked to pay for the negative externalities and should be subsidized for the positive externalities that they cause by their activities.

The fourth important understanding is that excessive concentration of market power is detrimental to efficient resource allocation and fair competition. Some form of intervention or regulation may then be appropriate.

The fifth important understanding is that herd behavior may occur, and investors as a group may be excessively exuberant or pessimistic. Government intervention may again be appropriate.

In the rest of this paper, I shall go through each of these in turn. But I will summarize my understanding about the major strengths and weaknesses of the Hong Kong economy as follows. Hong Kong's traditional "positive non-interventionism" has effectively nurtured Hong Kong's competitiveness. Hong Kong's entrepreneurs have developed a high sensitivity to the forces of the market, so that they generally respond very rapidly to the turns of the market, and they also have been quite able to capitalize on any emerging opportunities. Thus, for example, many of Hong Kong's entrepreneurs started investing on the mainland in the 1980s, well before others did so. They were ready to grasp the opportunities presented to them as the Mainland opened up. Not all of these ventures were successful, of course, and many entrepreneurs had suffered losses due to various reasons, including fraud and unfair treatment by their Mainland partners. But that did not deter them to continue to seek business opportunities. On the whole Hong Kong's entrepreneurs achieved huge gains in their Mainland ventures. In regard to R&D Hong Kong's entrepreneurs have concentrated on those kinds in which they enjoy a comparative advantage. For example, we do not have pharmaceutical companies that spend huge sums developing new drugs, but we have developed very successful items such as the Octopus card and electronic educational toys that rely less on primary research and more on design. Thus Hong Kong is strong in applying modern technology. Moreover, by various measures, such as trade-to-GDP ratios, per capita IDD calls, and internet usage intensity, Hong Kong is one of the most globalized economies in the world. Hong Kong people are about the most traveled in the world, and they have established excellent connections world wide. All this means that Hong Kong's entrepreneurs are well positioned to take advantage of the opportunities offered by globalization.

Hong Kong has some serious weaknesses too, but high cost is not one of them. As a matter of fact, in a free market economy high cost generally reflects the attractiveness of the place. Hong Kong's entrepreneurs tend to be short-sighted. Short term gains are considered important. Long term gains on the other hand are significantly discounted. The glaring example is the excessive aggressiveness of hotels during the handover, to the extent that travelers feel ripped off. Entrepreneurs appear to be impatient for longer term investments. Some entrepreneurs, particularly in the restaurant business, shirk their responsibilities and systematically exploit their employees, even to the extent of declaring bankruptcy and then opening up another restaurant with another name. More recently the government has laid charges on some law violators. The widening income and wealth gap is a major problem besetting the Hong Kong society and could become a problem for the economy if social stability is at risk.

*Common Myths about the Hong Kong Economy*

The HKUST Report is right in pointing out that there are some commonly believed myths about the Hong Kong economy. Such "myths" include the beliefs that Hong Kong operates on a laizzez-faire basis, that markets in Hong Kong are all free and competitive, and that Hong Kong has hardly any manufacturing activities. The HKUST team pointed out that "the Government has always monopolized land," that market concentration is a big problem, that in fact the government often interferes with the working the market particularly in regard to land and real estate. Moreover, while the share of GDP due to manufacturing is rather small, as much as 40% of Hong Kong's GDP is somehow related to manufacturing, and the activities may take the form of services.

I agree that Hong Kong is indeed not a purely laissez-faire economy. But then who else is? While the Government does monopolize the final ownership of land, and there are zoning laws and building codes to govern land development, the ownership of the right to use land is quite dispersed, and the government does not interfere with the transactions of properties as long as they are within the law. While market concentration is indeed a problem and there is a clear case to introduce competition law in Hong Kong, the "monopolization of land" by the government would not be a problem if the government releases land against the single criterion of marginal social benefit being larger than marginal social cost. If such land release policy results in land prices that are too high for some businesses to swallow, so be it. In 1994 the government decided that there was speculation and went about interfering with the speculative activities. This was a big departure from the tradition and might have been the main cause behind the overheating of the housing market in 1996-97. Notwithstanding Annex III of the Sino-British Declaration capping annual release of land at 50 hectares, there is not evidence that the colonial Government had ever intentionally restricted land supply to boost its coffers. In general, if the land release policy follows the marginal benefit marginal cost rule, but a business still finds it difficult to survive the high land costs in Hong Kong, the problem would lie with that business, which had better relocate elsewhere, and not with high land costs.

Another myth, not mentioned in the UST report, is that the most urgent and serious problem besetting the Hong Kong economy today is NOT to find a new direction for the economy, but to appropriately deal with the widening income disparity, the pervasive poverty in some communities such as Tin Shui Wai and Shum Shui Po, and the sense of injustice this engenders. Hong Kong's entrepreneurs are quite capable of, and are certainly far better positioned than government bureaucrats or academics, in finding out all the profitable opportunities that can be discovered. We can rely on the market to deal with economic restructuring. All that the government needs to do is to work with the market and to provide the necessary institutional and infrastructural support the market needs.

Although there has been significant measures taken by the government to alleviate the plight of the underprivileged, such as the public housing, free education, and subsidized health care, many families have difficulties making ends meet, working and toiling long hours notwithstanding. This has given fresh calls for capping long working hours and for introducing a legal minimum wage in Hong Kong. The SAR Government responded with a "wage protection movement" for cleaning workers and security guards, which are well known for their low wages. Announced in the 2006-07 Policy Address in October by the Chief Executive Donald Tsang, the wage protection movement is just a plead to the social conscience of business leaders to offer their cleaning workers and security guards wages no lower than the average wage rate for those occupations as reported in the Quarterly Report of Wage and Payroll Statistics published by the

Census and Statistics Department. The Government promised to "monitor the effectiveness of the Wage Protection Movement through the LAB (Labour Advisory Board) and conduct a comprehensive review two years after implementation. If the review finds that the Movement has failed to yield satisfactory results, we will set out to prepare for the introduction of legislation for a minimum wage in the cleansing and guarding services sectors." Given its voluntary participation nature, notwithstanding circulars sent to members by the Hong Kong General Chamber of Commerce stating its support for the movement, participation is miniscule. For June 2006, the average hourly market wage stood at $22.8 for lavatory cleaners and $24.2 for general cleaners. Security guards earned $23.2 to $30.6 per hour on average depending on the pattern of shift required. Such hourly wage works out to about $5000 to $6000 per month. Assuming both husband and wife make such wages, raising a family will remain very difficult, and life would be very hard indeed for those who earn lower than such wages. By the end of 2006, according to legislator Leung Yiu Chung, only about 600 enterprises had responded positively to the Wage Protection Movment. (Mingpao, 27 December 2006)

Notwithstanding the drop in unemployment from a high of 8.7 per cent around June 2003 to below 4.5 per cent by the end of 2006 many people continue to struggle with low incomes. The persistence of low incomes is evident in the fact that as of 2007 taxi drivers are still caught in a vicious competition, with many offering deep discounts for long distance travelers. For this reason when Chief Executive Donald Tsang referred to the Hong Kong economy as in the best shape in 20 years he elicited a lot of criticisms. For example the Editorial of Oriental Daily criticized Tsang as "gross exaggeration" (3 January 2007). The editorial cited a survey that indicated that only about 30% of the respondents enjoyed an improvement over ten years ago while about 36% indicated a decline in the standard of living. It criticized Tsang as either intending to mislead or "seeing the wood but missing the forest."

*Financialization and Globalization*

The Chief Executive was right if he was referring to the stock market or to the price that a piece of land on the peak sought in the last auction of the year. The Hang Seng Index surpassed the 20,000 level for the first time ever in 2006 and a 7,353 square meter luxury residential site on Mount Kellett Road at the Peak in Hong Kong fetched 1.8 billion HK dollars (about 231 million U.S. dollars), shattering all records for the per square foot price. (http://english.cri.cn/3130/2006/12/19/262@175843.htm accessed 1 February 2007) It is clear that the rich, particularly the super-rich, have never been so rich before and the excess liquidity is driving up prime asset prices. This phenomenon has even attracted a new term "financialization" and is global. The availability of excess liquidity on the one hand, and the drying up of profitable real investment opportunities in manufacturing and even services on the other hand, means that financial investments often bring higher returns than real investment. Engelbert Stockhammer (2004) summarized his paper with this: "Over the past decades, the financial investment of non-financial businesses has been rising, and the accumulation of capital goods has been declining." Hard work and hard investment often bring soft or meager returns. Speculative financial investments and investment in valuable assets of various kinds, including works of art, prime property, and antiques, on the other hand, often bring handsome, even huge profits. This is just a simple reflection of the working of supply and demand forces. When too many people seek employment, wages fall. When too many competitors seek opportunities in manufacturing and in services, returns on such new investments fall. The fact is, new profitable investment opportunities among the traditional industries are becoming harder and harder to find. The money that fails to find such profitable investment opportunities often end up chasing after rare assets, whose prices therefore have kept rising.

This is not to say that enterprises in the traditional industries do not make big money. They may. Such global companies as Walmart, Ikea, McDonnell, Nike, Starbucks, and Louis Vuitton are extremely profitable. These companies benefit tremendously from the opportunities made available to them by globalization. Their strengths may be derived from the scale of their operations which give them extremely good bargaining power when it comes to sourcing their supplies, or from the sheer size of the market to which they can sell their goods and services. They may be derived from the cost savings due to global production and sourcing, or from the price premiums that consumers are willing to pay for the use or ownership of "super-brand" products. The sales of Walmart, Ikea, and

McDonnell are targeted at the mass market, and certainly benefited from the low-cost sourcing and the scale of their operations. Those of Nikon, Nike, and Louis Vuitton on the other hand are targeted at the high end market, with their goods selling at premium prices reflecting the economic rent generated by the brand name, which becomes both a status symbol and an icon for quality. Starbucks and Pacific Coffee target at the burgeoning economically comfortable middle class. The key point is that while big money is made by some traditional enterprises which have successfully established themselves, and by a few very innovative enterprises which have been able to harness the opportunities presented by globalization, additional opportunities for productive investment are few and far between. The excess liquidity therefore end up buying financial and real assets and collectibles and boosting their prices, which then further vindicate the wisdom of such investments.

Real estate of course is one key destination where such money ends up. Over the past ten years investment in real estate has been very profitable globally. For a few years Hong Kong seemed to be the only exception, and those were the years from 1998 to 2003, when prices of homes, offices, as well as retail premises all plummeted in a gigantic way. While many blamed this "bursting of the bubble" to the Asian Financial Crisis, I have offered an alternative explanation (Ho and Wong, 2006), and suggested that the government's policies were to blame. The government not only dramatically boosted supply with an annual production target 85,000 residential units a year, but also killed demand by the public housing privatization scheme that offered sitting tenants of selected public housing blocks the opportunity of buying their own units at as much as 12% of the estimated market price. I argued that such a policy effectively destroyed any interest in the Home Ownership Scheme (HOS) which had served as the "next step" in the home upgrading ladder for public housing tenants since 1978. The TPS made HOS look extremely unattractive, effectively undercutting interest in both new HOS units and old units put on the market by their current owners intending to trade up. Since housing was also an important collateral for small and medium enterprises when they seek loans, the decline in the housing market also affected businesses and really struck a serious blow to the economy. With the economy falling into deep recession in 1998 and hardly recovering at all in 1999, the SAR government's fiscal position quickly turned into red, exactly as I had predicted in 1997 and 1998.

*Market Rents, Economic Rents, and the Conflict between Allocation and Distribution Goals*

One important aspect of the market that policy analysts and policy makers need to understand is that the market both creates "rent" and destroys "rent." In this context, I am referring to what economists call economic rent. David Ricardo, the classical economist, discovered economic rent and explained that fertile land attracts bidders and so commands a price premium over non-fertile land. Under perfect competition, after paying the price premium for the use of the land, a farmer who works on fertile land will fare just as well as a farmer who works on non-fertile land. Thus competition creates rent and destroys abnormal profits. Today, in Hong Kong we hardly have commercial farming, but Ricardo's idea still holds for an urban economy. Premises at the most attractive locations always command a price premium over those at other locations. Competition creates rent over scarce factors in exactly the same way as Ricardo depicted in the 19th Century. The key difference between true economic rent and "quasi-rent" is whether the scarcity of the factor of production in question is enduring or not.

If one owns a truly scarce factor that can hardly be duplicated, or when demand for it rises faster than it can be duplicated, the economic rent will increase with competition. Say, we have a prime location that shoppers find extremely convenient. It is evidently very valuable. From the resource allocation point of view we do want the highest bidder to have the use of it, since the highest bidder can generate the most income from it and can therefore afford to pay higher rent than anyone else. This demonstrates the rationality of market rent, no matter how high it goes.

Now suppose some innovative entrepreneur comes in with an idea, and is able to double the business volume at this prime location. He is the only one in town who knows how to do this. He out-competes any other bidder and earns a profit that is actually a "rent" due to his innovative idea. Unfortunately, he owns no patent to the idea, and his competitors soon learn the trick too. When the lease comes up for renewal, his "quasi-rent" disappears, because the rent for the premise is bid up. Competition has now destroyed his quasi-rent, and transferred the quasi-rent to the landlord. The landlord who owns the property did not do anything but benefits from the innovative idea. The entrepreneur has to come up with yet another idea in order to make any profit again.

We can see in this example that when ideas can be copied freely hard-working people including the entrepreneurs in the end only make "normal returns." There is economic growth, but the main benefit actually is captured by the landlord.

A paradox about the market is that while the workers and the innovative entrepreneurs generate economic growth, they may not benefit from it. In the earlier example it is the landlord who benefits. But it is also possible that consumers benefit. It is well known that in a bumper crop, farmers' total income may fall. If the excessive production comes from an innovative farmer whose idea is quickly copied by all other farmers, consumers benefit from the decline in prices, but farmers as a group actually earn much less than otherwise without the innovation. Farmers' total contribution to society has gone up because total output is higher. But farmers' total income and hence average income is lowered. More specifically, globalization and improved technology means that there were many more coffee producers in 2000 than say in 1990. The intensifying competition, which is further aggravated by the reduction in the number of buyers globally, has impoverished many coffee farmers. The gross imbalance in bargaining power between buyers and sellers led to very low coffee prices and has given rise to the call for fair trade.

Hong Kong of course does not grow coffee. But a similar story is happening here too. Because of the large number of unskilled workers who are available in the market, both in and outside Hong Kong, the wages of unskilled workers have hardly grown at all over the past decade, even though they may be working harder and their productivity is rising.

For these reasons, I have long argued that we need a more aggressive redistributive policy in Hong Kong. I would not interfere with prices, because the prices are effective in promoting efficient resource allocation. But market prices may be unfair. The redistribution that I am talking about is NOT a "welfare", NOR is it a redistribution from those who are productive and earn more to those who are less productive and earn less. The redistribution is necessary because the market mechanism does not reward fairly those who are the most productive and who actually contribute to the economic progress.

*Financial Centre, Pollution, and the World City*

The SAR Government identified four "pillar industries" of Hong Kong. These are Finance, Trade and Logistics, Tourism, and Specialized Business and Supporting Services. As a small open economy with little natural resources except its harbor and geographic location these "pillar industries" are indeed all very important to Hong Kong. In 2005, total exports inclusive of services were almost double the size of the GDP, while total imports exceeded 185 per cent of the GDP, Hong Kong obviously depends on trading to survive. But finance is unique in that while only 5.5% of the workforce worked in the industry in 2002, it accounted for 12.2% of the GDP. The relative value added per worker is much lower for any of the three other pillar industries. In trade and logistics, the share of employment in the economy was 24.1% but the share of the GDP was 26.5%. As it happens, the importance of tourism appears to have been exaggerated considerably in the media. The share of employment was only 3.9% while the share of the GDP was even lower, at 3.0%. For this reason, the claim that CEPA and individualized travel from the Mainland, which was officially launched in 2003, jumpstarted the economy, has little credibility.

Regardless of the talk about pillar industries, Hong Kong is today an important trading hub and a major international financial centre, and Hong Kong is likely to remain so in the years to come.[2] In a recent book *China, Hong Kong, and the World Economy* (Ho and Ash, eds. 2006), Jao concluded: "as long as Hong Kong distinguishes itself from other Chinese cities in respect of currency convertibility, capital mobility, economic

[2] This is indeed how the Chief Executive pictured Hong Kong in his latest assessment on 15 January 2007, following Economic Summit on China's 11th Five-Year Plan and Development of HK. He said: "Under the 'One Country, Two Systems' principle, the country has highlighted Hong Kong's role and the direction of our economic development in the 11th Five-Year Plan, that is to develop financial, logistics, tourism and IT industries and to preserve our status as an international financial, trade and shipping centre."

freedom, rule of law, and the quality of prudential supervision and corporate governance, it will remain China's main OFC (offshore financial centre)…. From Hong Kong's own point of view, the territory remains an integrated finical centre, and an IFC (international financial centre) in its own right." (p.146) With a total market capitalization of over HK$13.33 trillion (US$1.71 trillion) as of December 2006, the Hong Kong Stock Exchange ranks 7th in the world by market capitalization of listed companies. This ranking is expected to further move up over the next years, with more and more Mainland companies seeking listing in Hong Kong.

I am not interested in the ranking of Hong Kong in the world in this or in that, but in Hong Kong doing all it can and all it should to capitalize on the opportunities that are available. In this regard, I am particularly keen to point to the importance of each and every distinction that Jao alluded to Hong Kong: currency convertibility, capital mobility, economic freedom, rule of law, and the quality of prudential supervision, as well as corporate governance. Absent any of these factors, Hong Kong as an international financial centre would be gone. But I do not think that Hong Kong needs to be the only city in China with these factors. Many people are worried that should the RMB become fully convertible Hong Kong as a financial centre could be marginalized given the lower costs in China. Such worries are misplaced. In practice financial centres are not like manufacturing bases in that for financial centres costs seldom count. What count are investors' confidence about effective and appropriate regulations, the rule of law, and efficiency. High costs are often the result of the success of a city as a financial centre. On the other hand low costs have never been an important factor behind any city's emerging as a financial centre.

I cannot subscribe to the notion that the government needs to find new directions for the Hong Kong economy. As long as we have free markets, the economy will adjust, and how to achieve the necessary "economic restructuring" to keep up with the times will never be a problem that policy makers need to worry about. Yes we will need to worry about the problems that restructuring may bring, but if we have an adequate and well-functioning social safety net, those who suffer temporarily will have their suffering relieved and it will be bearable. But we will not need to preempt our entrepreneurs who are in the market place and who are so sensitized to the market that you can be sure they will make the necessary adjustments. Yes we will need to worry about improving our education and vocational training, but that is an ongoing thing. We will need to nurture a new generation of entrepreneurs and workers who have the stamina and the preparation to face challenges, but why would policy makers ever need to discover new "sunrise industries"? Sadly for Hong Kong, many commentators continue to ask such questions, putting pressures on the government to preempt the market. That would simply be wrong. In retrospect, none of the "centres" that Mr. Tung Chee-hwa envisaged for Hong Kong ever came to fruition.

On the other hand, Hong Kong is developing in its own way, driven by market forces, to become a leading international financial centre. Of course there are circumstances driving these developments, but they are not by the design of the SAR government. China is fast taking off, and many private enterprises are seeking capital to fund their operations. Many SOEs are being reformed and transformed. Many are becoming very profitable. Hong Kong has very nice traditions in upholding the rule of law and is commanding a lot of confidence from investors. Far more important than infrastructures, institutions and culture and business practices count and weigh heavily in investors' minds, when it comes to financial services. Hong Kong has clear natural advantages and need to build on these advantages to push itself forward. The RMB can become completely convertible overnight, but business practices and culture can never change over night.

What Hong Kong really needs to do is to make itself into a livable city, a fair city, a city with social harmony and respect and tolerance for differences. Hong Kong has been suffering from serious pollution, particularly air pollution, and in order to attract the best talents to work for Hong Kong, we really have to make our city clean and livable. It is well known that educated people and financially well-off people are very much concerned health and the health and the education of their children. If we have serious pollution, if our education system is lousy, or if we have poor healthcare, we will never be able to attract the talents we need to make Hong Kong into a top financial centre.

Thus, when on 27 November 2006, the Chief Executive signed the Clean Air Charter on behalf of the HKSARG, he was not making an economic sacrifice. He was, rather, investing in Hong Kong's future. It is time we count the cost to air quality as an economic cost. The Charter was initiated by the business sector in support of the Government's appeal to improve air quality in Hong Kong. Signatories of the Charter are committed to carrying out the following measures at their daily operational level to help reduce emissions –

(a) operating by recognized world class standard;
(b) using continuous emissions monitors;
(c) publishing information on energy and fuel use;
(d) adopting energy-efficient measures;
(e) taking appropriate measures during days of high pollution; and
(f) sharing air quality expertise with others.

The Charter is a voluntary act on the part of the business sector and should certainly be applauded. It is gratifying to see that there are businessmen who understand that air pollution is bad for business, and particularly bad for a financial centre. But voluntary acts are not enough. If a business costs others heavily but benefits privately by polluting activities there is a good possibility that it would pollute. Thus, regulations, pollution taxes, or emission trading may be necessary. It is nice to see that the SAR government is using a multi-thronged approach in dealing with pollution. The concept of emission trading is particularly interesting, as it directly deals with cross border pollution, but the scheme as proposed by the HKSAR may not be fair to Hong Kong, since it requires both power companies on the Mainland as well as Hong Kong's power companies to curtail their current emission levels by the same percentage. Given that Hong Kong's power companies have already achieved a much lower emission level than those on the Mainland, it will be much more costly for Hong Kong's power companies to reduce emission levels by the same percentage than Mainland's power companies. They are expected therefore to buy emission quotas from the Mainland companies, effectively subsidizing the emission reduction efforts of the latter, and this will end up being paid for by of Hong Kong's consumers, who will certainly have to pay higher electricity bills.

*Competition Policy*

The SAR government is well aware of the importance of “free and fair competition” in promoting economic efficiency and a healthy market economy. However, to date the government has followed only a “sectoral approach”, and refused to enact a comprehensive competition law. In 2000 and 2001, the government has passed laws prohibiting certain types of anti-competition behavior in the telecommunications and the broadcasting industries. According to the consultation document of 2006, for the rest of the economy, the Competition Policy Advisory Group (COMPAG), which was established in December 1997 and which was under the chairmanship of the Financial Secretary, would look at complaints of anti-competitive conduct and to investigate any reports of possible abuses of dominance. At the same time, the Consumer Council was asked to monitor and review trade practices and sectors prone to unfair trading practices.

The rationale behind this sectoral approach is not clear at all. What distinguish telecommunications and broadcasting to warrant special treatment? It seems that the reverse approach would make better sense. This reverse approach would apply the comprehensive framework on all sectors except the few where special consideration warranted the exceptional treatment. The burden of proof for justifying the exceptions must further be placed on the industries that seek the exceptional status.

In any case without a legal framework and the authority to impose sanctions, it is not clear what is the point of the investigations in the event of reports of possible abuses of dominance or unfair trading practices. To put it plainly, neither COMPAG nor the Consumer Council could do anything, regardless of the evidence obtained in such investigations.

Following the same logic, we need to raise a simple question. When practically all OECD countries as well as Singapore have already introduced competition laws of one sort or another, one needs to ask what distinguishes Hong Kong, a mature economy quite comparable to these economies, to warrant a different approach to ensuring that competition is free and fair? The Consultation Document says that Hong Kong is a “free and open economy” and that there are no significant entry barriers to most industries. These assertions are however quite misleading. In 2000 Carrefour, a major retailer from Europe which successfully took root on the Mainland, was forced out of the market in September 2000 after just four years in Hong Kong, citing difficulties in securing suitable premises and reasonable rent, as well as pressures from some 22 companies not to undercut prices. The Consumer Council investigation concluded that pressure was applied on Carrefour to keep price levels at the agreed price, or they would withdraw their goods for sale. (SCMP, 1 November 2005) Thus, barriers to entry in practice, though informal, are real, and they certainly had rendered competition far less effective than otherwise.

Paradoxically, the absence of government intervention apparently contributed to a “free economy” but in practice hurt the openness of various sectors to competition, Hong Kong remaining a truly “open economy” in the macro sense notwithstanding.

Related to competition is the subject of regulations of public utilities, particularly the power companies, which have been enjoying profit protection under the Scheme of Control. There are two power companies in Hong Kong, the China Light and Power Ltd., and Hong Kong Electric Company. The former was founded in 1901 and supplied electricity to Kowloon and the New Territories except Lamma Island. Hong Kong Electric Company Ltd. was established in 1889 and serves Hong Kong Island and Lamma Island. They operate under the Scheme of Control which would expire in 2008 and the new terms are currently under negotiation. The existing Scheme allows both companies to reap a profit at 13.5% of the total value of the average net fixed assets per year plus 1.5% of the shareholders’ investments made after 30th September 1978 For Acquiring Fixed Assets. When profits exceed such permitted rates of return, the excess would go into a Development Fund. When profits fall short, the companies are permitted to raise charges. The current version of Scheme of Control was established in 1992, at a time when inflation was high and the rates of return looked more reasonable. In today’s low inflation environment, it is generally believed that the permitted rates of profit are too high. Moreover, many commentators have pointed to the distortion of incentives since the permitted profit rates are based on average net fixed assets. The terms clearly would encourage excessive investment in assets and may well have been behind the gross over-estimation of power consumption growth in the past years.

The rationale behind the Scheme of Control is to provide incentives for the power companies to invest and to serve Hong Kong's best interest. But boosting the size of net assets will also allow the companies to reap handsome profit. As a matter of fact, 13.5% guaranteed profit is very high, if one considers that there is hardly any risk. On the other hand, if the profit was generated through efficient and innovative productive activities, we should not cap it and should allow the company to earn as much as it can. In the case of electricity generation, given the monopoly position of the power companies, higher profit can be achieved simply by raising charges. That is why any Scheme of Control would not make much sense. Instead of renewing the Scheme of Control when it expires in 2008, it is far better regulating electricity charges to make them in line with global levels, while putting up the right of operation for open bidding. We can spell out the terms of operation clearly, and require that the successful bidder pay the original operator for the undepreciated value of the original investment. Of course China Light and Power as well as Hong Kong Electric are both invited to bid. If they win, they would simply be "paying themselves" to acquire the undepreciated assets. We should also allow the possibility that either company takes over the operation of the other company too. If prices are regulated in a transparent way, bidders will take full account of the conditions and their bids will reflect such restrictions. We can also get the help of independent appraisers to assess the values of the undepreciated assets of the companies, which can be announced before the bidding day. Once this is done, we can let the companies make as much profit as they can without regulation.

*Speculation, Herd Behaviour, and the Incursion into the Stock Market*

Speculation is a scary word for policy makers. In 1994, the Hong Kong Government introduced rather drastic measures to curb speculation in the housing market, which then rapidly cooled off. But it then went back up in no less than a year, and in 1996 and 1997 housing prices went through the roof. Today it is widely held that speculation caused the housing bubble, which then burst in 1998 plunging the economy into a deep recession.

In the Report of the Task Force on Land Supply and Property Prices Planning, environment and Lands Branch June 1994 reference to the high vacancy rate for large developments as prima facie evidence of hoarding. Various measures were implemented to increase the cost of speculation and to reduce the profitability of speculation, such as confiscating 5% of the purchase price held as deposit if the purchaser fails to sign the formal sale and purchase agreement or if he enters into a Cancellation Agreement with the developer, and disallowing resale before the issuance of the certificate of compliance or the consent to assign. Despite the measures, housing prices surged again in the first quarter of 1996, and continued to rise through October 1997, ignoring the Asian Financial Crisis for a moment after it broke out in July.

It was against this background that Hong Kong people welcomed the announcement of Tung Chee-hwa to increase housing supply to no less than 85,000 units a year. It was widely believed that the surge in housing price before 1997 reflected shortage, and that the shortage was artificially propagated by the provision in Annex III of the Sino-British Joint Declaration of 1984 stipulating that the Government should not grant more than 50 hectares of land (excluding land to be granted to the Hong Kong Housing Authority for public rental housing) without the approval of the Land Commission comprising of equal members from the British and the Chinese sides. There is little doubt that speculative pressures were very much behind the run-up in housing prices prior to 1997, as many indicators do show that prices were rising out of the range that would be expected from forecasts based on economic fundamentals. However, to conclude that there is a gross imbalance between supply and demand would be wrong.

As pointed out in Ho (2003), while the number of households did exceed the number of dwelling units in the early 1980s, this had been reversed by 1990, and all through 1997 the number of housing units actually exceeded the number of dwelling units. There was therefore no physical shortage. Much of the surge in housing prices had reflected a rise in people’s wealth, and this is further multiplied by the effect of savings pouring into the housing market from among the public housing tenants who had enjoyed low rent but rising incomes. The latter effect was especially magnified when the government introduced in April 1987 a policy of making richer tenants pay higher rent.

Thus from the first day, the medicine of increasing supply was wrong for the illness, if there was an illness. It is well known that speculative demand can surge and disappear overnight. It is just not realistic to even attempt to get even with speculative demand, because supply produced cannot disappear overnight as demand can. There will be an overhang of excess supply whenever speculative demand subsides. Thus, we should attempt to produce supply to match society's long term needs, and simply let prices move up and down in the short run. If prices are momentarily too high and have to fall back, those who pay too high a price will suffer a loss. If prices are momentarily too low and have to rise, those who have the insight to the real situation will gain. This will give speculators as well as homebuyers the incentives to be alert.

Unfortunately the SAR Government read the signs wrong, and went about trying to boost supply even in 1998, when demand had actually shrunk tremendously both as a result of the Asian Financial Crisis and the Tenants Purchase Scheme. So the dramatic collapse of housing prices and the deep recession came as no surprise. (Ho, 1998)

With the economy bleeding, the hungry sharks lurking in the background eventually made a strike at Hong Kong. By a "double play" strategy, hedge funds made huge profits selling short the Hang Seng Index Futures and driving interest rates up at the same time putting pressures on the Hong Kong dollar. This strategy, together with a narrative of the counter-attack by the Government, is explained in the official SAR website (http://www.info.gov.hk/info/sar2/economy.htm):

"Severe and sustained market disorder prompted the government to launch a defensive incursion into the stock and futures markets in mid-August. The government spent a total of HK$118 billion (US$15.1 billion) buying the 33 constituent stocks of the Hang Seng Index. During the defence, turnover reached a record HK$79 billion (US$10.1 billion) on 28 August, the last day of trading for the month.

"Although controversial, the actions preserved the integrity of the financial markets and prevented a general loss of confidence in Hong Kong's economy. The government's actions were generally well received by both the domestic and international community. Opinion within the investment community was divided between those who believed it was the right thing to do under such contrived and unusual circumstances and those who believed market forces should have been given free reign and that the Hong Kong SAR Government had broken a cardinal rule by intervening in the stock market."

The "incursion" was very successful. Psychologically it immediately reversed the herd behaviour of the public. The Heng Seng Index rebounded and continued to surge soon after that. The profits from the action actually brought a handsome profit. The Exchange Fund Investment Ltd. was set up in October 1998 at arm's length from the Government and the Hong Kong Monetary Authority was entrusted with the task of managing the share portfolio, with the long-term aim of reducing the government's Hong Kong equity holdings to an amount equal to about 5% of the total assets of the HKSARG's Exchange Fund. The government's Hong Kong equity share portfolio was valued at HK$190 billion (US$22.8 billion) at the end of April 1999. The Tracker Fund of Hong Kong (TraHK) was launched in November 1999 as the first step in the Government's disposal programme with an initial public offer worth HK$33.3 billion (approximately US$4.3 billion). Since the IPO, approximately HK$140.4 billion (by 15 October 2002) in Hang Seng Index constituent stocks has been returned to the market. (http://www.trahk.com.hk/eng/homepage.html)

Just as the Government had "incurred" successfully into the stock market, in the end reaping a handsome profit and saving the stock market from even greater losses and ultimately reviving confidence in the Hong Kong economy, so it really should have considered a similar move in the face of gross excessive supply in the housing market. Such moves of course would attract severe criticisms from some liberal economists. Indeed I recall that Steven Cheung, the noted liberal economist, had described the government's incursion into the stock market as silly and like "dumping bags of sand to fill the ocean." But there are times when asset prices grossly deviate from underlying values based on economic fundamentals, such as when there is herd behaviour aggravating a loss of confidence or when there is a gross oversupply. One might think that we should let prices fall to "eliminate" the oversupply, but this thinking is extremely dangerous in the case of the housing market. Housing is such an important asset that declines in market prices due to a gross oversupply could damage the economy severely. Moreover, a gross oversupply of housing can never be eliminated by a decline in prices, and could lead to Hong Kong's homeowners being bankrupted and their homes being taken up by bargain-hunters from overseas. Withholding part of the excess supply from the market and releasing it slowly, on the other hand, is a responsible response in an over-supply situation, makes eminent economic sense, and would have helped moved the real economic recovery much earlier.

*Does High Cost Erode Hong Kong's Competitiveness and Marginalize the Hong Kong Economy?*

I am not in favour of a "high land price policy" nor a "low land price policy." In a well functioning market, with no impediments or artificial boosts in supplies, prices should seek the equilibrium market levels. The SAR Government should not prejudge if housing prices are too high or too low. However, it is very important that supply and demand balance, and that means the Government should provide as much as, and only as much land as can be absorbed by the market—provided that the value of the new development is larger than the social cost of the new development. There are two ways of counting the social cost of the land supplied. First is the social cost of making a plot of land usable and available. This could entail reclamation, providing access roads, providing incidental urban services, etc. Second is the opportunity cost of making a plot of land available to developers now rather than in the future. If a plot of land is released now, it may no longer be available in the future. If this "marginal rule" is followed, I would like land price be dictated by the market forces.

If the economy is very attractive to investors and buyers are cash-rich, it is entirely possible that the resulting land price still appear to be expensive in comparison with land prices elsewhere. This may only reflect the premium that investors are prepared to pay for Hong Kong's unique characters: low profit and income taxes, political and social stability, a vibrant economy, excellent prospects, etc. If so, then the high land prices in Hong Kong only testify to Hong Kong's attractiveness and competitiveness. There will be nothing to worry about. Even though some industries may find it hard to survive in Hong Kong's high cost environment, still it does not matter, because their departure only makes way for other more competitive industries. Of course one may still ask: why not provide more land at lower cost so these less profitable industries can still find a place in Hong Kong. As explained in the foregoing paragraph, this depends on the marginal benefit of providing the land versus the marginal cost of doing so. Only if it can be demonstrated that the marginal benefit is higher than the marginal cost should the additional land be provided for development purposes.

Worried if Hong Kong's competitiveness was being hurt by developers' greed, Sin-ming Shaw, wrote:

*"Local developers sit on $60 billion worth of land, enough to meet private housing needs for the next 10 years. These developers are in fact Hong Kong's largest speculative hoarders. Boosting property values may provide temporary relief, but it raises the hurdle of investment returns, deterring business expansions and start-ups. Given that much land is held by a cartel of property companies and not subject to market forces, the government should not allow the developers to dictate when they apply for rezoning or when they build. Initially, lower real-estate prices will arouse ire among homeowners and tycoons, but the alternative—becoming an uncompetitive, overpriced backwater—is even more frightening. Falling prices will quickly stabilize. The last five years of stagnation plainly show that short-term pain is far better than long-term torture."* (Time Asia, 8 July 2002)

And again:

*"An alternative would be to allow asset prices and wages to deflate until the market finds its own equilibrium. But the government fears a negative effect on Hong Kong's corporations, especially its banks, which rely heavily on real-estate revenue. It is also afraid of massive defaults,*

*because numerous homeowners are believed to be suffering from "negative equity." These misguided concerns have frozen the debate: no one seems to care that lower property prices would attract new home buyers and businesses, creating employment. Without bringing costs down, however, Hong Kong doesn't have much of a future.”* (Time Asia, 3 September 2001)

The implication of Shaw’s argument is that the developers in Hong Kong had withheld supply to produce a shortage and that in turn had kept housing prices rising through 1997. But to follow through the argument one has to present the evidence that indeed there was a physical shortage of housing. No one has yet provided the evidence for such a shortage. Did we have a low and falling vacancy rate? Did the number of households exceed the number of dwelling units? Statistically, we have seen, during the pre-1997 period, that the number of dwelling units had continued to exceed the number of households, and that space per person in each dwelling unit had been rising. Is there any evidence that the supply of private housing was stunted before 1997? The annual supply ranged from 20,000 units a year to 34,000 units a year between 1987 to 1993. Although supply was a bit low in 1994, it went back up to 41,000 units in 1995, obviously responding to the higher prices leading to 1994. But the policy to cramp down on speculation in 1994 actually led to a decline in supply, which fell to 10,000 units in 1997 and 16,000 units in 1998. It appears that developers had never artificially withheld supplies. They have actually worked very hard converting agricultural land and industrial land to residential and commercial uses. They have also tried to produce as many units as they are allowed under the zoning and town planning rules. If anything, they may be accused of developing too fast. Many citizens, for example, have criticized the government for excessive reclamation of the harbor, and they find the International Financial Centre II, whose 88 storey office tower rising almost right in the centre of the harbour, particularly distasteful.

Table 1: Statistics on Compulsory Winding-up and Bankruptcy for the period 1996 to 11-2006

| Year | Bankruptcy | | Compulsory Winding-up | |
|---|---|---|---|---|
| | Petitions presented | Receiving/Bankruptcy Orders made (Note 1) | Petitions presented | Winding-up Orders made |
| 1996 | 780 | 543 | 742 | 557 |
| 1997 | 829 | 639 | 658 | 503 |
| 1998 | 1362 | 893 | 946 | 723 |
| 1999 | 3876 | 3071 | 1161 | 795 |
| 2000 | 5487 | 4606 | 1241 | 910 |
| 2001 | 13186 | 9151 | 1401 | 1066 |
| 2002 | 26922 | 25328 | 1430 | 1292 |
| 2003 | 22092 | 24922 | 1451 | 1248 |
| 2004 | 12489 | 13593 | 1306 | 1147 |
| 2005 | 9933 | 9810 | 955 | 849 |
| 2006 through November | 9923 | 9671 | 633 | 502 |

Note 1: Receiving orders were made upon bankruptcy petitions presented before 1 April 1998 and bankruptcy orders, after that date.

Note 2: The number of orders made in a particular month is affected by the number of weekly hearings (usually on every Wednesday and, if necessary, Tuesday commencing July 1999) in the month when cases are heard in Court. Cases are not heard in public holidays.

Note 3: New statutory provisions came into operation on 1 April 1998.

Note 4: Petitioners appear to be getting used to new provisions for bankruptcy petitions effective from 1 April 1998.

Source: Official Receiver's Office

Private housing supply shot up to 54,000 units a year in 2001, following the implementation of the "85,000 units a year" policy. Instead of "quickly stabilizing", the prices fell through the floor, bankrupting tens of thousand of families, boosting the suicide rates and hurting business sentiments (Table 1). Only after Michael Suen, Secretary of Housing, Planning, and Lands, announced a nine-point strategy, in November 2002, that includes supply management and halting the Tenants Purchase Scheme after Phase 6A and 6B in 2003, that the groundwork for an economic recovery of the economy was laid. If it had not been for the outbreak of SARS that lasted through the middle of 2003, the economy probably would have recovered much sooner. But as it happened, most people mistakenly credited the Closer Economic Partnership Arrangements (CEPA) and individualized travel—both of which were announced in the summer of 2003—as the factors that jumpstarted the economy back to a growth path. In point of fact, CEPA saved Hong Kong exporters a total of 66.4 million yuan in the first year, when some US$12 billion dollars of

Hong Kong exports enjoyed zero tariff access to the China market (Mingpao, 25 January 2005). As to the benefits from individualized travel, according to the Tourism Bureau, 21.8 million visitors came to Hong Kong in 2004, spending a total of 91.8 billion dollars, up almost 20% from the previous year. Of this spending, HK$69.6 billion represents consumption spending in Hong Kong. Mainland visitors accounted for about half of this, i.e., 38.6 billion. (Mingpao, 10 March 2005) When it is realized that increase represents only a fraction of this and that only a fraction of any spending is value added in Hong Kong, such figures are simply miniscule to be able to account for the strong recovery of Hong Kong in 2004.

*China's Accession to WTO, RMB Reform and US Dollar Movements*

Since 1999, when the US-China WTO agreements were concluded, China's share in world trade has exploded, from some 4 per cent then to almost 10 per cent now. Surging exports boosted the current account surplus, while continued inflow of capital maintained a surplus in the capital account as well. China's foreign exchange reserves had kept rising, and pressures for the RMB to appreciate continued to build up. On 21 July 2005, the People's Bank finally decided to shift gear. The de facto link with the US dollar since late 1997 was abandoned, and the RMB was immediately devalued by 2.1%. According to the official statement, "China will reform the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. RMB will no longer be pegged to the US dollar and the RMB exchange rate regime will be improved with greater flexibility."

Since then the RMB kept appreciating, though occasionally with some hiccups, suggesting that there was no basket link in a substantive sense. In early January 2007 the RMB yuan was actually valued higher than the Hong Kong dollar for the first time since 1994, when China merged the official exchange rate with the "Foreign Exchange Adjustment Centre" rate. The Hong Kong Monetary Authority, however, maintained that regardless of the movement of the RMB in the foreign exchange market, the Hong Kong dollar will not change its link with the US dollar. The rise of the Yuan against the Hong Kong dollar will put pressures on Hong Kong's inflation rate but otherwise will benefit the economy by boosting its exports to the Mainland and tourism earnings. Investment from Mainlanders in Hong Kong is also expected to increase. Together with the more recent weaknesses in the US dollar, the Hong Kong economy is expected to continue to benefit from strong external demand and investment inflow. The outlook for the Hong Kong economy appears bright.

It is however interesting to compare the economic growth of Hong Kong in 2000 with the more recent economic recovery since 2003. There is little doubt that CEPA as announced in 2003 and China's accession to WTO in November 2001 benefited Hong Kong's external trade. Hong Kong's domestic exports, which had been falling steadily since 1992, started rising again in 2004, although there was a significant decline in the second half of 2006. (Table 2) Hong Kong's total trade with the Mainland recorded 4 consecutive years of double digit growth since 2003. GDP grew by 10 per cent in 2000 but only 8.6 per cent in 2004. The economic growth in 2000 was driven by very strong total exports, which rose 18%, as compared with only 16% in 2004. But strong growth in 2000 notwithstanding, housing prices had continued to decline, while the unemployment rate dipped only a while and then rose to new highs. On the other hand, the economic growth since 2003 has staying power. Housing prices rebounded, while the unemployment rate fell from a peak of 8.7 per cent in the second quarter of 2003 to 4.5 per cent by the end of 2006. It appears that the change in housing policy as announced in November 2002 by Michael Suen has played an important part in the stronger staying power of the more recent recovery.

**Table 2 : Hong Kong's External Merchandise Trade Figures from January 2003 to November 2006**

(HK$ Million)

| Year | Month | Domestic Exports | Year-on-year % Change | Re-exports | Year-on-year % Change | Total Exports | Year-on-year % Change | Imports | Year-on-year % Change |
|---|---|---|---|---|---|---|---|---|---|
| 2003 | 1 | 9,575.5 | -6.8 | 125,452.3 | +30.3 | 135,027.7 | +26.7 | 133,224.9 | +21.4 |
| | 2 | 7,102.7 | -17.2 | 98,044.8 | +13.1 | 105,147.6 | +10.4 | 115,984.1 | +18.3 |
| | 3 | 9,284.1 | -8.4 | 133,803.1 | +17.5 | 143,087.3 | +15.4 | 154,211.6 | +14.6 |
| | 4 | 8,414.3 | -16.9 | 125,731.7 | +11.3 | 134,146.0 | +9.0 | 141,302.1 | +8.4 |
| | 5 | 9,877.6 | -7.8 | 133,144.0 | +15.6 | 143,021.7 | +13.6 | 145,795.7 | +9.4 |
| | 6 | 10,289.0 | -10.4 | 132,054.2 | +16.5 | 142,343.2 | +14.0 | 146,368.6 | +11.5 |
| | 7 | 12,249.7 | -7.1 | 145,324.6 | +9.1 | 157,574.4 | +7.6 | 159,883.0 | +5.6 |
| | 8 | 11,791.4 | -2.4 | 139,379.4 | +7.9 | 151,170.7 | +7.0 | 152,917.9 | +6.0 |
| | 9 | 11,082.9 | -6.9 | 146,434.8 | +7.6 | 157,517.7 | +6.4 | 162,163.8 | +7.3 |
| | 10 | 10,791.3 | -5.8 | 153,961.3 | +10.7 | 164,752.6 | +9.4 | 168,970.6 | +10.2 |
| | 11 | 9,793.5 | -3.0 | 143,980.4 | +10.0 | 153,773.9 | +9.0 | 161,762.2 | +13.8 |
| | 12 | 11,536.1 | +3.6 | 145,177.1 | +16.9 | 156,713.2 | +15.8 | 168,167.6 | +17.9 |
| 2004 | 1 | 8,255.9 | -13.8 | 127,055.8 | +1.3 | 135,311.7 | +0.2 | 134,472.5 | +0.9 |
| | 2 | 7,849.7 | +10.5 | 126,944.7 | +29.5 | 134,794.4 | +28.2 | 154,645.8 | +33.3 |
| | 3 | 9,703.2 | +4.5 | 153,214.9 | +14.5 | 162,918.2 | +13.9 | 177,986.8 | +15.4 |
| | 4 | 8,969.0 | +6.6 | 151,010.1 | +20.1 | 159,979.1 | +19.3 | 175,993.1 | +24.6 |
| | 5 | 9,918.6 | +0.4 | 155,512.7 | +16.8 | 165,431.4 | +15.7 | 174,786.6 | +19.9 |
| | 6 | 11,082.8 | +7.7 | 157,189.2 | +19.0 | 168,272.0 | +18.2 | 177,809.6 | +21.5 |
| | 7 | 11,746.4 | -4.1 | 171,879.5 | +18.3 | 183,625.9 | +16.5 | 189,261.3 | +18.4 |
| | 8 | 12,091.6 | +2.5 | 170,653.4 | +22.4 | 182,745.0 | +20.9 | 185,960.1 | +21.6 |
| | 9 | 11,550.5 | +4.2 | 168,113.4 | +14.8 | 179,663.9 | +14.1 | 186,158.8 | +14.8 |
| | 10 | 12,300.9 | +14.0 | 178,930.7 | +16.2 | 191,231.6 | +16.1 | 191,478.0 | +13.3 |
| | 11 | 11,133.7 | +13.7 | 168,525.4 | +17.0 | 179,659.0 | +16.8 | 179,906.2 | +11.2 |
| | 12 | 11,449.8 | -0.7 | 165,473.6 | +14.0 | 176,923.4 | +12.9 | 185,843.6 | +10.5 |
| 2005 | 1 | 9,742.3 | +18.0 | 172,705.7 | +35.9 | 182,448.0 | +34.8 | 184,492.1 | +37.2 |
| | 2 | 6,250.2 | -20.4 | 121,276.6 | -4.5 | 127,526.8 | -5.4 | 137,729.0 | -10.9 |
| | 3 | 8,034.0 | -17.2 | 160,647.1 | +4.9 | 168,681.1 | +3.5 | 182,490.5 | +2.5 |
| | 4 | 8,046.7 | -10.3 | 164,441.9 | +8.9 | 172,488.6 | +7.8 | 182,710.5 | +3.8 |
| | 5 | 9,865.3 | -0.5 | 183,508.6 | +18.0 | 193,373.9 | +16.9 | 202,685.5 | +16.0 |
| | 6 | 10,126.2 | -8.6 | 179,353.0 | +14.1 | 189,479.2 | +12.6 | 196,538.0 | +10.5 |
| | 7 | 11,801.1 | +0.5 | 186,635.2 | +8.6 | 198,436.3 | +8.1 | 201,646.7 | +6.5 |
| | 8 | 14,139.1 | +16.9 | 191,798.2 | +12.4 | 205,937.3 | +12.7 | 209,869.9 | +12.9 |
| | 9 | 14,350.7 | +24.2 | 195,814.3 | +16.5 | 210,165.1 | +17.0 | 214,350.1 | +15.1 |
| | 10 | 15,697.3 | +27.6 | 197,806.4 | +10.5 | 213,503.7 | +11.6 | 210,027.8 | +9.7 |
| | 11 | 14,025.2 | +26.0 | 186,325.4 | +10.6 | 200,350.6 | +11.5 | 204,372.0 | +13.6 |
| | 12 | 13,992.1 | +22.2 | 174,778.5 | +5.6 | 188,770.6 | +6.7 | 205,627.9 | +10.6 |
| 2006 | 1 | 13,131.1 | +34.8 | 176,888.8 | +2.4 | 190,019.9 | +4.2 | 185,652.5 | +0.6 |
| | 2 | 9,523.2 | +52.4 | 144,094.5 | +18.8 | 153,617.7 | +20.5 | 176,650.0 | +28.3 |
| | 3 | 10,669.4 | +32.8 | 182,795.7 | +13.8 | 193,465.2 | +14.7 | 211,701.0 | +16.0 |
| | 4 | 10,265.3 | +27.6 | 178,518.8 | +8.6 | 188,784.2 | +9.4 | 203,244.2 | +11.2 |
| | 5 | 11,541.3 | +17.0 | 181,705.4 | -1.0 | 193,246.7 | -0.1 | 207,816.2 | +2.5 |
| | 6 | 11,793.4 | +16.5 | 190,383.7 | +6.2 | 202,177.1 | +6.7 | 215,985.2 | +9.9 |
| | 7 | 13,949.2 | +18.2 | 205,621.8 | +10.2 | 219,571.0 | +10.7 | 224,725.3 | +11.4 |
| | 8 | 12,950.5 | -8.4 | 213,293.9 | +11.2 | 226,244.4 | +9.9 | 235,636.8 | +12.3 |
| | 9 | 10,949.5 | -23.7 | 209,140.2 | +6.8 | 220,089.7 | +4.7 | 231,838.9 | +8.2 |
| | 10 | 11,453.6 | -27.0 | 218,932.2 | +10.7 | 230,385.8 | +7.9 | 233,494.2 | +11.2 |
| | 11 | 9,932.6 | -29.2 | 218,943.6 | +17.5 | 228,876.2 | +14.2 | 237,750.4 | +16.3 |

Note : Value of domestic exports and value of re-exports may not add up to the value of total exports due to rounding

*Conclusions*

We have reviewed the economic development of Hong Kong since the handover and have concluded that there has never been anything intrinsically wrong with the Hong Kong economy that ever needed a major surgery. There was indeed a speculative bubble in 1996 and 1997, but it was at least partly caused by the anti-speculation measures that momentarily suppressed demand in 1994-5 but that also stunted supply at the same time. While there is an ongoing economic restructuring going on, there has never been a need for the government to find a new direction for the economy. Hong Kong's entrepreneurs have traditionally been able to cope with rapid changes, and have been quite capable of dealing with risks and of capitalizing on opportunities that emerge from time to time.

Yet, in a very real sense Hong Kong is indeed in a crossroads. Notwithstanding a very bullish stock market, with daily turnovers breaking all historical records[3] (except the record set by government money going into the market on 28 August 1998), a falling unemployment rate, and strong economic growth, there are real concerns over the longer term stability of the Hong Kong society and economy. Over the 10 years since the handover, income disparity has widened, and it is threatening the stability of the society and raising the question if the ongoing tendency toward even greater disparity is sustainable. The latest official figure for the Gini coefficient to date is from the 2001 Census, and it had stood at 5.25 already. A higher number is expected to be released soon from the 2006 By-census. Reflecting such trends is the increasing "narrowness of the tax base," which was the main motive behind the proposal to introduce a Goods and Services Tax in Hong Kong. Although the GST has merits in its own right, to suggest that there is anything wrong with the tax system because the tax base is too narrow would be wrong.

So far the government's policy has been contributing to rather than reducing income disparity. With the fiscal budget running big operational deficits, the Government had frozen hiring of civil servants but continued to recruit contract staff on non-civil service terms, and that means with much poorer pay and benefits. On 1 January 2001, the Social Welfare Department (SWD) launched the Lump Sum Grant Subvention

[3] On 27 October 2006, turnover topped 76 billion dollars, just a shade behind the 79 billion dollars on the day of incursion into the stock market, namely 28 August 1998.

Arrangement (LSGS Arrangement) for providing financial assistance to non-governmental organisations (NGOs). The subvented organizations, under the new arrangement, will not pay workers higher wages than they have to. Because there is an abundance of unskilled workers, their wages tend to be depressed, and with an imbalance of bargaining power, unskilled workers actually often have to work harder, thus increasing the effective supply of workers and putting further pressures on the wages of low skill workers. In many statutory bodies, there are complaints of "fattening the top and squeezing the bottom." As a matter of fact, the top executives in these statutory bodies evidently are earning "economic rent" which were really not necessary. Evidence for this can be found in the fact that these positions often attract former civil servants who suddenly earn much higher than what they used to make as a civil servant. To decide if the salaries are adequate for such senior positions, the main consideration should be whether the current salaries are enough to attract or retain the talents who are needed to serve those positions.

As pointed out by the Bauhinia Foundation Research Centre, a private think-tank (Mingpao, 10 January 2007), households in the lowest income bracket have seen a drop of 20% in their incomes from 1997 to 2005, but those in the highest income bracket have seen a rise of 20%. The richest 10% of households on average make an income equal to 23 times that made by the lowest 10%. This multiple was only 13 times in 1993.

Against this background, there is little wonder that the proposal to introduce the Goods and Salaries Tax met with staunch opposition. While the business sector thinks it is bad for business, most people are concerned about the regressive nature of the tax. The measures proposed by the Financial Secretary Henry Tang to alleviate the impact on the poor, such as refunds for households in the bottom 20% income bracket and cuts in rates and water charges, appear to be ad hoc and inadequate. In the end, the Government yielded to public pressure and gave up the idea of introducing the GST.

To address the widely recognized poverty problem, late 2006 the Government came up with the idea of a "Child Development Fund," under which the Government, the business sector, or some NGO would contribute $1 for every dollar saved by the parents for their children's future development. Henry Tang thinks that this approach to build up assets for children is better than giving handouts.

(http://www.info.gov.hk/gia/general/200611/10/P200611100213.htm) However, it has been pointed out that supporting early child development may be far more effective than supporting developmental or educational needs at an older age. (Proceedings of National Academy of Science, July 2006) If parents have to, in order to generate the savings to build up assets, reduce spending that would have benefited the children at an early age, the harm so caused may be much greater than any benefit derived by higher spending when the child has grown older. In any case, for households in great poverty, asking parents to produce savings to help their children may be an additional source of frustration and distress. Mr Donald Tsang has promised that he will deal with poverty problems in his second term of office. Whether or not he can find an effective way to alleviate the income and wealth disparity problem in Hong Kong will prove crucial to the status of Hong Kong as a world city over the longer term.

**References**:

Engelbert Stockhammer, "Financialisation and the slowdown of accumulation," *Cambridge Journal of Economics*, Oxford University Press, Vol. 28, No. 5 (September 2004), pp. 719-741.

HKUST Forum on the Future Development of Hong Kong: A Report, May-July 2002. Otto C.C. Lin, Kang L. Wang and K.C. Chan. http://www.ust.hk/HKUST_Forum/hkforum_report.pdf

Ho, Lok Sang "Hong Kong in the 21st century," *New Asia*, (Korea: Yoido Society for New Asia), Vol. 4, No. 2, pp. 88-98. 1997a.

Ho, Lok Sang, "Flaws in housing policy," *South China Morning Post (Analysis)*, 30 December. 1997b.

Ho, Lok Sang, "Credit squeeze is wrong," *South China Morning Post (Analysis)*, 14 January. 1998a.

Ho, Lok Sang, "Policy blunder of the century," *South China Morning Post (Analysis)*, 24 March. 1998b.

Ho, Lok Sang, "Largest threat to the economy comes from the largest action of the government," *Mingpao*, 26 March. 1998c.

Ho, Lok Sang, “Depressing home truths,” *South China Morning Post (Analysis)*, 18 May 1998d.

Ho, Lok Sang, “Cost of bursting property bubble,” *South China Morning Post (Analysis)*, 15 June. 1998e.

Ho, Lok Sang, “Hong Kong’s economic crisis and misguided housing policy,” *HKIAPS Occasional Paper*, 2003.

Ho, Lok Sang, and Robert Ash (eds.) *China, Hong Kong, and the World Economy*, Hampshire: Palgrave Mcmillan, 2006.

Ho, Lok Sang, and Gary Wai-chung Wong, “Privatization of public housing: Did it cause the 1998 recession in Hong Kong?” *Contemporary Economic Policy*, Vol. 24, No. 2 (April 2006), pp. 262-273.

Ho, Lok Sang, and Gary Wai-chung Wong, “The nexus between housing and the macro economy: the Hong Kong case,” *Pacific Economic Review*, (forthcoming 2007).

Miller, Tony, “Time for a strong dose of economic realities,” *South China Morning Post*, 7 June 1998.

Mondejar, Reuben and William Boardman, “Extend, not curtail, sales of public housing” *South China Morning Post*, 7 April 1998.

Promoting Competition: Maintaining our Economic Drive: a public discussion document on the way forward for competition policy in Hong Kong, November 2006, Economic Development and Labour Bureau, Hong Kong.