

*The Asian Financial Crisis and After
Problems and Challenges for the
Hong Kong Economy*

Liu Pak-wai

Hong Kong Institute of Asia-Pacific Studies

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Director : Yeung Yue-man, PhD(*Chic.*), Professor of Geography
Associate Director : Lau Siu-kai, PhD(*Minn.*), Professor of Sociology

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Hong Kong Institute of Asia-Pacific Studies
The Chinese University of Hong Kong
Shatin, New Territories
Hong Kong

About the author

Liu Pak-wai is Pro-Vice-Chancellor and Professor of Economics at The Chinese University of Hong Kong.

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Problems and Challenges for the Hong Kong Economy

Introduction

In the 1990s as Hong Kong prepared for the changeover of sovereignty in 1997, the society was embroiled in the endless conflict between the Chinese government and the Hong Kong government (under British rule) over issues such as the financing of the new airport, the container terminal No. 9, the political system, direct elections and the interpretation of the Basic Law. According to the scheme of the Chinese government, Hong Kong was to maintain stability and prosperity under the "One Country, Two Systems" arrangement after 1997. During the transitional period, the political conflict, at time rather ferocious, raised doubt as to whether there would be stability in Hong Kong and whether the mainland government would honour its pledge of giving Hong Kong a high degree of autonomy after 1997. Economic prosperity was taken for granted whereas political stability was the main cause for concern. Indeed, it was the major push factor behind the emigration of Hong Kong residents.

It is ironic that, after the changeover of sovereignty in July 1997, political stability faded away as the issue of concern as the economy became the major focus. What many Hong Kong people and international observers feared about intervention by Chinese authorities did not happen. The Chinese government has gone out of its way to rein in central and provincial government officials from intervening in Hong Kong affairs, so much so that they have refrained from making comments on Hong Kong in public, in sharp contrast to the days of political struggle against the British

colonial government before 1997. The "One Country, Two Systems" arrangement went off to an auspicious start. Quite unexpectedly, economic prosperity which most people took for granted after long years of high and steady growth, abruptly gave way to a sharp recession following the outbreak of the Asian financial crisis. One year into the Asian financial crisis, the picture of what went wrong in the Hong Kong economy has become clear.

Structural Problems Causing Inflation

Before the outbreak of the Asian financial crisis, Hong Kong had one of the highest cost structures in the world. Its property prices, office rentals and wages were among the highest in the world. As an illustration, Table 1 shows the average office rental cost of several cities in Asia/Australia.

The high cost structure had built up after a decade of high inflation in Hong Kong. Inflation had accelerated since the mid-1980s as the result of rapid economic restructuring. Following the opening up of China in 1979, Hong Kong manufacturers had taken advantage of the low labour and land costs in south China which had been only a fraction of those in Hong Kong and had moved their labour-intensive low value-added production operation across the border into south China, leaving the front-end and back-end manufacturing processes, such as sourcing, merchandizing, marketing and design in Hong Kong. These were the higher value-added processes which required different skills from those of assembling. Products of these outward-processing activities of Hong Kong manufacturers in south China were mostly re-exported through Hong Kong. This stimulated a fast growth in the re-export trade in Hong Kong, and demand for services to support these activities including transportation, storage, business services, insurance and trade financing expanded rapidly. The economy of Hong Kong rapidly restructured itself to become service-oriented. What was unusual about the economic restruc-

Table 1 Average Office Rental Costs in June 1997, Selected Cities

Location	Average cost per sq. m. (US dollar)	Location	Average cost per sq. m. (US dollar)
Hong Kong		Sydney	
Central	1,153	Central	477
Wanchai	825		
Causeway Bay	789	Taipei	
		Min-Sheng	478
Shanghai		Tun Hwa South	456
Huangpu	1,063	Nanking-SC	401
Singapore		Tokyo	
Raffles Place	938	Maronouchi	1,123
Shenton Way	801	Toranomon	1,036
Orchard Road	760	Shinjuku	926

Note: Average of highest and lowest rental costs.

Source: Business and Professionals Federation of Hong Kong (1993).

turing of Hong Kong in the 1980s was its speed. From 1981 to 1991, the share of manufacturing in employment had fallen from 41.3 per cent to 28.2 per cent. An index of sectoral shift in employment measuring the minimum proportion of workers who had to change sectors as a result of sectoral shift in 1987-1992 for Hong Kong was 8.90 as compared with 3.27 for Singapore, 6.50 for Korea, 2.22 for Japan and 2.16 for the US (Suen, 1995).

To understand how the structural adjustment process worked to generate inflation, it is useful to think of the economy as producing two types of products: traded and non-traded. Manufactured products in Hong Kong are usually traded. Services include both traded and non-traded products, but as a whole they are less

tradeable when compared to manufactured products. The outward expansion of manufacturing activities into south China led to a growth in income from foreign sources for Hong Kong that was not recorded in GDP figures. This increase in wealth boosted the demand for consumption. While tradeables can be imported, consumption of non-tradeables have to be met by increased production at home. Given Hong Kong's linked exchange rate system, the prices of traded products are determined in world markets; their rates of inflation have to follow international levels. The prices of non-traded products are determined domestically; their rates of inflation depend on the excess of demand over supply.

Wage Inflation

On the supply side, the cost of producing non-tradeables, or specifically services, increased due to the slow down in the growth of the labour force which ultimately led to a labour shortage in 1987-1994. The slow-down in the growth of the labour force was caused by a number of factors. Following the abolition of the so-called "reached-base" immigration policy in October 1980, illegal immigration ceased to be a major source of supply of cheap labour, as it had been in the previous three decades. After the policy change, illegal immigrants were no longer able to obtain residence status by illegal entry into Hong Kong. Employing illegal immigrants who had no identification documents also became a criminal offence. This effectively cut off the supply of unskilled labour.

Reduction in the inflow of immigrants alone had a major effect on slowing down the growth of the labour force. This effect was exacerbated by a number of other factors. These were the declining rate of natural population increase, the changing age structure of the population, the declining labour force participation rate and the rising outflow of emigrants.

Declining Rate of Natural Population Increase

The rate of natural population increase has declined substantially over the last decades as a result of the rather rapid decline in fertility in Hong Kong. In 1965, Hong Kong's total fertility rate was 4.93. By 1990, it had fallen to 1.21, which was lower than that of virtually all North American, European and Asian countries. For instance, in 1990 the total fertility rates of the USA was 1.88 (1989 figures), Sweden 2.14, the UK 1.84, Switzerland 1.59, Australia 1.90 (1989 figures), Japan 1.54 and Singapore 1.83 (Kono, 1996).

Changing Age Structure of the Population

Since the labour force is mainly drawn from the population within the working age of 15 to 65, a shift in the age composition, in particular, from the younger age bracket to the older age bracket, will have a significant impact on the size of the labour force. To illustrate the shifting age composition, Table 2 shows the population size of two age groups. The age group 15-24 is the youngest group in the labour force which will provide manpower for the economy for many years to come. It shrank from 1.2 million in 1981 to about 886,400 in 1996. In contrast, the age group 55-64, which was due to retire from the labour force, grew in size from about 408,800 to 512,900 over the same period; the ageing of the population had reduced the supply of labour over time.

Declining Labour Force Participation Rate

Both the male, female and overall labour force participation rates reached a peak level in 1981 because the wave of illegal immigration in 1978-1980 brought a massive influx of young illegal immigrants from the mainland who by self-selection were mostly potential participants in the labour force. Since 1981, labour participation rates have declined (see Table 3), thus reducing labour supply over time.

Table 2 Age Composition of Population

Year	Age 15-24	Age 55-64
1976	975,100	338,900
1981	1,177,500	408,800
1986	1,023,200	469,600
1991	872,600	506,800
1996	886,400	512,900
1997	907,700	521,500

Sources: *Hong Kong Annual Digest of Statistics*, various years.

Table 3 Labour Force Participation Rates in Hong Kong (%)

Year	Labour force participation rates		
	Male	Female	All
1976	80.7	45.0	63.3
1981	82.5	49.0	66.3
1986	80.5	48.9	65.1
1991	78.8	47.8	63.4
1996	76.0	47.8	61.8

Sources: Economics Database, Department of Economics;
Hong Kong Monthly Digest of Statistics, various years.

The decline in overall labour participation rate was mainly due to the fall in the participation rate of the youngest and the oldest age groups in the labour force. The drop in the participation rates among youngsters of age 15-19 and 20-24 was the result of the rapid expansion of secondary and tertiary education in Hong Kong in the 1980s which provided more educational opportunities, causing many youngsters to defer entry into the labour force.

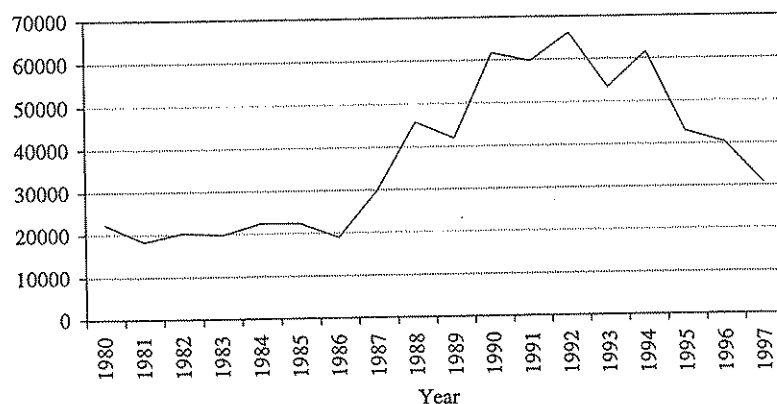
As for workers in the age group 55-64, the decline in their participation rate could be attributed to their retiring earlier than before. The rise in real wage increased workers' income, which induced them to consume more leisure and retire earlier.

Rising Outflow of Emigrants

Much of the 1980s and the early 1990s was underpinned by the rising tide of emigration. The number of emigrants was between 18,000 and 22,000 throughout the first half of the 1980s. It picked up in 1987 and rose sharply in 1990 following the June 4 incident of 1989 in Beijing. The number of emigrants peaked at 66,000 in 1992 before moderating to a lower level following the tightening of quotas in major recipient countries like Canada and Australia (see Figure 1).

Emigration hit the service sectors the hardest. Table 4 shows that a disproportionately large number of the employees who emigrated were from the service sectors. This contrasted sharply with the experience in the manufacturing sector. Experienced and skilled personnel who emigrated had to be replaced by junior staff with less experience. As a result, labour productivity growth in the service sectors was slowed down more than in the manufacturing sector.

The combined effect of the above factors slowed down the growth of the labour force. Since the abolition of the "reached-base" policy, the growth rate of the labour force fell to 1-3 per cent p.a. (see Figure 2). The tightness of the labour market in the late 1980s to the early 1990s had the effect of smoothing the structural unemployment problem which could have emerged from economic restructuring. Manufacturing workers released by industries moving north were readily absorbed into the service sector. In fact, during the period of the most rapid economic restructuring in the late 1980s when sectoral shift in employment from manufacturing to service was the largest, the labour market was so tight that there was a period of labour shortage in 1989-1994.

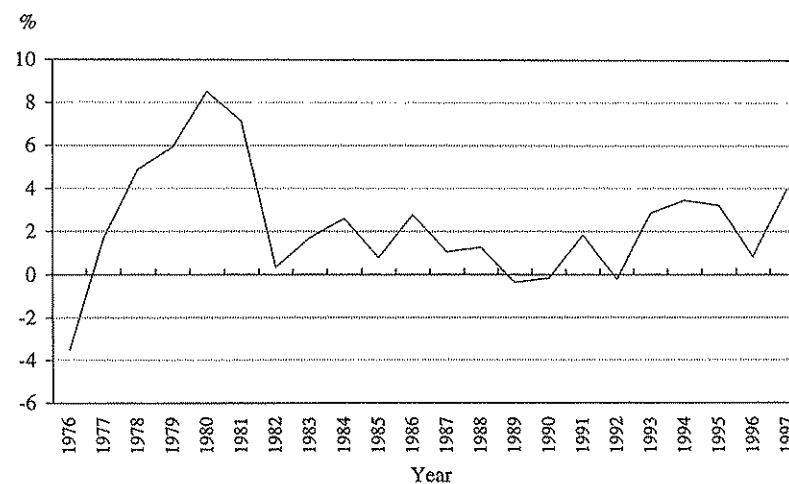
Figure 1 Total Estimated Emigrants, 1980-1997

Sources: *Hong Kong Monthly Digest of Statistics*, various years.

Table 4 Occupations of Emigrant Employees, 1988 (%)

Professional	33.6
Administrator/Manager	16.2
Clerical	13.4
Sales	13.1
Services	10.6
Production	9.0
Others	4.0

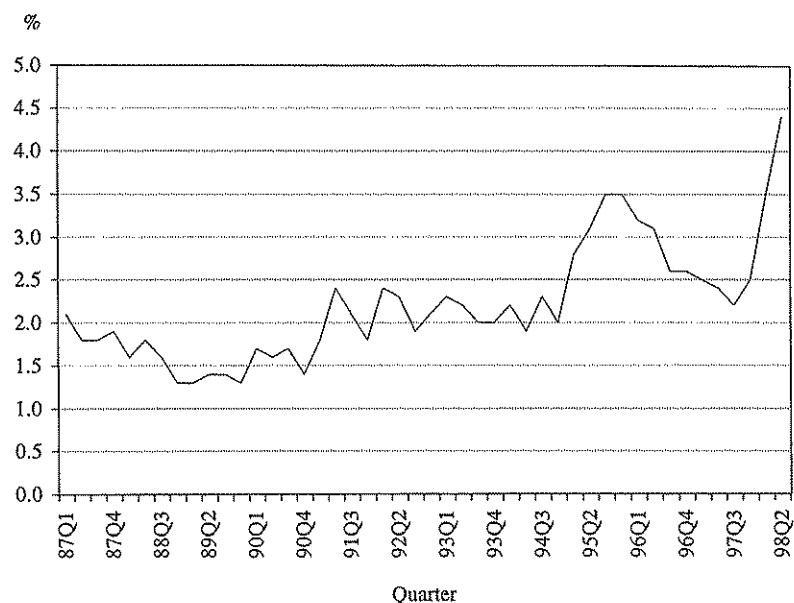
Sources: Census and Statistics Department and Consulates/High Commissions.

Figure 2 Labour Force Growth, 1976-1997

Sources: *Hong Kong Monthly Digest of Statistics*, various years.

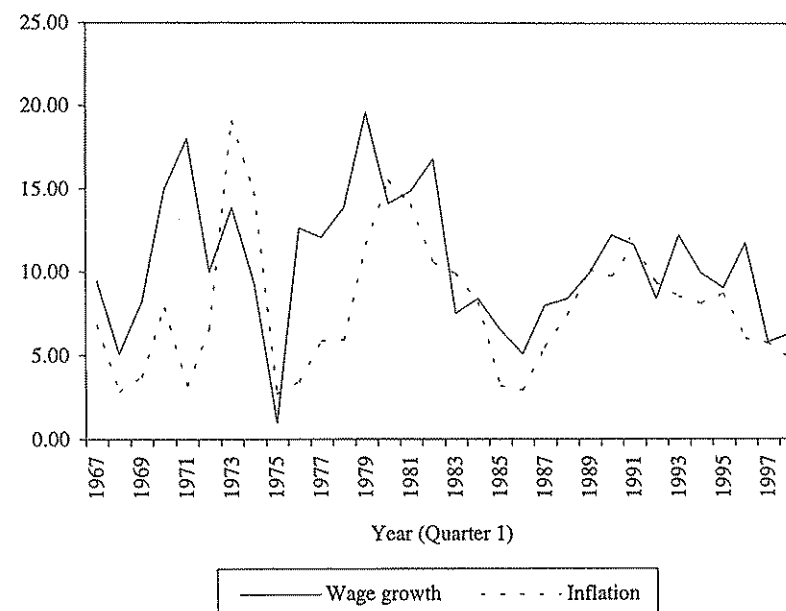
Unemployment rate fell to a historical low of 1.1 per cent in 1989 (see Figure 3).

In response to the labour shortage, the Hong Kong government introduced a modest programme of importation of semi-skilled and unskilled labour in 1990. At the peak of the programme, only about 27,000 workers were imported, including those working on the construction of the new airport (not counting domestic helpers). Political opposition made it difficult for government to expand the programme. By 1995, the labour market had eased, and unemployment rate had risen. The government was obliged to replace the General Scheme of Labour Importation with a Supplementary Scheme 1996 which imported only 2,000 workers. The opportunity to ease the labour market tightness and to moderate wage rise from mid-1980s to the mid-1990s with labour importation had not been fully exploited.

Figure 3 Quarterly Unemployment Rate, 1987-1998

Sources: *Hong Kong Monthly Digest of Statistics*, various years.

The consequence of an increased demand for labour, in particular in the service sector, running against a slow growing labour force was dramatic. Wages rose rapidly (see Figure 4). The net effect of a slower productivity increase but a nominal wage growth faster in the service sector than in the manufacturing sector was that production costs were pushed up faster in the former than in the latter. The rapid transformation of the economy that took place within the context of a slow growing labour force and the linked exchange rate combined to generate an accelerating inflation. This explains why the domestic rate of inflation has been higher than international levels since 1986.

Figure 4 Wage Growth vs Inflation, 1967-1998

Sources: *Hong Kong Monthly Digest of Statistics*, various years.

Asset Price Inflation

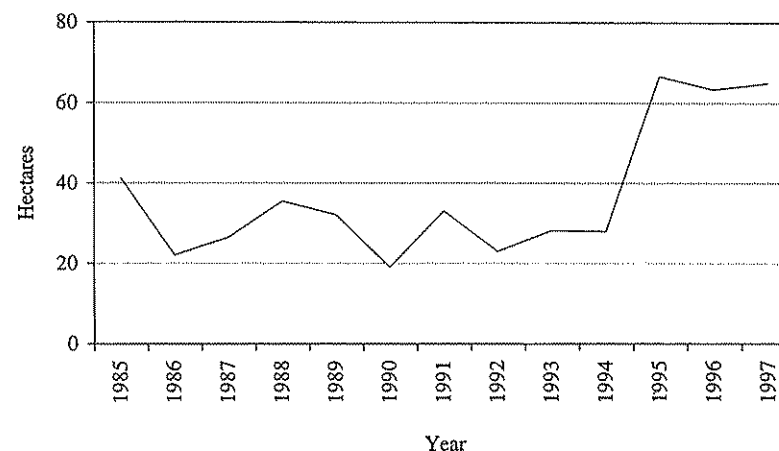
The inflationary pressure in the product market was also reflected in input markets other than the labour market. Capital which was internationally mobile was less subjected to inflationary pressure from economic restructuring. Residential land was a relatively non-traded resource. Hence, its value rose significantly.

The period of strong demand for land inauspiciously coincided with a period of restriction on the supply of new land. According to the Sino-British agreement on the future of Hong Kong signed in 1984, a Land Commission with representatives

from the two governments was set up to approve the sale of new land up to 1997 subject to a limit of 50 hectares p.a. The Chinese government was very suspicious that the British Hong Kong government would sell as much land as possible before 1997 and repatriate the reserves, thus depriving the future Hong Kong Special Administrative Region (SAR) government of a very valuable resource after 1997. This conspiracy theory led the Chinese government to insist on writing into the Sino-British agreement a restriction on the sale of land. Unfortunately, the limit of 50 hectares had been set in 1984, a year when the property market had been at the lowest point after the crash in 1981. The limit was set too low as the projection of future demand for land was undoubtedly influenced by the actual demand at that time as well as the suspicion of a British conspiracy.

The 50 hectares p.a. encompassed land for all uses, including residential, commercial, community and infrastructure, except public housing. In practice, had the Hong Kong government been able to put up a case for more land, the Land Commission could have approved more than 50 hectares. Given the atmosphere of mistrust and conspiracy which hanged over throughout the period of transition towards 1997, the Land Commission was not likely to be willing to approve much more than the 50-hectare limit. A large request beyond the 50 hectares put up by Hong Kong government representatives would cause suspicion and antagonism on the part of Chinese government representatives. Consequently, with the exception of special requests for construction of major public facilities like the new airport, the new land supply approved by the Land Commission was about 50-100 hectares a year. The actual disposal of government land for residential property construction from 1985 to 1994 was about 20-30 hectares p.a. Only in 1995-1997, when property prices had already reached extremely high level, did the Land Commission approve about 60 hectares p.a. (see Figure 5). It is interesting to contrast the annual supply of residential land over the last ten years with the planned supply of the Hong Kong SAR government in the first five years after the changeover as an indication of the possible large shortfall

Figure 5 Disposal of Government Land, 1985-1997: Residential Sector

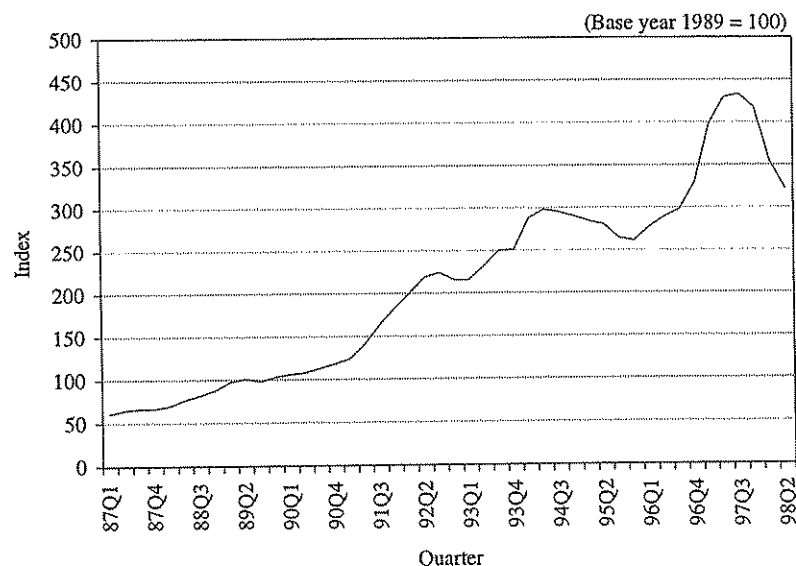


Sources: *Hong Kong Monthly Digest of Statistics*, various years.

in the supply of land before 1997. In his first Policy Address in October 1997, the Chief Executive announced a policy to cool down the overheated property prices with increased supply of new residential land. The planned average annual supply of new residential land was 76 hectares which was about two to three times the actual supply between 1985 and 1994.

The strong demand and the restricted supply of land pushed up property prices to an unrealistic level. Figure 6 shows that the residential property price index had increased sharply sevenfold in the last ten years before the market crashed in late 1997. Residential property prices in Hong Kong overtook Tokyo and all major cities to become the highest in the world by a wide margin. Commercial property prices and office rental followed more or less the same pattern.

To summarize, the analysis presented here offers an explanation for a wide array of phenomena in Hong Kong. First, we have

Figure 6 Property Price Index, 1987 Q1 to 1998 Q2

Sources: *Hong Kong Monthly Digest of Statistics*, various years.

an explanation for high inflation caused by rapid structural transformation of the Hong Kong economy that created a continuous excess demand for non-tradeables. Secondly, the opening of China generated an enormous boom in economic activity in Hong Kong, especially in the service sectors. The rapid growth of demand for labour ran against a slow growing labour force, leading to a situation of over-full employment. Thirdly, the slow growing labour force and full employment imposed capacity constraints on the economy. This was consistent with the observation of slow GDP growth. Fourthly, the increase in wealth that accrued to Hong Kong from investments in China explained why, despite slow GDP growth, asset prices in Hong Kong were rising faster than inflation. In the decade before the Asian financial crisis, the

Hong Kong government failed to address the structural problems of the economy to remove labour and land supply bottlenecks. Wages and property prices rose to unrealistic levels. A bubble economy was taking shape.

The Bubble Economy

The high cost structure of Hong Kong had been sustained for a decade before the onslaught of the Asian financial crisis. The opening up of China and her rapid economic growth had generated plenty of high value-added economic activities in Hong Kong which had been very profitable. It has been estimated that the re-export margin which Hong Kong earned from re-export of products from the mainland was as high as 21.1 per cent to 35.3 per cent in 1990-1994 (see Census and Statistics Department, 1996).

For reasons explained earlier, property prices soared, bringing huge windfall profits to property developers. Related industries, such as construction, surveying and engineering, also reaped huge benefits from the property boom. The wealth of property investors, speculators and homeowners alike expanded rapidly as their assets appreciated through capital gain. The property market boom attracted inflow of speculative capital, from Southeast Asia and the mainland. The credit lending of Hong Kong banks also contributed to the boom. Mortgage loans and property-related lending became the major and, probably, the most profitable business of banks. As property prices had risen for over a decade, bad mortgage loans had been almost non-existent, even though the Hong Kong Monetary Authority (HKMA) had a guideline for banks that no more than 40 per cent of their loan portfolios should be property-related. In practice, many banks exceeded the guideline. Mortgage loans were the most lucrative business, and, in the last couple of years before the Asian financial crisis, banks competed fiercely for mortgage borrowers by lowering their mortgage interest rate to as low as prime rate plus 0.25

per cent, even though historically the benchmark rate had been around prime rate plus 1.5 per cent.

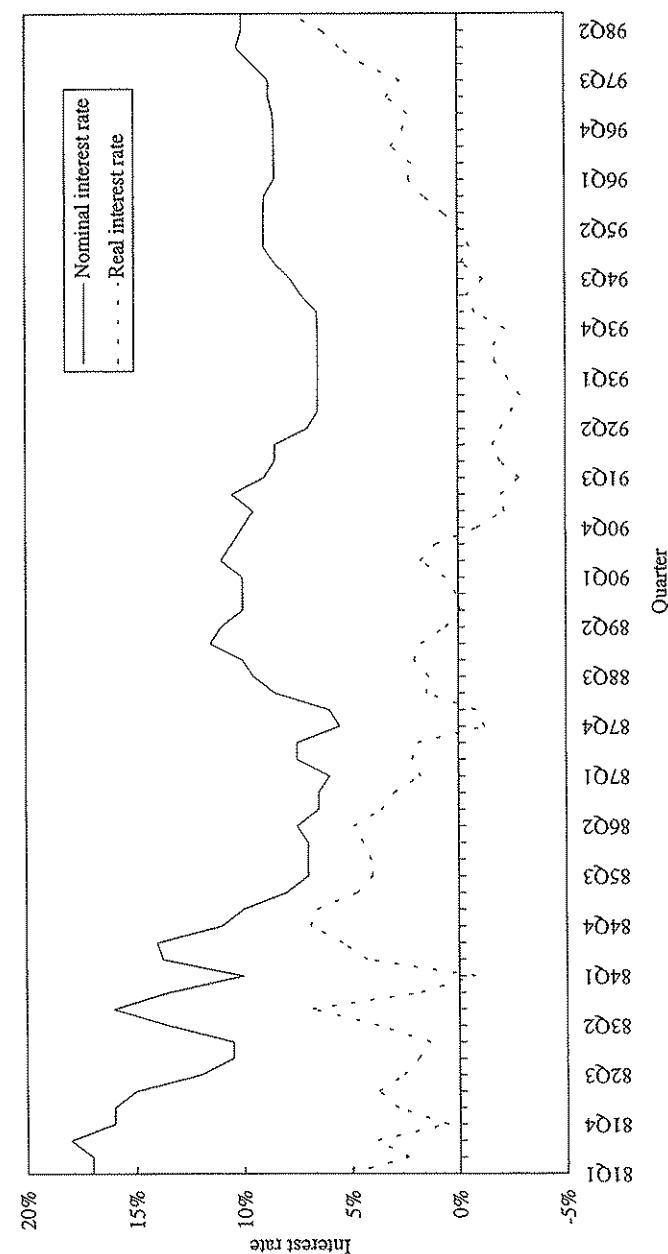
The interest rate of Hong Kong followed the US interest rate because the Hong Kong dollar had been linked to the US dollar at 7.8. As a result, throughout most of the ten-year period of high inflation in Hong Kong, the real interest rate (prime rate) was negative (see Figure 7). Negative interest rate, easy credit for mortgage loans, inflow of speculative capital, rising demand for land and property, and the shortage in the supply of new land were elements that contributed to the bubble in the property market. Residential property prices rose sharply. By mid-1997, the price of first rate luxurious condominium had risen to HK\$20,000 per sq. ft. (about US\$2,600 per sq. ft.). Medium-size flats for the middle class in urban locations were selling at HK\$8,000 per sq. ft. (about US\$1,000 per sq. ft.). The wealth effect of asset price inflation fed into the retail, restaurant and other consumption-related sectors. The boom enabled these sectors to sustain their high cost of operation. Property prices inflation also helped to push the Hang Seng Index of the stock market to historical height in August 1997. The bubble economy was ready to burst.

Asian Financial Crisis and Cost Deflation

In the last few years, concerns had been raised by many foreign investors and local businesses on the high cost of business operations in Hong Kong. There were warnings that Hong Kong would lose its competitiveness as its costs continued to inflate. However, because Hong Kong was located in the centre of the high growth region of East Asia and was the gateway to rapidly growing China, the profit and potential profit of investing in the region attracted local and overseas businesses to continue to invest, despite the high cost.

The Asian financial crisis began with the depreciation of the Thai baht in July 1997, at the time of the changeover of sovereignty of Hong Kong. Hong Kong was caught by the contagion effect on

Figure 7 Nominal and Real Interest Rate, 1981-1998



Sources: Hong Kong Monthly Digest of Statistics, various years.

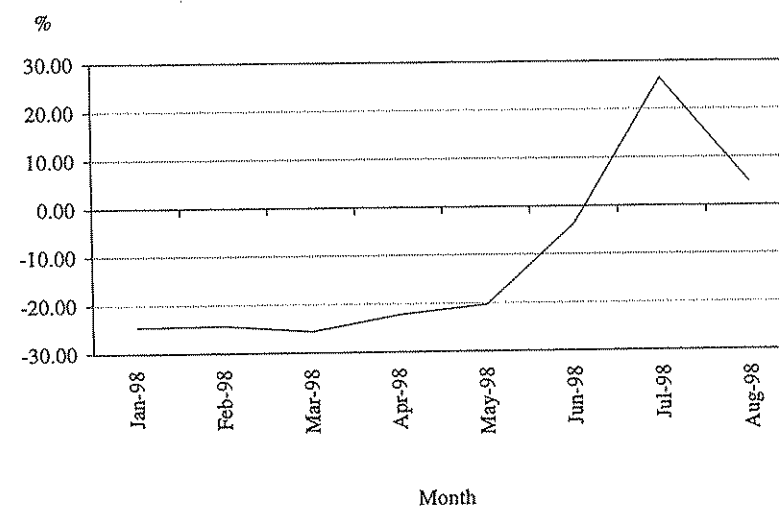
23 October 1997 when currency speculators attacked the Hong Kong dollar link with the US dollar after Taiwan depreciated its currency. To defend the currency link, the HKMA bought Hong Kong dollars unloaded by the speculators, and the clearing balance accounts of the banks at HKMA were depleted. The overnight interbank rate shot up to 280 per cent. The Asian financial crisis had swept into Hong Kong.

From 1 July 1997 to the end of January 1998, a number of Asian currencies had depreciated substantially with respect to the US dollar, the Indonesian rupiah by 79 per cent, the Thai baht by 51 per cent, the Korean won by 42 per cent, the Malaysian ringgit by 41 per cent, the Philippines peso by 28 per cent, the Taiwan dollar by 16 per cent, and the Singapore dollar by 14 per cent. The Hong Kong dollar link with the US dollar remained steady at 7.75. As a result, all these Asian currencies depreciated with respect to the Hong Kong dollar.

The relative high-cost structure of Hong Kong business operations gauged in US dollar was accentuated by the currency depreciation of the other Asian countries. Hong Kong abruptly lost competitiveness *vis-à-vis* its neighbouring countries in competing goods and services. The sector that was hit the most quickly and the hardest was tourism. The decline in tourism began two months before the changeover. Travelling to other Asian countries became much cheaper than to Hong Kong after their currency depreciation. The fall in tourism demand due to the relative price effect was aggravated by the income effect as a number of source countries, including Japan, slipped into recession. In the first half of 1998, the number of visitor arrivals declined sharply by 21 per cent as compared to the first half of 1997 (see Figure 8). Visitor arrivals from Japan, Southeast Asia and Europe sustained the largest drop.

As to Hong Kong's other goods and services which were non-competing with other countries either because they were non-tradeable or because of the unique location of Hong Kong with respect to China, the fall in their demand was also sharp. Recession in several neighbouring Asian countries and the slow-

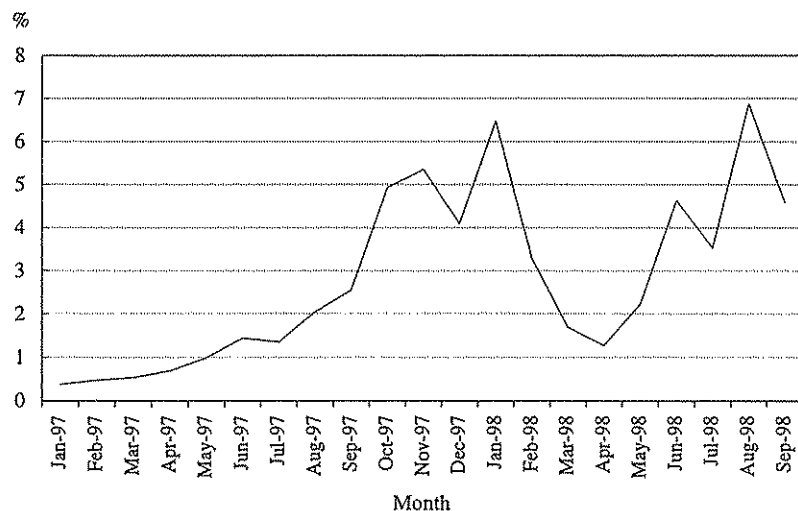
Figure 8 Monthly Growth Rate of Tourists, 1/1998-8/1998



Sources: *Hong Kong Monthly Digest of Statistics*, various years.

down of the growth in China reduced profits and the prospect of profit for business operations in Hong Kong. It is clear that Asia will no longer be the centre of growth for some years to come, as it has been in the last two decades. High profit has become something of the past. The high cost of operation in Hong Kong cannot be sustained. Examples of non-competing sectors are property and retail, which cater mainly to local demand, and services for China operations.

The contraction in demand for goods and services is underpinned by a sharp rise in interest rate. The defence of the Hong Kong dollar link by HKMA causes interest rate to rise sharply every time there is a speculative attack on the currency. Interest rate falls after the attack recedes but stays at a higher level than before. The spread between the three-month Hong Kong interbank interest rate and the three-month US treasury bill rate has

Figure 9 Three-month Interest Rate Spread, 1997-1998

Sources: Hong Kong Monetary Authority, *Monthly Statistical Bulletin*, various years.

widened from less than the 1 per cent of the pre-crisis level to 3-6 per cent, reflecting the increase in risk premium in holding Hong Kong dollars (Figure 9).

In a market as open, free and flexible as Hong Kong's, the cost adjustment has been swift. Asset price deflation has been dramatic. Residential property prices have fallen by over 50 per cent in the 12 months since the last quarter of 1997. Commercial property prices have fallen even more sharply. From the peak of 16,673 in August 1997, the Hang Seng Index fell by 60 per cent to a low of 6,600 points in August 1998. The swiftness of asset price deflation has no doubt been abetted by the sharply rising and volatile interbank interest rate.

Cost deflation has also been rather swift, following the pace of asset price deflation. Office and retail rentals have fallen dramati-

cally. Not only are new leases signed at a much lower rent, existing leases are re-negotiated downward between the sitting tenants and the landlords. The labour market is somewhat more sticky in adjustment. The initial cost adjustment has been accomplished through layoffs. The unemployment rate rose from 2.5 per cent in the fourth quarter of 1997 to 5 per cent in the third quarter of 1998. In recent months, price adjustment has been picking up pace as wages for newly hired have fallen substantially and existing wages of employees in hard hit sectors like retail, restaurant and hotel have been slashed.

The deflation of the high cost structure brought on by the Asian financial crisis has been swift and the adjustment has been deep, causing enormous pain as jobs have been lost and asset value has evaporated. Had it not been for the crisis, it would have been quite likely that the high cost structure would have adjusted downward anyway after July 1997 because the newly installed Chief Executive of the Hong Kong SAR government was determined to vastly increase the supply of land for residential property, a commitment which he emphasized in his inaugural speech as well as his first Policy Address of 8 October 1997. The bubble economy could have been deflated slowly and a soft landing of the residential property market made possible. Unfortunately, only two weeks after the Policy Address, the Asian financial crisis swept into Hong Kong, and the property market collapsed.

Post-crisis Challenges

When Hong Kong emerges from the Asian financial crisis, possibly one to two years from now, its high cost structure would have been adjusted downward. Hong Kong faces the challenges of another restructuring of its economy after the bubble economy has been deflated by the crisis. Specifically, what are the driving forces for future economic growth? After wages have adjusted downward substantially, what will sustain future wage growth?

In the last decade, two factors have supported the full employment, high wage growth and rising standard of Hong Kong. They have been the high value-added services associated with the opening up of China, such as the high re-export margin, and the high profit from the booming property sector which has spilled over to other related sectors. In the medium term after Hong Kong emerges from the Asian financial crisis, it is questionable whether these two factors can continue to support full employment and high wage growth to the same extent as before.

The high value-added nature of the services Hong Kong provides for investment in China and her re-export trade is reflected in the large wage gap between Hong Kong and China. Wages in Hong Kong are often ten times higher than corresponding wages in China. The reasons for the large wage gap are manifold. The openness of Hong Kong, the access to international markets, the free flow of information, the rule of law, the advanced physical infrastructure and the efficient financial sector are the comparative advantages of Hong Kong. They are the reasons why China relies on Hong Kong to source its materials, to merchandise, market and export its goods and to finance its trade and investments. The high wages of Hong Kong are supported by these high value-added activities. However, as China opens up further, gains freer access to information and international markets, develops its legal system and invests in infrastructure, Hong Kong's comparative advantages in these aspects will be eroded. Some of the services which Hong Kong provides will be replaced by cheaper services available in China. It is questionable whether the huge wage gap between Hong Kong and China can persist.

Furthermore, the bursting of the bubble in the property market has inflicted huge capital losses on many investors and homeowners and caused a painful adjustment of the economy. The Hong Kong SAR government is intent on managing land supply to avoid a repetition of a boom-bust property cycle. It is certainly sensitive to having another bubble in the property market. In the last several months, the Hong Kong SAR government has started to build up a land bank which it will continue to build. The land

bank will be used to moderate excessive property price movements in the future. The era of the bubble economy during which there were high profits to be made from property development, investment and speculation is probably over. Another important driving force behind high wage growth and rising standard of living of the past has gone.

To maintain the standard of living of Hong Kong, which is among the highest in the world, and to keep it rising, Hong Kong must find other high value-added economic activities which can generate employment and support high wages. Hereby lie the challenges for Hong Kong.

There are two areas of high value-added activities that Hong Kong may exploit. First, Hong Kong can develop into a truly first rate international financial centre, anchored on the prospect of rapid economic growth in China which would generate a growing demand for foreign funds in the next decade or two. Hong Kong is already a leading regional financial centre, but so far it is not in the same league as London and New York. As China continues to grow rapidly, more of its state enterprises will float in Hong Kong's stock market. It has been estimated that two to three decades from now, Hong Kong could become the largest stock market in the world in capitalization. Hong Kong can become the international financial centre of China, while Shanghai develops as China's domestic financial centre. Hong Kong has the conditions to be an international financial centre. Its financial markets are open. Its banking sector is efficient and relatively transparent. The supervisory framework is robust and the judicial system trustworthy.

However, to be an international financial centre has its costs. Openness makes one's currency an easy target for speculative attacks, particularly if there are structural weaknesses in the local economy or if the contagion effect of currency attacks spreads from neighbouring economies. The experience of the current Asian financial crisis shows that countries that have the most open financial markets are more vulnerable to speculative attacks, whereas countries which are shielded from the international capi-

tal markets like China or countries which have some measures of capital control like Taiwan and Singapore, are less subject to attacks.

Another cost of being an international centre is the giving-up of some monetary autonomy. International fund flows are measured in trillions of US dollars and are growing rapidly. It is difficult for a small country to operate a completely open international financial centre using its small volume of domestic currency as the instrument. Regular fund flows in and out of the financial centre will cause too many shocks to the domestic monetary system, let alone occasional speculative attacks. To immunize the domestic economy from the shock of currency conversion, more and more transactions of the international financial centre will have to be conducted in an international currency like the US dollar. For instance, not only syndicated loans will have to be denominated in US dollars, bonds and share market listings will also have to be in US dollars. As Hong Kong develops into an international financial market, market force will drive the economy towards more extensive use of the US dollar, and there will be progressive dollarization. The Hong Kong SAR government should allow the market to evolve and not prevent this from happening. In this regard, the successful defence of the Hong Kong dollar link at 7.8, and its continuation after the crisis, will help strengthen Hong Kong's development into an international financial centre.

A second area of high value-added activities which Hong Kong can exploit is innovation and technology. Studies by Young (1994, 1995), Kim and Lau (1994a, 1994b) and Lau (1997) show that technical progress and total factor productivity make negligible contribution towards the rapid growth of the Asian newly industrialized economies. For an economy as advanced as Hong Kong, there is little room for fast growth on the basis of high savings and investment. Technical progress has underpinned the further growth of the US and European economies, and that is the direction in which Hong Kong should be heading. In restructuring into a service economy, labour-intensive manufacturing operations

have been relocated from Hong Kong into south China. Hong Kong had not invested much in technology in the past. However, there is a potential for Hong Kong to become a regional centre of innovation and technology. Hong Kong can capitalize on its synergy with south China, make use of the scientific and engineering personnel in the region, organize research and development (R & D) projects and commercialize the product. Innovation and technology are not only confined to manufactured products. They can be applied to processes such as design and deployed to upgrade the service sector performance as well. They also have the benefit of diversifying the Hong Kong economy. An economy narrowly based on financial services is more vulnerable to external shocks as we have become keenly aware in the current financial crisis.

In early 1998, the Chief Executive of the Hong Kong SAR appointed a Commission on Innovation and Technology. The recommendations of the interim report were accepted by the Chief Executive and incorporated into his Policy Address in October 1998. An Applied Science and Technology Research Institute will be established to do mid-stream research, filling in the gap between up-stream research done in the universities and down-stream research of the corporations. An innovation and technology fund of HK\$5 billion will be set up to support R & D. Greater co-operation between universities and industries will be promoted.

It will be some years before these efforts on innovation and technology bear fruit. At the end of the day, innovation and technology are not likely to replace financial services as the major pillar of the Hong Kong economy. However, it could be a significant sector of the economy with an important spillover effect on the service sector, and it helps to diversify the economy. Innovation and technology will be a major challenge for Hong Kong in the next decade or two.

A key ingredient in developing Hong Kong into an international financial centre and a centre for innovation and technology is human capital. A first-rate international financial centre like New York does not rely on New York City solely to supply the

skilled professionals. It draws talent from all over the US and, indeed, from all over the world. Similarly, leading R & D projects in major US corporations, such as Microsoft, IBM and Intel, are not done only by scientists who are US nationals but by researchers from all over the world. Indeed, the percentage of foreign-born scientists and engineers in the US is very high.

To become a first-rate international financial centre and a centre for innovation and technology, Hong Kong must draw on the global pool of talent. Herein lies a comparative advantage for Hong Kong. While Hong Kong may offer limited attraction to Western professionals to come to work here, it is very attractive to professionals in the mainland as well as to mainland professionals residing overseas. This pool of talent is virtually limitless, by virtue of the sheer size of China's population. Under the "One Country, Two Systems" arrangement, it is possible to bring in talent from the mainland to study, work and, ultimately, reside in Hong Kong. Before the changeover of sovereignty in 1997, this would not have been politically possible.

Large scale admission of talent from China is essential to the development of Hong Kong into a first-rate international financial centre and a centre for innovation and technology. It could catapult Hong Kong into other areas of high value-added activities as well. It would help sustain Hong Kong's economic growth through productivity gain, maintain the large wage gap between Hong Kong and the mainland and keep Hong Kong's standard of living rising. Studies of immigration in the US and Hong Kong have shown that immigrants do not have a significant adverse impact on wages and employment of local people (Suen, 1994; Lam and Liu, 1998). Quite the contrary, immigration expands the productive capacity of the economy and creates employment for other people. The Hong Kong SAR government must muster political support to change its immigration policy to allow mainland talent to come to study, to work and to stay in Hong Kong.

The Third Economic Restructuring

Since the Second World War, the economy of Hong Kong has gone through two major economic restructurings. In each instance Hong Kong was able to exploit the economic opportunities which arose from a hardship situation, and flexible in adjusting economic structure. Each restructuring has propelled Hong Kong to higher levels of GDP and higher standard of living.

The first major economic restructuring came during and after the Korean War. Before the Korean War, Hong Kong served as an entrepôt for south China. The trade embargo imposed by the United Nations on China during the Korean War stifled the entrepôt trade between China and the Western world. Hong Kong's livelihood was under threat. The people of Hong Kong were able to turn the crisis into opportunities by transforming its economy from being an entrepôt into a manufacturing centre. Entrepreneurs from Shanghai who arrived in Hong Kong after 1949 brought with them capital, skills and experience. They took advantage of the availability of cheap labour from the vast pool of refugees who had fled the mainland after 1949 and started labour-intensive manufacturing.

For two decades, Hong Kong developed as a centre of labour-intensive manufacturing, becoming the world's largest producer of garments, toys and watches at one time or another. The abolition of the "reached-base" immigration policy in 1980 closed off the possibility of future large influx of cheap labour through illegal immigration. By the early 1980s, industrial wages had increased to such a level that labour-intensive manufacturing in Hong Kong was rapidly losing its competitiveness *vis-à-vis* other newly industrializing countries in Asia. Manufacturing industries in Hong Kong were in serious difficulties. Just around this time, China launched its economic reform and open door policy in 1979. Again, Hong Kong manufacturers seized the opportunity and relocated their factory operations into the Pearl River Delta to take advantage of the cheap land and labour. Hong Kong was trans-

formed from a manufacturing economy into a service economy. This was the second major economic restructuring.

After Hong Kong emerges from the Asian financial crisis, Hong Kong could be facing its third major economic restructuring to transform itself into a first-rate international financial centre and a regional centre of innovation and technology. Unlike the previous two restructurings, instead of capital in search of cheap labour, the third economic restructuring will be driven by a large-scale inflow of human capital in the form of highly skilled professionals, scientists and engineers of mainland origin and from overseas. The changeover of sovereignty in 1997 and the "One Country, Two Systems" arrangement make this flow of talent into Hong Kong politically possible. The Hong Kong SAR government must change its immigration policy to make this happen. As in the previous history of Hong Kong's economic restructuring, opportunities beckon. It is up to the people and government of the Hong Kong SAR to take up the challenge.

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The Asian Financial Crisis and After

Problems and Challenges for the Hong Kong Economy

Abstract

Before the outbreak of the Asian financial crisis, Hong Kong had one of the highest cost structures in the world. Hong Kong's economic restructuring after 1979 led to a rapid increase in demand for non-tradeables, namely land and labour. However, the supply of land was restricted by the Sino-British agreement in 1984, and the labour force grew sluggishly because of the declining rate of natural population increase, the changing age structure, the declining labour force participation rate and emigration. This led to a decade of high wage price inflation.

The Asian financial crisis has caused severe cost deflation in Hong Kong. After the crisis, Hong Kong faces the challenges of finding more high value-added economic activities to sustain its economic growth and high wages. Hong Kong can become a first-rate international financial centre, like New York and London, and a regional centre for innovation and technology. To achieve this goal, Hong Kong cannot just rely on local talent but must draw on the global pool of talent. Hong Kong will undergo its third economic restructuring since World War II, which will transform it into a first-rate international financial centre and a regional centre for innovation and technology. This restructuring will be driven by a large scale inflow of highly skilled human capital, principally of mainland origin. The Hong Kong SAR Government must change its immigration policy to allow this inflow.

亞洲金融危機及危機後 香港經濟面對的問題和挑戰

廖柏偉

（中文摘要）

在亞洲金融風暴未發生前，香港是世界上營商成本最高的地方之一。自一九七九年以來，香港經濟轉型造成對非貿易品（如土地和勞工）急切的需求。但是，一九八四年的中英聯合聲明卻限制了土地的供應量，而人口自然增長率的下跌、年齡結構的改變、勞動人口參與率的下調及移民外流，則令勞動人口增長停滯不前，這些因素導致長達十年的高工資通貨膨脹。

亞洲金融危機令香港遭受嚴重的成本通縮。危機過後，香港面對的挑戰是如何發展更多高增值的經濟活動，藉而維持經濟增長和高工資。香港有實力成為一流的國際金融中心，如紐約和倫敦，及成為地區性的創新科技中心。要實現這個目標，香港需要吸引全球的專才來港工作，而不能只依賴本地的人才。

香港將經歷二次世界大戰以來的第三次經濟轉型，香港將轉型成為一流的國際金融中心及地區性的創新科技中心，這次經濟轉型將由大量輸入高技能的人力資本所推動，這些人才主要源自中國內地。為此，香港特別行政區政府必須改變移民政策，讓這些人才流入。