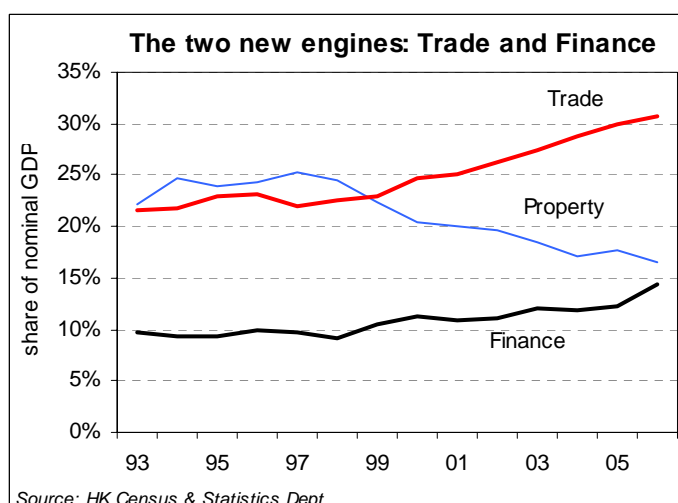


## Ten years later – same buoyancy but different economy

Since the establishment of the Hong Kong SAR (HKSAR) in 1997, the city has seen considerable ups and downs. As we near the tenth anniversary of the sovereignty transfer, many in Hong Kong wonder if we are better off than we were 10 years ago. In fact, the Hong Kong economy has grown significantly over the past decade. Real GDP per capita has risen by a very respectable 35% over the period. Unfortunately, our success has been obscured by our long bout with deflation.

### Major drivers of the economy today

The greatest shock to the economy over the past decade was delivered by the collapse of the property market. Despite the recovery since the SARS outbreak in 2003, average home prices were still down by 41% in April 2007 from the peak in 1997. While total residential property transactions recovered from the low in the early 2000s to reach 82,472 units in 2006, this was still less than half the activity seen in 1997. As a result, the share of nominal GDP attributed to property-related activity dropped from 25.3% in 1997 to an estimated 16% in 2006.



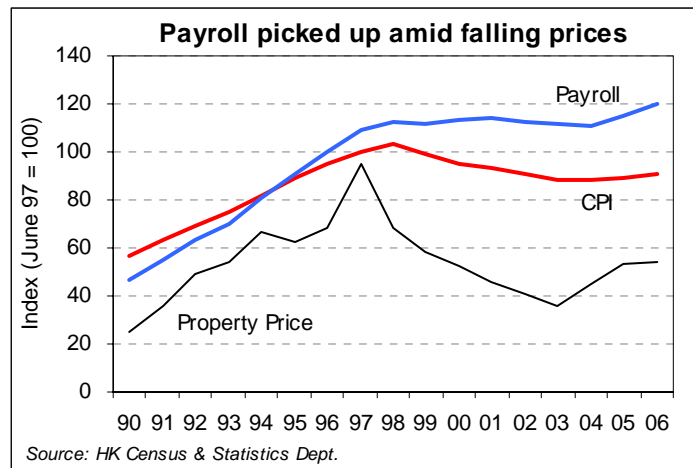
Hong Kong's strong economic growth in recent years has been underpinned by two new engines: trade and finance. The trade sector's share of nominal GDP increased from 22.0% in 1997 to an estimated 30% in 2006, making it the single largest contributor to GDP. Meanwhile, the direct contribution of finance-related activities accounted for an estimated 14% of total nominal GDP in 2006, compared to only 9.8% in 1997.

### A deflationary environment

The consumer price index (CPI) decreased by 9.4% between 1997 and 2006. Nearly two-thirds of this drop was caused by the decline in housing rents, which have tumbled by 21% since 1997.

The decline in housing rents was partly due to the broad economic downturn following the Asian Financial Crisis. However, the slump was significantly exacerbated by the policy decision to increase housing supply. Between 1997 and 2005, the population rose by 5.0%, yet the stock of private housing skyrocketed by 21.8%.

The second largest contributor to the decrease in the overall price level was durable goods, which saw prices falling by more than 35% over the 10-year period, contributing 1.9% to the overall decline of prices. Even though the economy has rebounded strongly since 2004, prices for durable goods has not picked up, probably due to the cheaper import prices for computers and other electronic equipments.



### Payroll sustained by economic transformation

Despite the deflationary environment and sliding asset prices, payrolls have defied gravity and continued to trend upwards. Between 1997 and 2006, nominal payroll rose by 9.8%. Taking deflation into account, the real payroll bill jumped by 22.5% over the 10-year period.

This handsome rise in wages was made possible by Hong Kong's economic transformation during the period.

In the trade sector, this transformation has been supported by important structural changes. For example, the logistics industry is now significantly more efficient and more sophisticated than it was in 1997. Total trade transported via air surged by 167% to HK\$1.7 trillion by 2006. On the other hand, shipments by ocean and river stayed roughly constant throughout the 10-year period.

The financial markets have also seen substantial development. The market capitalization of the stock market rose by 249% over the decade to HK\$14.9 trillion as of May 2007 – 10 times the level of Hong Kong's annual GDP.

Trade and finance also contributed to the economy by generating significant job opportunities in peripheral service industries<sup>1</sup>, which created a total of some 393,200 jobs between the first quarters of 1997 and 2007, and represented the major driver of employment growth during the period. The unemployment rate in these sectors remained low at around 3%, and the high value-added nature of these activities helped generate a considerable number of high-paid job opportunities. This drove up the overall wage level; the number of people earning more than HK\$15,000 per month increased by 263,600 between 1997 and 2006<sup>2</sup>.

### Increasing polarization of the labour market

However, the fruits of success have not been shared by everyone. During this period, the number of people earning less than HK\$7,000 per month increased by 245,200, after adjusting for the 61,800 increase in foreign domestic helpers. On the other hand, the population earning between \$7,000 and \$15,000 saw a contraction of 256,000 during the period. A skills barrier has prevented lower-income earners from successfully migrating to a higher income group.

The single largest job loser over the past decade was the manufacturing industry, as the relocation of production jobs to the Mainland continued. The trade sector, which absorbed many of these displaced workers, did not expand fast enough to fully compensate for the loss of jobs in manufacturing. The net job loss stood at 52,100 in the first quarter of 2007.

Employment also contracted in the construction industry, which has shrunk by 18,100 jobs since 1997. Unemployment in this sector was as high as 10.3% in the first quarter of 2007.

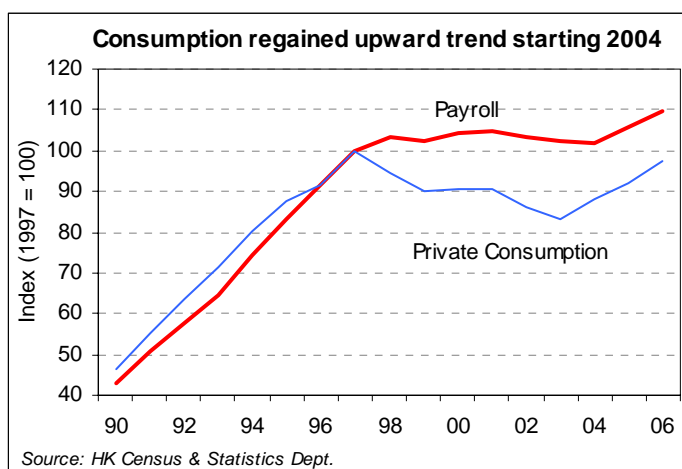
Despite the consistently low unemployment rates in the financial and services sector, the skills barrier prevents those displaced from manufacturing and construction from successfully migrating to these sectors. The destination of choice has been the local catering and retail industries<sup>3</sup>, which helps to explain their high unemployment rates at the 5.7% level in the first quarter of 2007, despite the economic recovery.

## Private consumption is making a comeback

Since the start of the recovery in 2004, real economic growth has remained strong at around 7% in each of the past three years. The last time that real GDP growth stayed at such levels for three consecutive years was back in 1986-1988.

In spite of the rosy conditions, private consumption has lagged behind the trend of payroll growth. Before 1997, private consumption rose with the growth in payroll. However, starting in 1998, the level of private consumption started to trend downward, while payrolls remained at a relatively high level. Job insecurity affected those at all levels, while the sharp decline in home prices left many in the middle class in “negative equity”. Confidence took considerable time to recover, and it is debatable whether it has fully returned even today.

Private consumption finally turned the corner in the aftermath of SARS. But it was not until 2006 that private consumption regained the level registered in 1997.



## Challenges still lie ahead for Hong Kong

Two major Government policy decisions led to Hong Kong's economic transformation over the past decade. The first was the decision to engineer a significant increase in housing supply. While the policy sharply reduced the wealth of the middle class and harmed the viability of many small and medium enterprises, it also reduced the cost of living and made homes more affordable for the general public. It became easier for young people to move out from their parents' home. This is a major reason that the average household size decreased from 3.3 in 1996 to 3.0 in 2006.

The second was the increased Government commitment to education. This has been successful in nurturing a more educated workforce, which has facilitated the economic transformation into higher value-added activities. The share of employed persons with tertiary education surged from 22.3% in 1997 to 30.1% in 2006. However, the progress at the lower spectrum of education levels is relatively slow. The skills barrier remains a concern. Thus, the widening income gap will continue to be one of the biggest challenges facing the HKSAR Government.

<sup>1</sup> Including the real estate & business services and community, social & personal services sectors.

<sup>2</sup> Mid-year figures were used for both 1997 and 2006. Due to changes in income breakdowns reported starting 2006 Q3, the most recent figures could not be used for this comparison.

<sup>3</sup> Including the wholesale, retail, restaurants and hotel sectors.