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TRADE POLICY REVIEW

HONG KONG, CHINA

Report by the Secretariat

This report, prepared for the Trade Policy Review of Hong Kong, China, has been drawn up by the WTO Secretariat on its own responsibility. The Secretariat has, as required by the Agreement establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), sought clarification from the Government of Hong Kong, China on its trade policies and practices.

Document WT/TPR/G/52 contains the policy statement submitted by the Government of Hong Kong, China

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SUMMARY OBSERVATIONS

(1) MAIN DEVELOPMENTS

1. The period under review (1994-98) was marked by two main events. The first was Hong Kong's reversion to the People's Republic of China, on 1 July 1997, and its designation as a Special Administrative Region (SAR) with a high degree of autonomy with regard to economic (and most other) policies under the "one country, two systems" framework established in accordance with the Basic Law. This framework involves a 50-year commitment to allow the SAR to maintain its existing free and open market system, which has long been the hallmark of Hong Kong's economy, making it one of, if not the most liberal among WTO Members and has contributed to a level of GDP per capita that is among the highest in the world (over US$26,000 in 1997). There is no indication that Hong Kong's traditional openness to trade and foreign investment has been affected by reunification, and as such, the present economic regime may be broadly characterized as "business as usual".

2. The second main event during the review period was the outbreak of the economic crisis in Thailand in July 1997 and its spread to other countries in and beyond South-East Asia. The crisis, and the associated drop in demand throughout the region, has seriously impaired Hong Kong's economic performance since the third quarter of 1997, causing a dramatic slow-down in economic activity. Real GDP is expected to decline by 4% in 1998 compared to robust growth of 5.3% in 1997. At the same time, the unemployment rate has more than doubled to 5% in August 1998, the highest level since 1983. It is noteworthy that, despite the present extraordinary economic difficulties, Hong Kong has maintained its traditional openness to both trade and investment and has not taken any measures directly affecting imports or foreign direct investment.

3. Nor, it would appear, has the Government attempted to influence the long-run structural evolution of Hong Kong's economy during the period under review. One of the main features of this evolution has been the increasingly closer links with the fast-developing adjacent region of South China. The strong growth in cross-border trade and investment, together with the relocation of the lower - value-added, assembly-type manufacturing operations to South China, has been accompanied by a growing demand for service-oriented activities in Hong Kong. The outcome has been a continuing erosion of manufacturing's share of GDP, down to 7.3% in 1996 from 9.2% in 1994, while the share of services rose from 83.4% in 1994 to 84.4% in 1997. This continuous shift from manufacturing to services has been reflected in the composition of Hong Kong's imports and exports.

4. Throughout the period under review, Hong Kong has run a substantial and growing merchandise trade deficit. This has been offset to a large extent by a rising surplus in non-factor services. For merchandise and services combined, a deficit equivalent to 3.5% of GDP was recorded in 1997, compared to 1.4% in 1996. Besides declining regional demand, this rise may be linked in part to the recent sharp currency depreciations in neighbouring countries, which have weakened the competiveness of Hong Kong's exports.

5. The financial crisis put considerable pressure on the Hong Kong dollar, which since 1983 has been pegged to the U.S. dollar under a currency board type of arrangement, whereby the Hong Kong dollar is fully backed by foreign reserves. The pegging of the Hong Kong dollar to the U.S. dollar has limited the authorities' scope for controlling the money supply and interest rates. The peg has also resulted in an effective appreciation of the Hong Kong dollar, particularly in relation to the devalued currencies of those countries in the region much more heavily affected by the Asian financial crisis. The Government is committed to maintaining the peg, which it views as the cornerstone of Hong Kong's *financial and monetary system and which it believes has a long-run stabilizing effect on the economy and is essential to Hong Kong's role as a major international financial centre. Since the latter half of 1997, however, the Hong Kong dollar has come under increased pressure, largely as a result of spillovers from the financial turmoil elsewhere in the region. While this pressure has hitherto been successfully resisted through the corresponding tightening of domestic liquidity, the resulting higher interest rates have contributed to sharp falls in stock and property prices and depressed domestic consumer and investment demand.*

6. In response to domestic calls for the Government to take action in order to alleviate, if not reverse, the recent slow-down in economic growth and the consequent rise in unemployment, in June 1998 the Government introduced a package of relief measures, which is expected to contribute to a budget deficit of 1.5% in 1998. Apart from the implementation of a few "emergency" measures aimed at stabilizing inter-bank interest rates as well as land, stock and foreign exchange markets, the authorities have largely refrained from interfering with the normal functioning of the free-market system.

(2) Trade and Investment Policies and Practices

7. There have been several notable developments in Hong Kong's trade- and trade-related policies since the previous Trade Policy Review in 1994, including modification of the Rice Control Scheme, accession to the WTO Agreement on Government Procurement, stricter enforcement of intellectual property rights, and the strengthening of some aspects of competition policy. However, there have been no major changes in the trade policy regime since the transfer of sovereignty on 1 July 1997. The Government's basic approach is still to let markets operate freely and openly both for trade and investment. Thus, it has not sought to promote or rescue individual industries, even in the face of the Asian crisis.

8. The openness of the Hong Kong economy to trade is such that all imports enter the region duty free, although it should be noted that tariff bindings apply to less than half of all tariff lines. Non-tariff border measures (NTMs) are almost absent; those that do exist either stem from Hong Kong's obligations under various international undertakings or are applied for health, safety, security or environmental reasons or to protect intellectual property rights.

9. The most noteworthy of these NTMs is the Rice Control Scheme, under which the amount of rice an importer is licensed to bring into Hong Kong is linked to that importer's contribution to the maintenance of a reserve stock. The Scheme, whose rationale is security of supply, has remained in place since Hong Kong's reunification with China. Clearly, the Scheme grants a certain market power to importers, with the associated economic rents meant to defray the cost of participation in the reserve scheme; however, price mark-ups can be high, 100% of the c.i.f. import price in the case of Thai fragrant rice, for example. The Government reviewed the Scheme in 1997 and introduced an Optional Quota System in October 1997, with a view to encouraging competition among importers; the Consumer Council had urged the Government to introduce "competition clauses" into the import licences to safeguard against anti-competitive behaviour. In 1998, the level of the reserve rice stock was reduced from 45,000 tonnes to 40,000 tonnes.

10. There are virtually no government controls on the composition or destination of exports, except in the case of restrictions maintained under the WTO Agreement on Textiles and Clothing and for UN sanctions (for which the Central People's Government is now responsible). Nor has Hong Kong resorted to unilateral action to address trade disputes and problems.

11. Hong Kong has few restrictions on inward investment. Moreover, it has hardly any sector-specific measures that could constitute incentives to foreign direct *investment (FDI), although the tax exemption for profits from certain international shipping services is an important exception. Hong Kong's openness to FDI combined with sound macroeconomic policies, its transparent rules-based legal environment, the availability of financial facilities and infrastructure, a skilled and reliable labour force, together with its proximity to other major markets, notably China, as well as a simple and predictable tax system, with low tax rates across the board, have greatly contributed to Hong Kong's attractiveness to business.*

12. Shortly before the transfer of sovereignty, the authorities acceded to the WTO Agreement on Government Procurement (GPA), which entered into force on 19 June 1997.

13. The Government, during the period under review, also confirmed its commitment to a policy of "minimum intervention and maximum support". Furthermore, it indicated that, within the framework of a free-market, it would pursue an industrial support policy aimed at sustaining and promoting the productivity and international competitiveness of manufacturing and service industries. This policy does not appear to be aimed at "picking winners" through the use of industry/firm-specific measures or incentives. Instead, the authorities have sought to ensure a business environment conducive to structural adjustment, investment and growth by emphasising broad initiatives to enhance the skills and technology base of economy, encourage new products and processes, remove infrastructural and land constraints, and liberalize regulated industries, particularly those providing basic business inputs (e.g. telecommunications services). In the face of the exceptional difficulties arising from the Asian financial crisis, the Hong Kong Monetary Authority (HKMA) did intervene in August 1998 to stabilize the Hong Kong stock market, by purchasing substantial stakes in several major manufacturing and service companies; according to the authorities, the acquisitions broadly represented the Hang Seng Index (HSI) without preference for particular companies or sectors. As a result of this market intervention, the HKMA's shareholding in three major conglomerates now exceeds 10%. It is worth noting that, however carefully done, intervention can work to the advantage of some market participants; thus, for example, by maintaining the price of their shares above levels that might otherwise have prevailed, HSI-listed companies may be provided with an advantage vis-à-vis non-listed companies in the cost of acquiring capital through new share issues. Also, in the case of the roughly 9% stake purchased by the HKMA in Hong Kong and Shanghai Banking Corporation (HSBC), Hong Kong's largest bank, there is the possibility of a conflict of interest because the regulator is a major shareholder in one of the banks it regulates.

14. In the course of the discussions leading to this Review, the authorities emphasized that it is not their intention to interfere with the management and operation the companies in which the Government now holds shares. To address concerns over potential conflicts of interest, the authorities announced, in September 1998, the establishment of a new company, the Exchange Fund Investment (EFI) Limited, to manage these shares, at "arm's length" from the Government and regulators; the EFI will have its own board of directors, one third of whom have been drawn from the Government.

15. During the review period, the authorities implemented comprehensive legislation aimed at ensuring Hong Kong's compliance with the TRIPS Agreement. More recently, the authorities have taken steps to strengthen the enforcement of laws intended to protect intellectual property rights.

16. In the authorities' view, competition is best nurtured and sustained by allowing the free play of market forces and keeping intervention to a minimum. Hence, the Government has eschewed an all-embracing competition law; the authorities are persuaded that Hong Kong's high degree of openness to trade and foreign direct investment and its strong reliance on market *forces in combination with sector-specific regulatory, administrative and, in the case of telecommunications, legislative measures are sufficient to ensure highly competitive markets both for goods and services. This approach has been questioned by the Consumer Council, which has pointed to a lack of competition in certain sectors, including residential property, retailing, wholesaling and distribution, banking, telecommunications and energy. However, the Government has taken steps to strengthen some aspects of it competition policy. These steps include the establishment of guidelines and of a body to handle complaints about anti-competitive private practices. In addition, certain sectors, particularly telecommunications and legal services, have been subjected to increased competition. The authorities are also studying the possibility of increasing competition in the energy sector.*

(3) PROSPECTS

17. The recent marked decline in real GDP and the associated sharp increase in unemployment can be traced in large part to the adverse effect of regional demand on Hong Kong's external trade and the fall in domestic demand. The deterioration in Hong Kong's external trade balance is probably also linked to a certain loss of net-export competeviness in the face of large devaluations by some of its neighbours. The fall in domestic demand owes much to the higher interest rates that have been needed under the currency board arrangement for the Hong Kong dollar. Higher interest rates have increased the cost of borrowing to consumers and businesses alike, and contributed to the recent decline in property and stock prices. The consequent negative wealth effects of the decline in such asset prices may have exacerbated the fall in domestic demand.

18. Wages and other prices will need to be sufficiently flexible downwards, and productivity improved, to help regain growth momentum, given the relative currency appreciation and decline in demand. Although nominal and real wages reportedly rose 4.5% and 0.1%, respectively, on an annual basis in the second quarter of 1998 despite the economic recession, more recent newspaper reports indicate that some firms may be starting to cut wages substantially. Property prices and rents have already undergone sharp declines during the past year. While labour productivity in the economy as a whole has grown only 1%, in manufacturing it increased by 9% in the 12 months ending June 1998 (up from 8% in 1997). The fact that the trade deficit is expected to narrow considerably in 1998 suggests that domestic product and factor markets may be adjusting so as to reverse Hong Kong's recent decline in export competitiveness. The recent fall in the value of the U.S. dollar, especially relative to the Japanese yen, together with cuts in U.S. interest rates will also help to improve Hong Kong's growth prospects. This, together with its traditional adherence to a free and open market system, should facilitate Hong Kong's emergence from the current economic crisis and a resumption of its strong economic performance.