BACKGROUND

Review of Public Finances

In the 2000-01 Budget Speech, the then Financial Secretary launched a review of public finances. The driving force behind the review was two consecu tive years of operating deficits and a forecast that these deficits would continue up to 2002-03. The phenomenon of successive years of operating deficits was without precedent in the preceding 50 years.

2. To determine the underlying nature and extent of the problem, the then Financial Secretary directed the setting up of a Task Force on Review of Public Finances to ascertain whether the Hong Kong Special Administrative Region (HKSAR) Government is facing a short-term cyclical, or a more fundamental structural, fiscal problem. Members of the Task Force were drawn from the Finance Bureau, the Inland Revenue Department and the Economic Analysis Division of the Financial Services Bureau. In the course of its work, the Task Force enlisted technical assistance from the Census and Statistics Department and commissioned focused studies from local academics and an international consultant. The Terms of Reference of the Task Force and its membership are at Annex I and Annex II respectively.

Annex I
Annex II

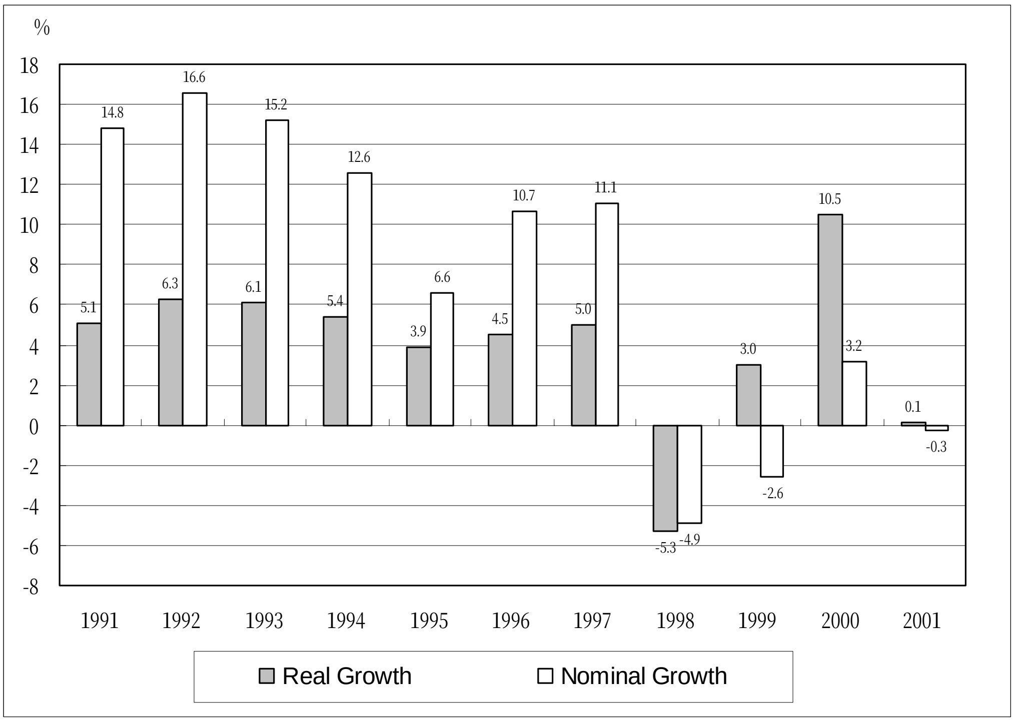
3. To enable feasible solutions to be developed in a timely manner, the then Financial Secretary also appointed an Advisory Committee on New Broad-based Taxes to look into new types of broad-based taxes which could be introduced if needed.

4. This parallel approach was intended to ensure that well thought-out strategies would be ready for implementation if required.

The Economic Backdrop

5. Over the past ten years Hong Kong has faced markedly different fortunes. Between 1991 and 1997, **economic growth** was relatively high, yet more stable. Between 1998 and 2001, economic growth averaged distinctly lower, yet also more volatile. The former period was characterised by an upsurge of the asset markets toward 1997. The latter period, by contrast, was characterised by the heavy impact from a double-blow stemming from the Asian financial crisis in 1998 and from the global economic downturn in 2001. The year-on-year GDP growth rates, in real and nominal terms, are set out in Chart 1 below.

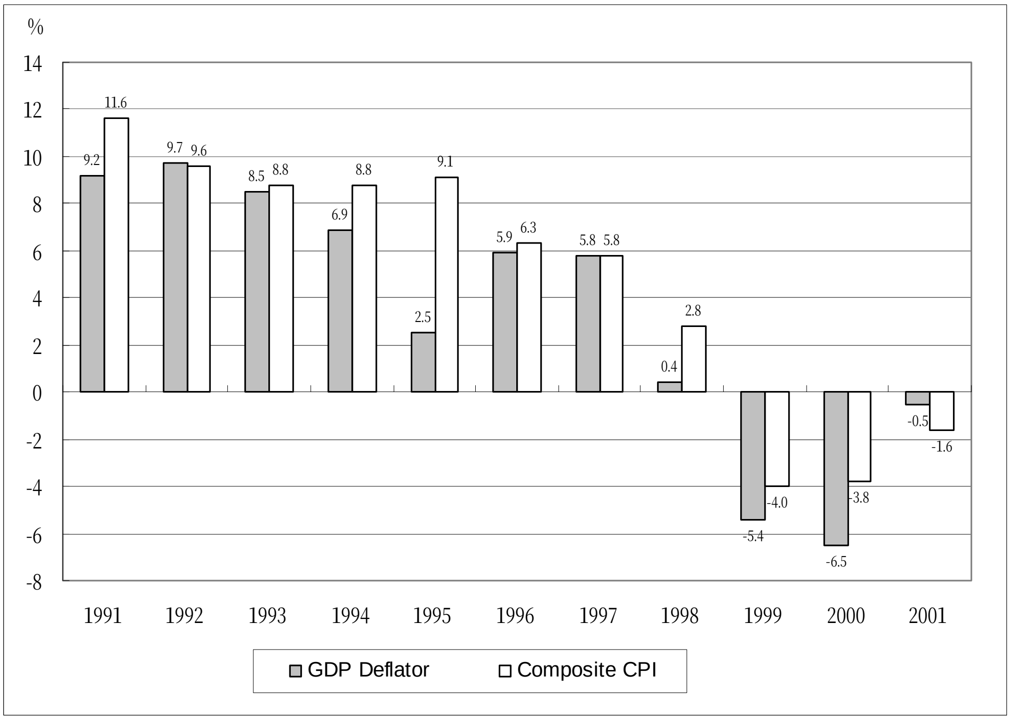
Chart 1 – Year-on-Year GDP Growth Rates in Real and Nominal Terms



6. Between 1991 and 1997, real GDP growth averaged 5.2% per annum, whereas between 1998 and 2001 it averaged only 1.9% per annum. In the former period, the annual real GDP growth ranged between 3.9% and 6.3%. Yet in the latter period, it ranged between -5.3% and 10.5%.

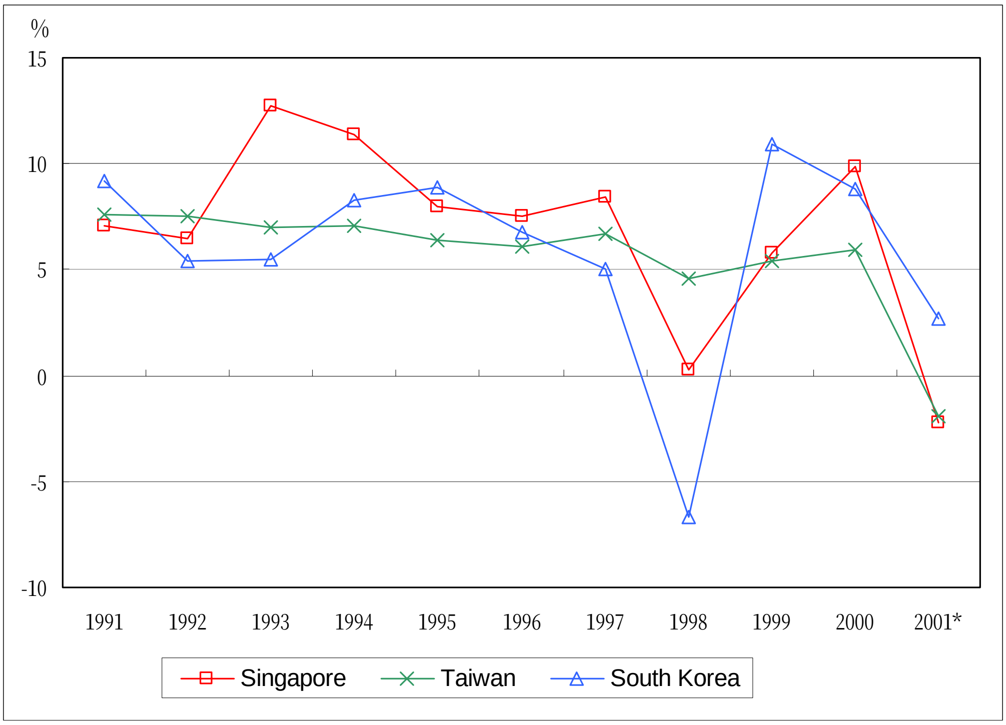
7. Along with the buoyancy in the former period, there were distinctly higher inflationary pressures. The GDP deflator rose by an average of 6.9% per annum, while the Composite CPI rose even faster, by an average of 8.5% per annum. Inflationary pressures were practically seen off by the economic fallout in the latter period. Indeed, both the GDP deflator and the Composite CPI turned negative year-on-year in the latter part of 1998, and the economy has gone through three years of deflation since. The changes in the GDP deflator and the Composite CPI averaged -3.0% and -1.6% per annum respectively in that period.

Chart 2 – GDP Deflator and Composite CPI



8. A slower yet more volatile pace of growth pace in more recent years was not confronted by the Hong Kong economy alone. Most of the other economies in East Asia, to varying degrees, were similarly posed. The Asian financial crisis hit some economies that had previously enjoyed particularly high growth more heavily, while recently the global electronic product down-cycle has struck economies with a high concentration of electronics exports much more severely. Singapore, Taiwan and South Korea, just like Hong Kong, now have to look forward to a pick-up in the global economy and, in particular, the US economy for impetus to revive.

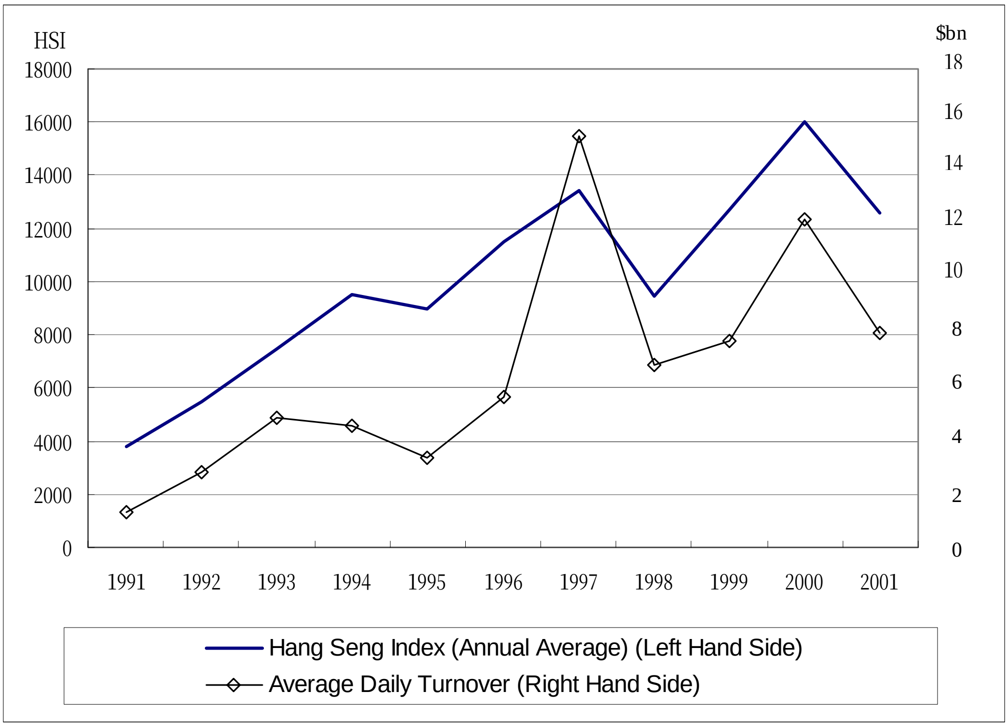
Chart 3 – GDP Growth in Selected East Asian Economies



Note : (*) Average year-on-year rates of change for the first three quarters of 2001 for Taiwan and South Korea, as the respective full-year figures are not yet available.

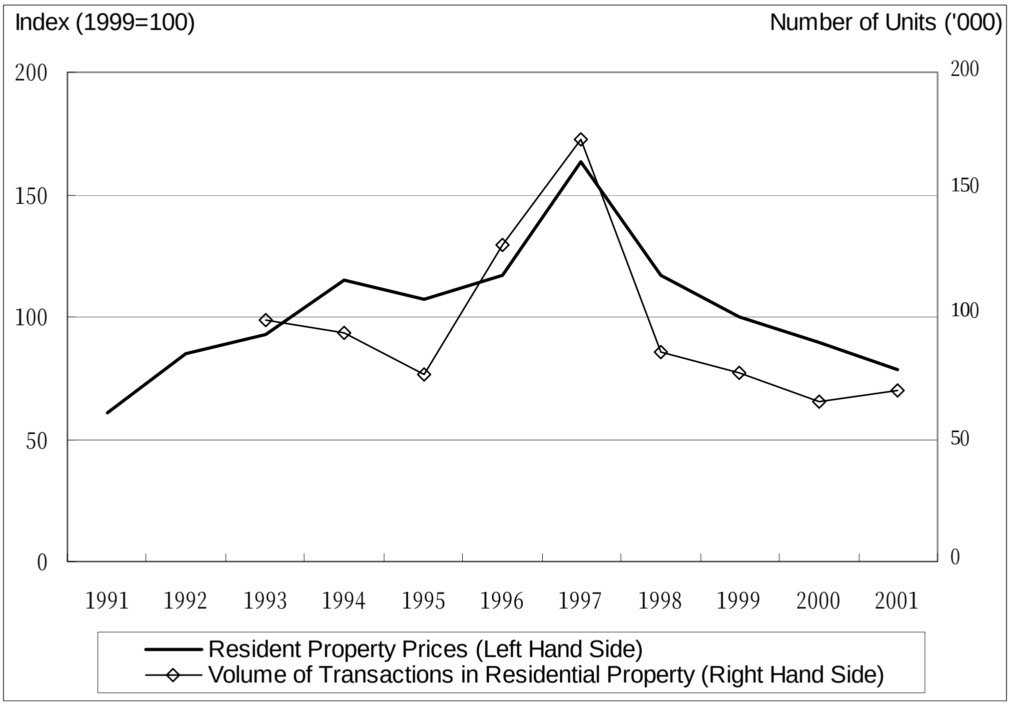
9. The local **stock market** has also experienced peaks and troughs. Between end-1991 and end-1997, the Hang Seng Index rose by a cumulative 150%, averaging 16.5% per annum, with a historical peak of 16,673 attained on 7 August 1997. Between end-1997 and end-2001, the Hang Seng Index was up by a cumulative 6% only in four years, averaging 1.5% per annum. It plummeted to a low of 6,660 on 13 August 1998 amidst a heavy attack on the Hong Kong dollar, then picked up to a high of 18,302 on 28 March 2000 at the height of the IT (information technology) fervour, and fell back to a low of 8,934 on 21 September 2001 after the IT fervour cooled off and as the global economic downturn gathered force. Average daily transactions shrank from a high of $31.9 billion in August 1997 to a mere $3.2 billion in February 1999, and stood at $6.7 billion in December 2001.

Chart 4 – Hang Seng Index and Stock Market Turnover



10. Likewise, if not more so, in the **property market** the bubble has swelled and burst. Taking the residential property sector for illustration, between the fourth quarter of 1991 and the fourth quarter of 1997, the prices of private residential flats went up by a cumulative 122%, averaging 14.3% per annum, with a historical peak reached in the third quarter of 1997. Between the fourth quarter of 1997 and the fourth quarter of 2001, the prices of private residential flats were mostly on a downward trend, falling substantially by 55% altogether, averaging 18.2% per annum. Monthly transactions dwindled from a high of 22,960 units or $90.4 billion in total value in April 1997 to a low of 3,860 units or $9.5 billion in total value in January 2001, before recovering back somewhat to 6,625 units or $15.7 billion in total value in December 2001.

Chart 5 – Residential Property Price Levels and Residential Property Market Turnover



11. The buoyancy in both the stock and property markets in the earlier years could be associated with the low to negative real interest rate then prevailing. As the cost of borrowing was not material in real terms, and as strong expectations for price appreciation predominated, the asset markets were easily fuelled. In stark contrast, high real interest rates have overshadowed the asset markets in more recent years. The heightening in the real interest rates occurred with the onset of deflation as the economy slumped, while nominal interest rates stayed high owing to increased perceptions of risk. With protracted deflation, real interest rates are likely to remain distinctly positive, and could continue to have a dampening effect on the asset markets.

Chart 6 – Nominal and Real Interest Rates