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HONG KONG: MACROECONOMIC DATA AND FORECASTS

	1996	1997	1998	1999	2000	2001	2002e	2003f	2004f	2005f
Population (bn)	6.4	6.5	6.5	6.6	6.7	6.7	6.8	6.9	7.0	7.1
Nominal GDP (US$bn)	154	170	159	154	165	164	163	167	173	180
GDP per capita (US$)	23,963	26,236	24,300	23,321	24,782	24,383	24,010	24,365	24,680	25,469
Real GDP growth (%)	4.3	5.1	-5.0	3.4	10.2	0.6	2.3	2.4	3.4	4.1
Consumer price inflation (an. avg %)	6.3	5.8	2.8	-4.0	-3.8	-1.4	-3.0	-0.3	-0.5	0.5
Lending rate (% pa)	8.5	9.5	9.0	8.5	9.5	5.1	5.1	5.0	6.0	7.5
HKD/US$ (eop)	7.7	7.7	7.7	7.8	7.8	7.8	7.8	7.8	7.8	7.8
HKD/US$ (period average)	7.7	7.7	7.7	7.8	7.8	7.8	7.8	7.8	7.8	7.8
Merchandise exports (US$bn)	180.8	188.1	174.0	173.9	201.9	189.9	200.3	215.0	232.0	245.0
Merchandise imports (cif, US$bn)	198.6	208.6	184.5	179.5	212.8	201.1	208.0	231.0	251.0	270.0
Trade balance (customs, US$bn)	-17.8	-20.6	-10.5	-5.6	-10.9	-11.2	-7.7	-16.0	-19.0	-25.0
Current account (US$bn)	-	-5.3	4.4	12.0	9.1	12.3	17.8	10.1	12.1	10.8
Current account (% GDP)	-	-3.1	2.8	7.8	5.5	7.5	10.9	6.1	7.0	6.0
Foreign reserves (US$bn) *	63.8	92.8	89.7	96.2	107.5	111.2	111.9	110.0	116.0	122.0
Import cover (mths) **	3.9	5.3	5.8	6.4	6.1	6.6	6.5	5.7	5.5	5.4
Budget Balance (HKDbn)	25.7	86.9	-23.2	10.0	-3.0	-60.0	-70.0	-53.1	-32.3	-13.4
Budget Balance As % of GDP	2.2	6.6	-1.9	0.8	-0.2	-4.7	-5.5	-4.1	-2.4	-1.0

*f = BMI forecast, eop = end of period, * excluding gold; ** no. of months imports covered by FX reserves + gold. Sources: Census and Statistics Department, Hong Kong Monetary Authority, BMI.*

BMI Ratings - Hong Kong

The BMI Ratings can be used to rank emerging markets in terms of political risk, the economy and the quality of the business environment. There are four ratings: a composite rating, a political rating, an economy rating and a business environment rating. These ratings are reviewed every month and the results posted on BMI's online service **Emerging Markets Online** (www.businessmonitor.com). The political and economy ratings have short- and long-term components. The long-term ratings are designed to reflect more structural considerations and will not change greatly in the short term. The short-term ratings will change frequently in response to more transient influences. All ratings are expressed as a number between 1 and 100. A high rating is an indicator of lower risk.

RATINGS DYNAMICS –Spending Cuts Present No Danger

Hong Kong is introducing a set of new laws that seem to avoid what many sceptics feared, namely political prostration to the mainland, hence our short-term political rating stays at 80.0. Our short-term economic rating remains at 66.0, since the government's cuts in public spending, so long as they are not too deep, present no danger. Our business environment rating stays at 85.0, while our short-term composite rating remains at 72.7.

BMI Risk Ratings –Hong Kong

	Latest Rating*	Rank†	Previous Rating**	Trend	Region Avg	Emerg Mkts Avg
Composite Rating	72.7	28	72.7	⇔	66.4	59.9
L-T Political Rating	51.7~	58	51.7	⇔	57.7	56.8
S-T Political Rating	80.0	23	80.0	⇔	67.7	65.5
L-T Economic Rating	60.0	34	60.0	⇔	63.4	53.4
S-T Economic Rating	66.0	33	66.0	⇔	65.7	55.9
Business Environment Rating	85.0	8	85.0	⇔	62.0	55.2

*trend arrows reflect two consecutive months of movement in same direction. ~ indicates rating is below global markets average †out of 90 global markets rated *21/02/03 **22/01/03*

POLITICAL RISK –Civil Liberties Squeezed

Factors that influenced **BMI** political ratings in February include:

- Hong Kong seemed, on the surface, to be proving successful in resisting Chinese demands to allow tighter mainland control over the city's affairs. In February, Hong Kong's government watered down new national security laws that threatened to act as a legislative backdoor through which China could funnel its political commands. The government says it has made an effort to strike a balance between protecting national security and safeguarding rights and freedoms. But **BMI** remains sceptical. The amendments remain hazy in their meaning and some clauses will be prone to fudge.

ECONOMIC RISK –Deflationary Spiral

Factors that influenced **BMI** economic ratings in February include:

- The biggest threat to the Hong Kong economy continued to be deflation, meaning falling prices. And there is a chance that the government may have added to that threat by choosing, in February, to announce a plan to cut welfare payments by 11.1%, affecting around 260,000 families. The government has already pledged to cut the size of civil-service salaries by 10%. The unintended consequence could be a collapse in spending, causing retailers to cut prices even further, adding to Hong Kong's deflationary spiral. However, **BMI** believes the risk of this is minimal. Cuts in public spending, if moderate, will help to narrow the budget deficit and revive the economy.

BUSINESS ENVIRONMENT –Taxation

Factors that influenced **BMI** business environment ratings in February include:

- Hong Kong seemed in danger, according to some critics, of losing its appeal as Asia's low-tax hub for foreign companies if Hong Kong's new budget in March leads, as **BMI** thinks it will, to a marginal rise in the city's effective rate of taxation. In Singapore taxes are falling. Singapore has announced a 15% tax rate for three years to new foreign companies that meet specific criteria after setting up regional headquarters in Singapore –a reduction from its basic 22% corporate-tax rate. Hong Kong levies a flat 16% corporate rate. All the same, Hong Kong remains, for now, the least burdensome city in Asia when it comes to tax.

BMI Risk Ratings –Asia Tables

	Composite	L-T Political	S-T Political	L-T Economic	S-T Economic	Business Environment
Australia	75.8	85.0	82.0	79.4	70.0	74.2
Bangladesh	46.5	41.7	48.0	-	45.0	38.9
Cambodia	57.9	-	62.0	-	54.0	-
China	76.3	45.0	71.0	69.7	82.0	62.5
Hong Kong	72.7	51.7	80.0	60.0	66.0	85.0
India	64.0	55.0	63.0	58.7	65.0	51.7
Indonesia	55.4	41.7	52.0	51.0	59.0	48.7
Japan	70.9	91.7	74.0	76.1	68.0	81.0
Malaysia	70.5	51.7	73.0	65.2	68.0	62.9
New Zealand	77.8	85.0	84.0	71.6	72.0	72.8
Pakistan	52.4	35.8	50.0	45.2	55.0	48.0
Philippines	55.0	53.3	57.0	54.8	53.0	56.5
Singapore	84.5	74.2	86.0	81.3	83.0	87.2
South Korea	68.8	65.0	57.0	74.2	83.0	65.3
Sri Lanka	54.9	54.2	58.0	47.1	52.0	53.5
Taiwan	77.8	66.7	72.0	74.8	84.0	73.0
Thailand	73.5	42.5	71.0	54.2	76.0	57.3
Vietnam	61.6	41.0	79.0	51.6	48.0	35.7
Regional Averages	66.4	57.7	67.7	63.4	65.7	62.0
Emerging Market Averages	59.9	56.8	65.5	53.4	55.9	55.2
Global Market Averages	64.2	64.3	69.5	58.8	60.2	61.5

Countries rated on 06 March 2003

Asia Ratings League Tables

Composite Rating

	Composite	Rank*	Trend
Singapore	84.5	5	⇔
New Zealand	77.8	17	⇧
Taiwan	77.8	17	⇧
China	76.3	21	⇔
Australia	75.8	22	⇩
Thailand	73.5	27	⇧
Hong Kong	72.7	28	⇔
Japan	70.9	31	⇔
Malaysia	70.5	34	⇔
South Korea	68.8	39	⇩
India	64.0	53	⇧
Vietnam	61.6	59	⇔
Cambodia	57.9	63	⇔
Indonesia	55.4	67	⇧
Philippines	55.0	68	⇩
Sri Lanka	54.9	69	⇔
Pakistan	52.4	71	⇔
Bangladesh	46.5	79	⇔
Regional Average	*66.4*		
Emerging Market Average	*59.9*		
Global Market Average	*64.2*		

Short-Term Political Rating

	S-T Political	Rank*	Trend
Singapore	86.0	8	⇔
New Zealand	84.0	11	⇔
Australia	82.0	19	⇩
Hong Kong	80.0	23	⇔
Vietnam	79.0	27	⇔
Japan	74.0	41	⇔
Malaysia	73.0	44	⇔
Taiwan	72.0	47	⇔
China	71.0	50	⇔
Thailand	71.0	50	⇔
India	63.0	64	⇧
Cambodia	62.0	66	⇔
Sri Lanka	58.0	71	⇔
South Korea	57.0	72	⇔
Philippines	57.0	72	⇔
Indonesia	52.0	76	⇔
Pakistan	50.0	78	⇔
Bangladesh	48.0	81	⇔
Regional Average	*67.7*		
Emerging Market Average	*65.5*		
Global Market Average	*69.5*		

Short-Term Economic Rating

	S-T Economic	Rank*	Trend
Taiwan	84.0	4	⇧
Singapore	83.0	5	⇔
South Korea	83.0	5	⇔
China	82.0	8	⇔
Thailand	76.0	15	⇧
New Zealand	72.0	23	⇧
Australia	70.0	26	⇩
Japan	68.0	30	⇔
Malaysia	68.0	30	⇔
Hong Kong	66.0	33	⇔
India	65.0	38	⇔
Indonesia	59.0	52	⇧
Pakistan	55.0	59	⇔
Cambodia	54.0	62	⇔
Philippines	53.0	64	⇩
Sri Lanka	52.0	66	⇔
Vietnam	48.0	70	⇔
Bangladesh	45.0	76	⇔
Regional Average	*65.7*		
Emerging Market Average	*55.9*		
Global Market Average	*60.2*		

Business Environment Rating

	Business Environment	Rank*	Trend
Singapore	87.2	6	⇔
Hong Kong	85.0	8	⇔
Japan	81.0	13	⇔
Australia	74.2	22	⇔
Taiwan	73.0	23	⇔
New Zealand	72.8	24	⇧
South Korea	65.3	30	⇔
Malaysia	62.9	35	⇔
China	62.5	36	⇔
Thailand	57.3	49	⇧
Philippines	56.5	50	⇩
Sri Lanka	53.5	56	⇔
India	51.7	60	⇔
Indonesia	48.7	61	⇧
Pakistan	48.0	63	⇔
Bangladesh	38.9	79	⇔
Vietnam	35.7	80	⇔
Regional Average	*62.0*		
Emerging Market Average	*55.2*		
Global Market Average	*61.5*		

Not Ranked: Cambodia

Long-Term Political Rating

	L-T Political	Rank*	Trend
Japan	91.7	4	⇔
Australia	85.0	15	⇔
New Zealand	85.0	15	⇔
Singapore	74.2	27	⇔
Taiwan	66.7	39	⇔
South Korea	65.0	42	⇔
India	55.0	51	⇔
Sri Lanka	54.2	55	⇔
Philippines	53.3	57	⇔
Hong Kong	51.7	58	⇔
Malaysia	51.7	58	⇔
China	45.0	71	⇔
Thailand	42.5	74	⇔
Bangladesh	41.7	76	⇔
Indonesia	41.7	76	⇔
Vietnam	41.0	78	⇔
Pakistan	35.8	82	⇔
Regional Average	*57.7*		
Emerging Market Average	*56.8*		
Global Market Average	*64.3*		

Not Ranked: Cambodia

Long-Term Economic Rating

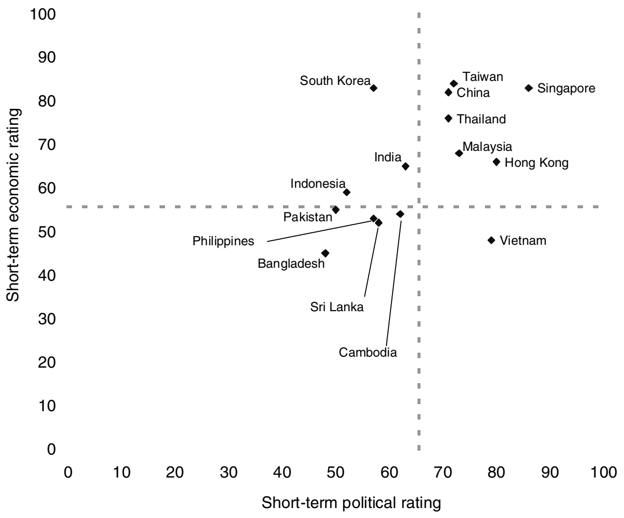
	L-T Economic	Rank*	Trend
Singapore	81.3	3	⇔
Australia	79.4	7	⇔
Japan	76.1	10	⇔
Taiwan	74.8	12	⇔
South Korea	74.2	14	⇔
New Zealand	71.6	18	⇔
China	69.7	21	⇔
Malaysia	65.2	26	⇔
Hong Kong	60.0	34	⇔
India	58.7	35	⇔
Philippines	54.8	45	⇔
Thailand	54.2	46	⇔
Vietnam	51.6	55	⇔
Indonesia	51.0	58	⇔
Sri Lanka	47.1	66	⇔
Pakistan	45.2	69	⇔
Regional Average	*63.4*		
Emerging Market Average	*53.4*		
Global Market Average	*58.8*		

Not Ranked: Bangladesh, Cambodia

trend arrows reflect two consecutive months of signficant movement in the same direction
** out of 90 global markets rated*

Risk Interaction Diagram

BMI's **Risk Interaction Diagrams** give a more informative picture than the composite rating of the information conveyed jointly by the political and economy ratings. One problem with the composite, which is an unweighted geometric mean of the short-term political and short-term economy ratings, is that a misleading picture can be presented if the two components are widely different. In the Risk Interaction Diagram, the short-term political rating is plotted along the horizontal axis, the short-term economy rating along the vertical axis. The averages for all countries rated by **BMI** are indicated by horizontal and vertical broken lines. Countries in the top right quadrant, therefore, have above-average ratings. The more "equally balanced" countries appear along the diagonal of the quadrant.



Axes cross at emerging markets average

BMI Ratings – Brief Methodology

Composite Rating

The composite rating is an unweighted geometric mean of the short-term political and short-term economy ratings, allowing a ranking of all countries in **BMI**'s emerging markets universe.

Political Ratings

The political ratings are an indicator of political stability, seen as a pre-requisite for a stable economy and business environment. The long-term political rating considers more structural elements such as: Is there a functioning democracy? Are there free and fair elections? Is there separation between party and state? Have recent governments pursued similar, enlightened policies amid a stable political environment? The short-term political rating considers more transient influences such as: Have there been recent large-scale demonstrations or strikes? To what extent have these threatened the political status quo? Is unemployment currently a potential source of political instability? What is the current position in the political cycle – to what extent is this contributing to political risk? Is the government having trouble passing legislation?

Economy Ratings

The economy ratings assess the degree to which the country approximates the ideal of non-inflationary growth with contained fiscal and external deficits and manageable debt ratios. The ratings use as raw material historical data and forecasts fed in from **BMI**'s country databases: as historical data is revised and forecasts change, so the ratings change. Factors in the long-term rating include GDP growth, unemployment, inflation, real interest rates, exchange rates, the fiscal balance, the current account balance and external debt. A number of other structural factors are also thrown into the equation, including dependence on the primary sector, reliance on commodity imports, reliance on a single export sector, and central bank independence. The factors included in the short-term rating are a subset of those in the long-term rating.

Business Environment Rating

The business environment rating is a broad indicator of the investment climate, for both domestic and foreign players. While areas such as competitiveness, finance, openness and environment comprise the bulk of the rating, there is also an important feed from the political and economy ratings. The factors considered include: the state of the national infrastructure, the education system, cronyism/corruption, red tape, the legal framework, property rights, market access, and the corporate tax regime.

chapter 1 Political Outlook

Domestic Political Outlook

Introduction

After nearly six years under Chinese rule, Hong Kong's government is facing mounting unpopularity. Changes to the territory's security laws combined with austere economic policies have left the public uneasy. But with limited accountability, political stability is nevertheless assured.

As a Special Administrative Region (SAR) of the People's Republic of China, Hong Kong has the power to conduct its own affairs in all areas except foreign policy and defence. This system has worked fairly well since its implementation in July 1997 (when the British handed Hong Kong back to Chinese rule), but cracks are now beginning to appear. The 1997 handover provided Hong Kong with a mini constitution, know as the Basic Law, and guaranteed a 'high degree of autonomy' for at least 50 years, the crux of Beijing's 'one country, two systems' formula. While in reality Hong Kong does have some say over its foreign policy, particularly concerning issues such as immigration, the true independence of its domestic policy is becoming increasingly unclear. Hong Kong's government is decidedly pro-Beijing in structure, ensuring policymaking is broadly agreeable to the mainland. Furthermore, Hong Kong's highest lawmaker –the chief executive –is chosen by the mainland government. In turn the chief executive then selects an executive council to assist in policy making. With only 24 directly elected legislators in the 60-seat legislative council, there is little chance of the opposition blocking any bills.

The 'one country, two systems' formula has come under intense scrutiny in recent months with Hong Kong's amendments to its security laws. While a change was required under the Basic Law, this amendment to the constitution has raised fears that the mainland will slowly tighten its grip on Hong Kong's freedoms, bringing the territory more in line with the mainland where political, religious and press freedoms are severely restricted. Despite ongoing concerns, the government seems determined to have the bill passed through parliament by July this year. Popularity has suffered due to the proposed new laws and austere economic policies, but the government's limited accountability means stability is nevertheless assured. That said, the government needs to tread carefully so as not to cloud the territory's revered reputation for its solid and accountable legal system and individual freedoms.

A Silent Opposition

The resignation of Martin Lee, the former leader of Hong Kong's main opposition party, bodes ill for a continued opposition voice in government.

With political parties prohibited before 1990, and China's overarching power in Hong Kong's current affairs, the territory's political landscape remains relatively underdeveloped. Prior to handover, individuals representing certain interests dominated the political environment rather than professional politicians, (given that the executive and legislative bodies had little more than an advisory capacity). With domestic political power still limited by the mainland, there is an inherent lack of incentive to participate in the political process. With only 24 directly-elected seats up for grabs in the 60-seat legislature, even a solid majority is far from enough to block proposed bills in parliament.

With limited power as it stands, the weakening of Hong Kong's main opposition party, the Democratic Party (DP), is cause for concern. Martin Lee, the DP's founder, stepped down as leader in December last year, making way for Yeung Sum. Lee was well known for his efforts to promote Hong Kong's democracy, both at home and overseas, a trait that led Beijing to view him as subversive. As such an ardent examiner of government policy, and stickler for Hong Kong's freedoms, his resignation comes as a blow to the opposition voice in government. Yeung is unlikely to be so vociferous in his critique of government policy, and factional infighting may weaken his position further. However, with Hong Kong's economic malaise unlikely to lift for some time ahead, pressure for democratic accountability will increase. The growing unemployed population will want someone to blame for their hardship.

Troublesome Security Laws

Revisions to Hong Kong's security laws have sparked widespread public outcry over concerns that individual freedoms will be restricted. The government's handling of the process is making matters even worse.

A consultation document detailing proposed changes to Hong Kong's security laws, as required under Article 23 of the Basic Law, was distributed in September last year and has proved to be the government's most controversial issue so far under Chinese rule. A paper stating laws against subversion, sedition, secession and treason was circulated, in what the government claimed was little more than a formality under the terms agreed previously. Many in Hong Kong, however, saw the new laws as curbing freedom of speech and open to interpretation. Opposition to the enactment of the new laws was widespread, with the territory witnessing some of the biggest demonstrations since handover. Religious groups, human-rights groups, academics, journalists and lawyers were among the protesters, each raising concerns with the government. The consultation period is now over and the government has produced a revised version of the laws in order to allay concerns. Changes include the right to trial-by-jury for the most serious of crimes; removing the possibility of foreign nationals being charged with treason; allowing the possession of seditious material; and more concise definitions of other crimes (reducing the possibility of arbitrary implementation). But while these changes have been welcomed, many still argue that they have not gone far enough. Furthermore, the government has, as yet, resisted pressure for another consultation period that would allow examination of the exact wording of the revised document. The government seems determined to get the bill into parliament by July, and in the absence a credible opposition, it will then pass into law easily.

The government claims to have drafted these new laws in line with international standards and sees no further need for changes. If this is indeed the case, the government should not be worried about allowing a second consultation period so as to allay fears. Hong Kong's future as a high value-added service sector is reliant on the reputation of its sound legal and financial system, rule of law and low corruption. Perceived bowing to Beijing in any aspect of policy must therefore be kept to a minimum.

chapter 2 Economic Outlook

Introduction

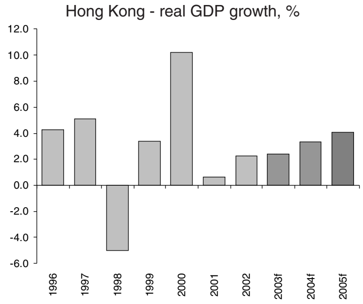
Onerous Challenges Ahead

Hong Kong's economy faces tough challenges ahead to offset increasing competition from the mainland. With both fiscal and monetary policy set to tighten, this will be no easy task.

Hong Kong will face further economic malaise during the coming years. The territory's high value-added service economy faces a huge structural challenge in positioning itself in a changing Greater China region. The manufacturing sector will almost certainly lose out to an increasingly open and competitive China, while the mainland's gradual move up the value chain may also woo Hong Kong's lower value-added services into China. To make things even worse, domestic factors will continue to be unfavourable during the coming quarters. Consumers have seen wealth drop substantially during the past few years as the lingering effects of a property price crash in 1997 has left many homeowners with mortgages greater than the current value of property, a situation referred to as negative equity. In addition, a drop of more than 40% in the local stock market has eroded the value of savings. Bankruptcies and unemployment have reached record levels and concerns over job prospects mean consumers will continue to be reluctant to spend. Domestic demand did very little to support growth in 2002 and there is not much reason to expect any significant pick-up soon. The external sector should continue to improve but the current geopolitical risks and still relatively sluggish growth in the world's major economies mean that the risks remain on the downside.

Slow Progress

Hong Kong - real GDP growth, %



f = BMI forecast; Source: Census and Statistics Department - Hong Kong SAR, BMI.

The greatest challenge of all is that of an increasingly open and competitive Chinese economy. China's abundant supply of low-cost labour and its increasing skills base has seen Hong Kong's role as a middleman drop drastically in the past year. China's ongoing trade and investment liberalisation, due to its accession to the World Trade Organisation in late 2001, has increased its attractiveness as a destination for foreign direct investment and reduced the need for goods and services flows via Hong Kong. This can only get worse. The territory's manufacturing and shipping industry will face growing competition from China's nearby Pearl River Delta (PRD) region, while services such as lower-value logistics and backroom operations may also move to the mainland in line with the increasing number of foreign firms now operating there.

Hong Kong's economic lifeline lies in high value-added financial services where the territory offers significant advantages that will not be overtaken by the mainland anytime soon. Low corruption, a common law system, rule of law, a low and simple tax system and a large pool of trained professionals all lie in Hong Kong's favour and cannot be easily obtained by China. Nevertheless, the future growth potential will be determined by how well Hong Kong manages to exploit these advantages and offset the likely rundown of its manufacturing sector.

Adding to the current gloom is the limited nature of government stimulus, either monetary or fiscal. Hong Kong's currency-board system that ties into law an exchange-rate peg of HKD7.8/US$ means that monetary policy is effectively set by Washington. The Hong Kong Monetary Authority (the territory's de facto central bank) must move interest rates in line with those in the US so as to avoid any unwanted pressure on the currency peg through either an inflow or outflow of funds. With the US economy looking increasingly vulnerable and consumer and business confidence at some of the lowest levels on record, US interest rates are no longer expected to rise in 2003. This neutral or possibly more accommodative monetary policy is good news for Hong Kong as higher interest rates would further dissuade consumers and investors from borrowing. Moreover, the need to rein in the territory's lingering budget deficit means that fiscal policy will be contractionary in 2003. The 2003 Budget brought a mixture of tax rises, welfare cuts and salary reductions to be phased in during the next few years in an attempt to bring the government's finances back into balance by 2006-07. With a large chunk of the increase in revenues attributed somewhat optimistically to sharper economic growth, there is the very real possibility that the government will be forced to announce additional fiscal tightening further down the line.

The economy is undoubtedly in for a tough time during the next few years. **BMI** expects real GDP growth to pick-up only slightly in 2003 to average 2.4% compared with 2.3% in 2002. Deflation will continue as Hong Kong faces further price and wage competition from the mainland and property prices fall even further. The weakness in domestic demand will mean that growth will remain below the 5%-6% rates seen in the early 1990s, with an average of 3.7% expected for real GDP growth in 2004 and 2005.

Economic Activity

Outlook Depends On Exports

GDP growth will continue to be driven by external demand in 2003 and beyond as the outlook for the consumer remains weak. This trend is worrying given only small economy-wide benefits from external demand.

Hong Kong's economy is in store for another tough year. Despite modest real GDP growth of 2.3% in 2002, with a particularly buoyant 5.0% year-on-year (y-o-y) expansion in Q4, the outlook is disappointing. Domestic conditions will remain unfavourable as the economy grapples with the emergence of China as a major manufacturing base, alongside the lingering effects of the domestic property bubble burst in 1997. Net trade (particularly services exports) will continue to drive growth in 2003, although even here there will be a shift away from re-exports and into offshore services and tourism exports. GDP growth is expected to slow during the coming quarters given the upcoming belt tightening by the public sector (see fiscal policy), and continued fears over job prospects by consumers.

POPULATION AND OUTPUT

	1996	1997	1998	1999	2000	2001	2002e	2003f	2004f	2005f
Population (mn)	6.4	6.5	6.5	6.6	6.7	6.7	6.8	6.9	7.0	7.1
Nominal GDP (US$bn)	154.2	170.2	159.0	154.1	165.2	164.0	163.0	166.9	172.5	179.6
GDP per capita (US$)	23,963	26,236	24,300	23,321	24,782	24,383	24,010	24,365	24,680	25,469
Real GDP growth (% y/y)	4.3	5.1	-5.0	3.4	10.2	0.6	2.3	2.4	3.4	4.1
Manufacturing output (% y/y)	-3.7	-0.8	-8.7	-6.4	-0.5	-4.4	-9.8	-3.2	-0.6	1.2
Unemployment rate (%)	2.8	2.2	4.7	6.2	4.9	5.1	7.2	7	6.5	5.3

e/f = BMI estimate/forecast. Sources: Census and Statistics Department - Hong Kong SAR, BMI.

Weak domestic conditions will further weigh down on growth this year. Domestic demand subtracted 1.3 percentage points from growth in 2002 with private consumption accounting for 70% of this fall. Private consumption fell y-o-y for the last five consecutive quarters and with bankruptcies reaching a record high, and unemployment set to climb back up from the 7.2% in January (measured on a seasonally adjusted three-month moving average basis), there is little reason to expect any pick-up in private consumption soon. The number of families claiming welfare benefits also reached a record high in February. The number of households claiming benefits jumped 10.1% y-o-y while unemployment-benefit claims rose 2.4%, the sharpest rise in five months. Given that the government has announced an 11% cut in welfare payments alongside an increase in tax rates and a lowering of minimum salary requirements to widen the tax base, Hong Kong's poor will feel decidedly less wealthy during our forecast period ending in 2005.

The external sector will remain the major driver of growth in 2003 and beyond. Net trade provided the lion's share of growth last year, contributing 3.6 percentage points overall, with more than 90% of this coming from net services exports. While this does have some wider economic benefits, these are less in the case of Hong Kong than they are in other open economies such as Thailand. This is because the service sector accounts for more almost 90% of Hong Kong's GDP, with manufacturing accounting for around only 5%. So although stronger external demand has a direct impact on GDP, it has a much lower second-round effect given that exports are largely manufacturing re-exports. Re-exports (goods imported by Hong Kong and then sold again overseas at a higher price with little economic input) accounted for 91.5% of total merchandise exports in 2002 while volume goods exports accounted for 81.4% of total exports on a national accounts basis. So although it is traditionally the net services surplus that pulls GDP growth, it is goods trade that accounts for most of the economic activity. Therefore, with only a small manufacturing sector, economy-wide gains from employment and rising incomes will be small.

Despite the expected gloom during the coming years, all is not lost. The economy is fundamentally strong, with per capita income among the highest in the world at around US$24,000 in 2002. Both fiscal and foreign currency reserves are vast, indicating that the financial system is sound despite the current concerns. Moreover, the high value-added service sector should retain its eminent status for many years ahead even with the development of Shanghai.

Fiscal Policy

Balancing The Books

Despite the uncertain outlook for economic growth in 2003, the government has announced a host of measures to reign in its budget deficit. Although unpopular, these are necessary to avoid a protracted loss of confidence in the economy.

With a budget deficit currently above 5% of nominal GDP, Hong Kong is faced with contractionary fiscal policy going forward. The territory's fiscal position is increasingly being described as a crisis and is hurting confidence in an economy already facing difficult times. The fear is that a prolonged budget deficit, which must be financed either by running down savings or by accumulating debt, will expose the economy to the risk of a financial disaster. It will also leave less scope for fiscal manoeuvring in the future. Hong Kong has so far financed its three-year deficit by running down its fiscal reserves. At HKD314bn these are sufficient to cover another four years of a similar size deficit. But the concern is that a prolonged deficit would force the government to either tap into foreign-exchange reserves or borrow from international markets. Hong Kong's exchange-rate regime requires that the monetary base be fully backed up by foreign reserves. If reserves are run down and the exchange-rate peg comes into question, this would have serious consequences for the territory's reputation as an international financial hub. While this is very real, perhaps a more imminent worry is that the decline in confidence associated with Hong Kong's large fiscal deficit will result in an outflow of capital –and therefore an increase in interest rates –to maintain the fixed exchange rate. This coul d hamper growth given the very weak domestic demand.

Fiscal Tightening

2003-04 Budget Measures

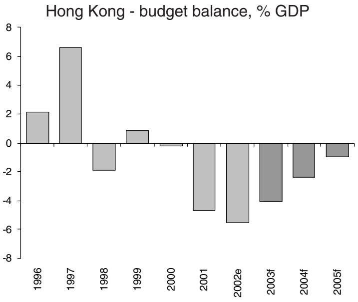
2003-04 Budget Measures	Current	Proposed
Standard Salary Tax Rate	15%	16%
Corporate Profits Tax	16%	17.5%
Property Tax	15%	16%
Betting Duty (exotic horses)	19%	20%
Air Passenger Departure Tax	HKD80	HKD120
Single Person Allowance	HKD108,000	HKD100,000
Married Person Allowance	HKD216,000	HKD200,000

Source: Government Information Office - Hong Kong SAR.

With a deficit at an estimated HKD70bn in fiscal 2002-03 (April 2002 –March 2003) the problem is undoubtedly serious. For fiscal year 2003-04 the government has announced a three-pronged approach to cutting the deficit, namely, increasing revenues, reducing expenditures and stimulating the economy. A total of HKD40bn is to be trimmed from the deficit through revenue-raising and expenditure-reducing measures. The other HKD30bn is to accrue through sharper economic activity. If this course of action is successful, the government will achieve its target of balancing the budget by 2006-07. **BMI** believes this to be a little optimistic. The HKD30bn contingent on sharper economic growth in the face of contractionary fiscal policy and an uncertain global economy will be the hardest target to achieve. The economy remains sluggish and there is a very real fear that the expenditure-reducing measures to come into force could be counterproductive. Consumers may become even more reluctant to spend as taxes rise and benefits falls, therefore harming the already-weak economy.

Fiscal Reserves Take Up Slack

Hong Kong - budget balance, % GDP



e/f = BMI estimate/forecast; Source: Hong Kong Monetary Authority, BMI.

Perhaps the most worrying aspect is the government's failure to reduce its dependence on the property market. This is the single biggest cause of Hong Kong's fiscal woes as the sale of government-owned land is a huge earner for the government. The more than 60% drop in property prices since 1997 has meant a sharp reduction in government revenues, and the current oversupply of real estate suggests that proceeds are likely to remain low for some time ahead. The most appropriate revenue-raising method available to Hong Kong is a goods and services (value-added) tax. The government has at last admitted the need to impose such a tax at some point, however now, it says, is not the right time.

It is apparently the right time, however, for a variety of other measures. The government has confirmed plans to cut the size of the civil service by 10% (by 2006-07) and impose a reduction in salaries of 6% over a two-year period. In addition, the government has allowed

NATIONAL GOVERNMENT FINANCE - FISCAL YEARS* (HKDBN)

	1996	1997	1998	1999	2000	2001	2002e	2003f	2004f	2005f
Revenue	208.4	281.2	216.1	233.0	251.7	194.7	188.0	193.3	204.9	217.2
Current Revenue	170.8	204.4	176.8	175.2	-	-	-	-	-	-
Capital Revenue	37.5	76.8	39.3	57.8	-	-	-	-	-	-
Expenditures	182.7	194.4	239.4	223.0	254.7	254.7	258.0	246.4	237.2	230.5
Current Expenditure	135.9	160.6	177.4	175.9	-	-	-	-	-	-
Capital Expenditure & Equity	46.8	33.8	62.0	47.1	-	-	-	-	-	-
Budget Balance	25.7	86.9	-23.2	10.0	-3.0	-60.0	-70.0	-53.1	-32.3	-13.4
Budget Balance As % of GDP	2.2	6.6	-1.9	0.8	-0.2	-4.7	-5.5	-4.1	-2.4	-1.0

** fiscal years begin in April; e/f = BMI estimate/forecast. Sources: Hong Kong Treasury, BMI.*

a reduction in the minimum wage of foreign domestic helpers by HKD400 with a corresponding tax rise for their employers. Sluggish economic growth and an ageing population have also meant revenue growth from other taxes (such as salaries) has been weak while social-security expenditure has risen. Although it is widely accepted that the government must stabilise revenue and broaden the tax base, the latest budget has come under severe criticism and dented the government's already-waning popularity. The middle classes were hit hardest by the changes announced in the budget with rising taxes on income, property and cars. With this income group already hit hard by negative equity, the tax rises may well put a lid on domestic demand-led growth going forward. Reductions in benefits and rises in income taxes also hit lower income households.

The success or otherwise of these measures is partly dependent on overall economic prospects. As Hong Kong is a high open economy, this is dependent on the global economy. **BMI** expects that the measures announced will go some way towards reining in the deficit as economic growth continues to be pulled forward by a vast surplus of services exports. The lingering dependence on property taxes and ongoing reluctance to impose a value-added tax will however mean that the government is unlikely to balance its books by 2006-07.

Monetary Policy

More Deflationary Gloom Ahead

Hong Kong's 20 year-old pegged exchange-rate system will continue to be a source of controversy going forward. The link to the US dollar at HKD7.8/US$ is undoubtedly putting the already-gloomy economy under strain. Competitiveness has been eroded (by barring depreciation and keeping export prices high), and deflation exacerbated (as import prices remain low), leaving asset prices to take the full flack of the economic slowdown. Removing the currency peg and allowing the currency to depreciate could alleviate some of this pain. However, **BMI** does not believe that the authorities will do so, neither does it believe they should.

Hong Kong's ongoing integration with the mainland and the vast differentials between land and labour prices suggest that more deflation is in store.

The Hong Kong Monetary Authority (HKMA), the territory's de facto central bank, is responsible for the stability of the currency (the Hong Kong dollar), the banking system and the financial system. As the government operates a fixed link against the US dollar that is written into law –a regime known as a currency board –the HKMA's main role is to keep the currency stable, and manage the Exchange Fund that provides the back-up for its currency peg, (Hong Kong's official foreign exchange reserves). This exchange-rate regime requires that the monetary base be fully backed up by foreign exchange reserves at the chosen exchange rate.

CONSUMER PRICE INDEX AND INTEREST RATES

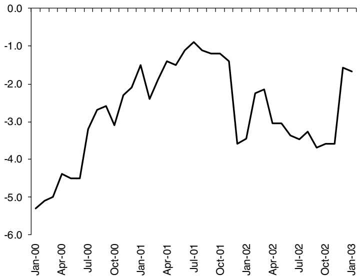
	1996	1997	1998	1999	2000	2001	2002	2003f	2004f	2005f
CPI (% y/y, an.avg)	6.3	5.8	2.8	-4.0	-3.8	-1.4	-3.0	-0.3	-0.5	0.5
Lending rate (%, an. avg)	8.5	9.5	9.0	8.5	9.5	5.1	5.1	5.0	6.0	7.5

f = BMI forecast. Sources: Hong Kong Monetary Authority, BMI.

The currency peg it not the cause of Hong Kong's economic pain. The prolonged bout of deflation –consumer prices dropped year on year for the 51st c onsecutive month in January –is largely due to a drop of more than 60% in property prices since 1997. Falling rents and property prices have accounted for around half of the 12% reduction in consumer prices since 1998. The property crash was sparked by a combination of an end to the artificial under-supply of land, and the onset of a regional financial crisis that pushed several regional economies into a protracted recession. This under-supply created a speculative bubble, pushing prices artificially high, and would have most likely unwound anyway. Moreover, Hong Kong's ongoing integration with the mainland, and the vast price differentials for land and labour that exist between the two regions, indicate that prices have further to fall. In terms of competitiveness effects, this city is again shedding little more than cyclical froth built up during the 1990s. So while a currency depreciation may provide temporary relief, it will not address Hong Kong's fundamental problems. Moreover it could well erode the stability that has successfully allowed the territory's financi al sector to flourish.

Deflation To Persist

CPI , % y-o-y



Source: Census & Statistics Department

Hong Kong's currency board implies that interest rates must move roughly in line with those in the US. If interest rates fail to move upwards (downwards) with those in the US, an outflow (inflow) of capital could result that may eventually jeopardise the fixed exchange rate. With US economic prospects deteriorating during recent months, it is now much less likely that interest rates will rise. **BMI** has now downgraded its 2003 forecast for real GDP (see Global assumptions) which bodes ill for Asian exporters like Hong Kong.

Exchange-Rate Policy Will Follow China

Regardless of the merits or otherwise of Hong Kong's fixed exchange-rate system, policy will follow that set in Beijing.

Regardless of the merits or otherwise of Hong Kong's exchange r ate peg to the US dollar, the authorities face the intractable problem that exchange rate policy is linked to Beijing. Although the Hong Kong Monetary Authority technically has complete control over monetary policy, a change in the exchange rate would put serious pressure on China to follow suit. The international community has called for a change in both regimes, with a preponderance of pressure on China given its larger export base and growth potential. On the other hand, the currency board arrangement is a vital source of stability both for Hong Kong's status as an international financial hub and China's rap idly changing economy. With an immature financial sector, which has far to go before it will be able to liberalise interest rates or eventually the capital account, **BMI** does not expect any change to China's currency peg during our forecast period ending in 2005. In turn, **BMI** does not expect any change to Hong Kong's currency peg. Furthermore, the viability of Hong Kong's (or China's) pegged exchange-rate is not under question as foreign exchange reserves are vast, at around US$110bn, or six months of import cover.

EXCHANGE RATE

	1996	1997	1998	1999	2000	2001	2002	2003f	2004f	2005f
HKD/US$ (eop)	7.7	7.7	7.7	7.8	7.8	7.8	7.8	7.8	7.8	7.8
HKD/US$ (an. avg)	7.7	7.7	7.7	7.8	7.8	7.8	7.8	7.8	7.8	7.8

f = BMI forecast; eop = end of period. Sources: IMF, BMI.

Balance Of Payments

The Future As A Middleman

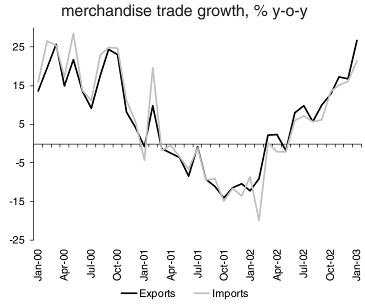
The future of Hong Kong's status as a gateway into (and out of) China is uncertain now that China belongs to the World Trade Organisation (WTO) and is bound by its rules regarding trade and investment liberalisation. Moreover, as Taiwan too has now joined the WTO, direct trade and investment links between the two sides will continue to gather pace during the coming years despite the political hurdles that remain in place. While Hong Kong may eventually lose out in goods trade between the two nations, its attraction as a base to invest in China will remain as the legal and regulatory environment in the mainland is severely underdeveloped. For the time being, this will be enough to offset any losses through trade.

Hong Kong's future as a middleman for trade between China and Taiwan is uncertain as both are now under fair trading obligations imposed by the WTO.

Both China and Taiwan joined the WTO just over a year ago and the impact of this can be seen clearly in Taiwanese trade data. In order of top trading partners, Taiwanese exports expanded in 2002 by 14.5% to Hong Kong, -3.2% to the US, -6.0% to Japan, 109.8% to China and 8.1% to Singapore. China could easily overtake Japan as Taiwan's third biggest export market in 2003, although the extent to which Hong Kong would lose out from this is as yet unclear.

On The Up

merchandise trade growth, % y-o-y



Source: Census and Statistics Department.

Since 1999 Hong Kong's re-exports to China have increased as a percentage of total re-exports, reaching 40% of total re-exports last year. The proportion of domestic exports going to China has followed a similar trend apart from a slight dip in 2002 to 31.6% from 32.3% in 2001. With re-exports accounting for 91.6% of total merchandise trade in 2002, it is here that Hong Kong would be hit hardest by any reduction in its role as middleman. However, it seems that China's rapid GDP and import growth may well be enough to sustain a higher level of imports both directly from Taiwan and from Hong Kong.

Traditionally Hong Kong runs a trade deficit that is offset by a substantial surplus on the services account to keep the current account in surplus. This suggests that as long as Hong Kong can maintain its status as an international financial hub the services surplus will continue to offset any potential deterioration in the trade deficit. **BMI** expects that Hong Kong will in fact see deterioration in its trade balance as export growth remains moderate (single digit) compared with historic rates, while import growth picks up. The services surplus will however continue to boost the current account surplus as China is a long way from competing in high-value added financial services exports.

BALANCE OF PAYMENTS (US$BN)

	1996	1997	1998	1999	2000	2001	2002e	2003f	2004f	2005f
Goods exports (fob)	-	192.2	175.8	174.7	202.5	190.9	200.3	215.0	232.0	245.0
Goods imports (cif)	-	-209.5	-183.7	-177.9	-210.7	-199.2	-206.1	-228.9	-248.7	-267.5
Trade balance	-	-17.3	-7.8	-3.2	-8.2	-8.3	-5.8	-13.9	-16.7	-22.5
Net services income and transfers	-	12.0	12.3	15.2	17.3	20.6	23.6	24.0	28.8	33.3
Current account balance	-	-5.3	4.4	12.0	9.1	12.3	17.8	10.1	12.1	10.8
Current account (% of GDP)	-	-3.1	2.8	7.8	5.5	7.5	10.9	6.1	7.0	6.0

e/f = BMI estimate/forecast; Sources: Census and Statistics Department - Hong Kong SAR, BMI.

chapter 3 Key Economic Sectors

Introduction

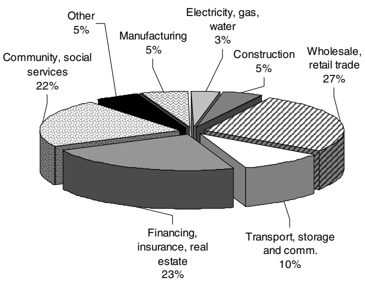
A Balancing Act With Beijing

Hong Kong must maintain its unique advantages such as its sound legal and regulatory system to ensure that it maintains its status as a international financial hub. But it must also maintain close ties with the mainland to maintain strong growth in merchandise trade.

With almost no natural resources, Hong Kong's economy is overwhelmingly dominated by its service sector. The emergence of the Chinese economy and its commitments to continued trade and investment liberalisation from accession to the World Trade Organisation pose great challenges to Hong Kong during the coming years, both for its manufacturing and service sectors. The Chinese city of Shanghai, with its blooming trade links through its proximity to the Yangtze river delta, is threatening to usurp Hong Kong's role as an entrepôt for regional trade. Moreover, many analysts see Shanghai as a very real contender in the race to become Asia's premier international financial centre. Shanghai's financial district has expanded at a rapid pace during the past few years, with the number of foreign banks and regional head offices up sharply from a few years ago. The worry is that Hong Kong's service sector, and economic lifeline, will lose out to its giant sibling to the north. **BMI** does not expect this to be so, at least not in the foreseeable future.

Service Sector Dominates

Hong Kong - real GDP by sector



Source: Census and Statistics Department - Hong Kong SAR.

In Hong Kong the service sector accounts for around 85%-90% of real GDP, compared with just 5% for the manufacturing sector. This is a marked difference from the Chinese economy where the services and manufacturing sectors account for around 30% and 50% of real GDP respectively. Given Hong Kong's economic structure, any decline in its service sector would see growth hit hard. However, China's financial sector, while undoubtedly gaining steam, is unlikely to rival Hong Kong's anytime soon. And by soon we mean decades rather than years. **BMI** expects Hong Kong will be able to maintain its status as an international financial centre for the foreseeable future. This assumption is based on a combination of the territory's unique advantages (and sound legal and regulatory system and low corruption) and the intrinsic disadvantages apparent in the mainland (a fragile banking system, rampant corruption and a lack of separation between the ruling Communist Party and the legal system). Moreover, while Hong Kong's manufacturing sector accounts for only a small proportion of GDP it is still expanding, primarily in terms of port facilities to cope with the increased cargo coming from China's Pearl river delta region. While this will not offset any losses that the territory may experience from the emergence of Shanghai as a financial centre, it is important so as to maintain Hong Kong's re-export base and the overall economic linkages between Hong Kong and the mainland. While Hong Kong must ensure that its low corruption and sound legal system remain intact under Chinese rule, it must also ensure that it benefits from the mainland's increased manufacturing base and investment opportunities.

Despite a combination of a cyclical and structural downturn that has plagued the economy for the past few years, Hong Kong's financial sector and therefore wider economy remains fundamentally sound. The recent weakness in the US dollar has allowed Hong Kong to regain some of its competitiveness although given the large devaluations in several other Asian economies during the 1997-98 financial crisis, the currency remains more expensive than most. But perhaps the biggest worry going forward is the global trade cycle. With the outlook for the US economy increasingly gloomy, Hong Kong's highly open economy may be faced with a dearth of demand in 2003. The highly lucrative re-export market which is dominated by the mainland means that Hong Kong cannot afford to distance itself too much from China.

Energy

Overview

Population growth and increasing numbers of vehicles on the roads of Hong Kong suggest rising oil consumption and refined products imports.

Hong Kong has no indigenous energy resources. It produces no oil, natural gas or coal. It has no oil refineries. Service stations are operated by international oil companies (IOCs) and supplied with imported gasoline and diesel. There is limited thermal power generation capacity, but the bulk of electricity is imported from mainland China. Some natural gas is imported for power generation use, but Hong Kong is dependent largely on locally-produced synthetic town gas and liquefied petroleum gas (LPG) supplied by foreign oil refiners. Town gas accounts for 74% of the total fuel gas sold in energy terms and LPG for 26%. Town gas is manufactured in plants at Tai Po and Ma Tau Kok, both using naphtha as a feedstock. They have output capacities of 8.4mn and 2.2mn cubic metres per day respectively. The gas is supplied through an integrated distribution system to the customers. There is a growing emphasis on energy efficiency and the environment, which may offset the higher use of energy resulting from population growth and additional cars on the roads of Hong Kong. At present, electricity is generated by three power stations, namely, Castle Peak (4,108MW), Black Point (1,875MW) and Penny's Bay (300MW), with the total installed capacity being 6,283MW. **CLP Power** has contracted to purchase about 70% of the power generated at the two 984MW pressurised water reactors at the Guangdong Daya Bay Nuclear Power Station, some 50km from Hong Kong. It also has the right to use 50% of the 1,200MW capacity of Phase 1 of the Guangzhou Pumped Storage Power Station at Conghua. **Hongkong Electric** supplies electricity to Hong Kong Island, Ap Lei Chau and Lamma Island. Electricity is supplied from the 3,305MW Lamma Power Station. There are two major thermal coal users in Hong Kong, CLP Power and Hongkong Electric, that make up around 98% of Hong Kong's import coal demand. **Green Island Cement** accounts for the rest. Hong Kong's imports of coal are around six million tons per annum, and have been falling steadily.

HONG KONG ENERGY SECTOR: HISTORICAL DATA & FORECASTS

	1991	1999	2000	2001	2002e	2003f	2004f	2005f
Oil consumption, '000 b/d	-	354.8	350.0	352.0	355.0	365.7	376.6	387.9
Oil Imports, '000 b/d	-	354.8	350.0	352.0	355.0	365.7	376.6	387.9
Oil Exports, US$mn	-	-2,058	-3,092	-2,973	-3,045	-2,669	-3,024	-3,115
Gas consumption, bcm	-	-	-	0.6	0.7	0.8	0.8	0.9
Coal Consumption in mn tonnes of oil equivalent	9.7	6.4	6.1	6.0	6.0	6.0	6.0	6.0

Source: BMI Research

Market Structure

Electricity is supplied by CLP Power and The Hongkong Electric Company Limited which are investor-owned. CLP Power supplies electricity to more than 1.9mn customers in Kowloon and the New Territories, including Lantau, Cheung Chau and most of the outlying islands. The Castle peak, Black Point and Penny's Bay power stations are owned by **Castle Peak Power Company** (CAPCO), 60% of which is owned by **ExxonMobil** and 40% by CLP Power. CLP Power and Exxon have built a thermal power station at Black Point, Western New Territories. The 2,500MW station is fuelled by natural gas from offshore Hainan Island and is currently being commissioned. Hong Kong is planning to construct a new power station at an extension to its Lamma Power Station to meet future electricity demand. The first 300MW-generation unit is expected to come into operation in 2004. The interconnection of the company's transmission system with that of the CLP Power by a cross-harbour link has an installed capacity of 720MVA enabling the provision of emergency support to each other during generator failure and hence reduces potential loss of supply to customers.

Town gas is manufactured and distributed by **The Hong Kong and China Gas Company**. The principal uses of town gas are for cooking and water heating for domestic customers and catering and heat processing for commercial and industrial customers. There is an even split in gas consumption between domestic and commercial/industrial use. LPG, supplied by oil companies such as **Shell**, **Mobil**, **Esso**, **Caltex** and **China Resources**, is imported into Hong Kong by sea and stored at five terminals on Tsing Yi before being distributed to some 0.8mn customers. About 55% of total sales is supplied in cylinders by some 300 distributors. The government has encouraged the installation of piped gas supply in new buildings to discourage further growth in the use of LPG cylinders in domestic dwellings. The percentage of domestic dwellings now using cylinders has fallen to around 25%.

Trends & Latest Developments

Oil/Gas

In October 2002, **Hong Kong Oil and Petrochemical** unveiled plans to build a US$5bn-US$8bn energy project, including an oil refinery and power plant in Hong Kong. The refinery would supply oil products to the Hong Kong and southern China markets. There is no oil refinery in Hong Kong –the country uses oil supplied by foreign oil majors, including Shell. The project, which requires Hong Kong government approval, would create 20,000 jobs and include an oil storage facility. It would be developed in two phases to be completed in 2004 and 2008. Memoranda of Understanding are already signed with several partners for the project, including Chinese oil giants **PetroChina** and **Sinopec**.

KEY PLAYERS: HONG KONG ENERGY MARKETS

Sector	Company	Sales (US$m)	Mkt share/ % of capacity	State/private
Downstream gas	HK & China Gas	879	100	public
Downstream oil	IOCs	n/a	100	
Electricity	CLP Power	930	71	public
	Hongkong Electric	1,393	29	public

Source: BMI Research. n/a = not available

Forecasts

Population growth and increasing numbers of vehicles on the roads of Hong Kong suggest rising oil consumption and refined products imports. While government initiatives aim to reduce the use of cylinder LPG, demand will remain high. The rate of oil products demand growth and imports should therefore closely match the underlying GDP trends, although a drive towards energy conservation may moderate the market's expansion. Natural gas is still only viewed as a power generation fuel, but more will be consumed as gas-fired capacity expands. A gradual move towards gas in power generation probably means no further expansion of Hong Kong's coal requirement.

Pharmaceuticals

Market Structure

While the Hong Kong pharmaceutical market is small, it is sophisticated, as it is receptive to the latest products. Advanced drugs, however, are largely imported, with the well-established local manufacturing industry geared towards low-cost generics, traditional Chinese medicines and consumer health products. Over-the-counter (OTC) products are popular, largely as a result of a lack of compulsory health insurance.

The constant demand for the latest, and most expensive products, continuing economic growth and an ageing population, will sustain steady growth in the Hong Kong pharmaceutical sector over the short term.

Market growth has tended to decelerate in recent years. The government is a significant market force, accounting for over 50% of hospital pharmaceutical purchases. Per capita expenditure in Hong Kong is among the highest in Asia, at around US$129 in 2002. Per capita spending in China was US$11 in 2002.

Re-exports

Despite falling levels in recent years, the re-exporting of pharmaceuticals is a major area of trade in Hong Kong, largely as a result of the country's traditional role as a regional trading centre. The majority of re-exports are bound for China (60%). Hong Kong's position also provides a route for products of lesser quality out of the region, largely from China and Taiwan. Hong Kong's re-export trade is the cause of some international concern, especially regards the infringement of intellectual property rights.

HONG KONG PHARMACEUTICAL SECTOR: HISTORICAL DATA & FORECASTS

	1996	1997	1998	1999	2000	2001	2002e	2003f	2004f	2005f
Drug expenditure at consumer prices (US$mn)	650	675	675	725	775	825	875	925	975	1,025
Drug expenditure per capita (US$)	101	104	103	110	115	123	129	135	139	145
Drug expenditure % GDP	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.6
Exports (Total) (US$mn)	120	101	100	93	103	130	125	130	135	155
Re-exports (Total) (US$mn)	880	845	750	700	600	585	570	580	570	550
Imports (US$mn)	1,200	1,100	1,020	940	890	835	825	815	805	795

Source: UN, Hong Kong Department of Health

Latest Trends/Development/Regulatory

Sector activity primarily surrounds the issue of patent protection, in particular international drug industry concern of the level of protection afforded to products in Hong Kong. Dispute centres on the lack of enforcement of patent legislation despite Hong Kong being a signatory to all major intellectual property agreements. The US drug association, PhRMA, has identified two main areas of concern: Department of Health approval of generic products without referral to the original product's patent, and the lack of registration needed for products entering Hong Kong which are intended for re-export, leading to the presence of non-approved drugs on the market.

Regarding the former, PhRMA refers to the approval of generic compounds that it alleges infringe the patents of the originators (in particular a case of 14 compounds in 1999). The international industry, through the Hong Kong Association of the Pharmaceutical Industry (HKAPI), has lobbied the Hong Kong drug authorities to implement legislation to close any loopholes. These efforts, however, have had little effect on halting the practice.

In terms of the latter, PhRMA has expressed concern over Hong Kong's position as a regional distribution centre, alleging that some imported pharmaceutical products are entering the market illegally. The association points towards inadequate registration procedures: 'although imports are recorded upon entry, if they are officially designated for re-export (mostly to China), there is no requirement that they be approved in Hong Kong, or for the presentation of records on whether, and in what quantity, the shipments have left

HKAPI MEMBERS	
A Menarini	Janssen Pharmaceutica
Abbott Laboratories	Leo Pharma HK
Alcon HK Ltd	Lundbeck HK
Allergan Asia Ltd	Merck Apotec Ltd
AstraZeneca HK Ltd	Merck, Sharp & Dohme (Asia) Ltd
Aventis Behring Asia Pacific Ltd	Novartis Pharma (HK) Ltd
Aventis Pasteur Organon (HK) Ltd	Otsuka Pharmaceutical (HK) Ltd
Aventis Pharma Ltd	Pfizer HK Ltd
Baxter Healthcare Ltd	Pharmacia Asia Ltd
Bayer China Co Ltd	Procter & Gamble HK Ltd
Beaufour Ipsen Int	Reckitt Benckiser HK Ltd
Berna Biotech Ltd	3M Pharmaceuticals
Boehringer Ingelheim (HK) Ltd	Roche HK Ltd
Boots Company (Far East) Pte Ltd	Sankyo Company Ltd
Bristol-Myers Squibb (HK) Ltd	Sanofi Synthelabo HK Ltd
Byk Gulden	Schering (HK) Ltd
Daiichi Pharma Asia Ltd	Schering-Plough
Eli Lilly Asia	Schwarz Pharma (HK) Ltd
Ebewe Arzneimittel	Servier HK Ltd
Eisai (HK) Co Ltd	Solvay Pharma
Ferring Pharma Ltd	Takeda Chemical Industries (Taiwan) Ltd
Fresenius Kabi HK Ltd	TRB Chemedica HK Ltd
Fujisawa HK Ltd	UCB Pharma
Galderma HK Ltd	Wyeth (HK) Ltd
GlaxoSmithKline	

Source: BMI Research

the S.A.R'. PhRMA claims it is this state of affairs that leads to the diversion of substantial quantities of non-approved products to the local market, thus eroding the market exclusivity of patented medicines of multinationals in Hong Kong. While international concern remains, little is being done to resolve the matter.

PhRMA has also raised the issue of market access barriers to patented products, referring, in particular, to the length of the drug approval process. The association claims that in some circumstances products approved by the Pharmacy and Poisons Board are taking up to six months to be approved by the Legislative Council, effectively shortening the product's patent life by this length of time.

Company Rankings, Strategy & Deals

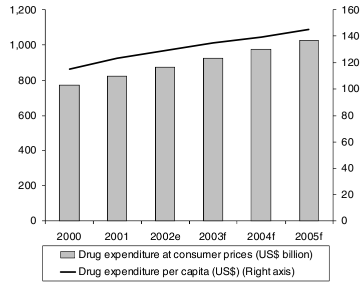
Multinationals are represented by The Hong Kong Association of the Pharmaceutical Industry (HKAPI). Members account for around 70% of prescription sales. Products are almost entirely imported, with very little manufacturing taking place in Hong Kong.

In October 2002, Biometrics Technology Ltd, a unit of Hong Kong company **MAXX Bioscience Holdings**, announced its intention to acquire **Joy Route Development Company of Monaco** for US$5.1mn. Joy Route owns a 70% stake in **Best Express Worldwide** and the two companies are engaged in research and manufacture of cardiovascular and cerebrovascular preparations.

In August 2002, UK pharmacy and healthcare company **Boots** announced it had signed an in-store joint venture agreement with **AS Watson**, the pharmacy division of Hong Kong's Hutchison Whampoa. The new agreement provides Boots with selling space in Hong Kong branches of AS Watson. This is in addition to an existing agreement covering 40 stores in Taiwan.

Steady Growth Ahead

Drug Market Trends, 2000-2005



Source: BMI

Forecasts

The pharmaceutical market in Hong Kong can be expected to continue to grow steadily in the short term. Growth will be driven by a number of factors, including: the advanced nature of the Hong Kong market, with a constant demand for the latest, and most expensive products; continuing economic growth, with the economy performing particularly strongly in Q4 2002; and an ageing population, with the percentage of over 65s forecast to follow a steady upward trend in the short term. Hence, the market should reach around US$1.0bn at consumer prices by 2005. Imports, while falling moderately, are likely to continue to remain high, largely as a result of the demand for advanced products and because Hong Kong re-export trade is a major means by which China gains access to leading products. Re-exports levels can be expected to fall slightly, largely as China becomes more open about importing, especially from the West, and uses the Hong Kong less for this purpose.

There are factors, however, that could limit growth: the global economic ramifications of the US led war against Iraq, and the increasing erosion of Hong Kong's autonomy by China. While uncertainty surrounds the former, the latter has been taking place gradually over the last five years. The pace of erosion is likely to have a considerable effect on the country's political stability, and hence, market development.

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