

BPF's Views and Recommendations on the 2009/10 Government Budget
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A Silver Lining?

- 1 The financial tsunami has overwhelmed the global capital markets, and no one could say for sure that we have seen the worst of the series of worldwide panics that have buffeted the global financial system since mid-September. It may be small consolation, but we have reasons to be thankful that our financial system had not been overleveraged going into this tumultuous period thanks to the foresight of our regulators in putting sensible limits on real estate lending and maintaining prudent bank capital ratios. Given that Hong Kong has highly open financial markets with no capital controls, it has naturally borne the brunt of the global financial contagion. But, the absence of excess leverage has helped soften the impact of the deleveraging process that is proving to be extremely punishing on overextended financial systems elsewhere. The fly in the ointment, however, is that of the Lehman mini-bonds debacle, which calls for stronger regulatory oversight to prevent the marketing of esoteric financial products to an unsuspecting public.
- 2 Hong Kong's reputation as a financial center was reinforced when we came out of the Asian financial crisis of 1997-98 with an intact currency regime. While the damage inflicted on the global financial system by the current crisis could take years to heal, the silver lining is that Hong Kong could again emerge with its role as an international financial center strengthened, not weakened. The financial tsunami has highlighted the pitfalls of a closely integrated international financial system, where countries with highly open financial markets have few means of shielding themselves from systemic contagion. Yet through this painful lesson the value of Hong Kong to China has become ever more apparent, in that we offer a financial system, fully transparent to Beijing, through which China could readily tap into the global capital markets, at the same time that it provides a natural firewall that could buffer the Mainland economy from global financial contagion. In a nutshell, the financial tsunami has underscored Hong Kong's unique advantages in serving as China's leading international financial center. This is

therefore a time when we should be actively pursuing opportunities to strengthen and broaden this role including, for example, positioning Hong Kong as the preferred captive insurance domicile for mainland companies and developing our bond markets.

Fiscal Policy

- 3 At the reading of the Government Budget in Legco last February, the projected budget surplus for 2007/08 was a record \$115.6 billion. This year the Budget is being stood on its head, with every indication pointing to a massive deficit. The huge swings in the Budget point to a fundamental shortcoming with our revenue system--that of highly unstable tax receipts and other major revenue sources including the land premium, stamp duty, and investment income. Long term, the revenue system should be overhauled to produce more stable sources of government receipts. But before any major tax reform could be put in place, we must in the meanwhile manage our fiscal policy more rationally.
- 4 Specifically, recent events should dismiss for good the erroneous notion that Hong Kong has no need for large fiscal reserves. To start with, fiscal reserves are needed to finance budget deficits. And Hong Kong is no stranger to deficits, as we ran operating deficits in seven of the past ten fiscal years, and consolidated deficits in five of those years (98-99 to 07-08), and we are sure to return to deficits in the current fiscal year. Secondly, the fact that we are now undergoing the second severe external financial shock in a decade underscores the need for adequate reserves to weather recurring financial crises.
- 5 Economics textbooks tell us that if fiscal policy is to be used as a macroeconomic stabilization tool, then it should be used in a counter-cyclical manner, i.e., the government should cut taxes and raise spending to provide a boost during economic downturns, and do the opposite when the economy is booming. However, the way that fiscal policy has been conducted in Hong Kong has generally run counter to this basic principle. There are historical reasons for our unusual tradition, for unlike many advanced countries that regularly resort to deficit spending, Hong Kong has generally aimed to run a surplus or at least balanced budget. Hence, when the economy is good and government finances show a surplus, taxes and levies are refunded or reduced and government spending raised, whereas when the economy is poor and the government

finances are tight, the government is under pressure to raise taxes and levies, and cut spending.

- 6 This kind of fiscal tradition is an anomaly and should be changed, for what it does is add fuel in times of boom and further undercut the economy during downturns. In the future, budget surplus should in general be added to fiscal reserves, so that the government could save for a rainy day and provide the necessary economic stimulus during downturns. The most recent budget cycle is a good illustration as to why our fiscal policy needs rethinking. Last year when the economy was booming and a record budget surplus was anticipated, all public attention was on how the government would hand out fiscal goodies. That kind of fiscal populism rarely makes for good policy, and indeed if more of last year's surplus had been set aside to build up fiscal reserves, the Government would be more flexible in tackling the recession today. In fact, in the current crisis, the very fact that the prospects of tax increases had even been raised is an anomaly, for this is certainly not the time for contractionary fiscal policy. On this point too, it must be emphasized that although the Government has of late correctly pledged not to raise taxes, the Government must resist all temptation to tighten its grip on tax collection in the face of budget shortfalls. If anything, the opposite action should be taken at present, as there is ample room for tax relief for the hardest hit business sectors.

Taking a Second Look at Government Bonds

- 7 Hong Kong has a very shallow government, or "sovereign", bond market. The reason given in the past was that there was really no market demand for government bonds. But recent events show that there could be strong, emerging public interest in government bonds as a store of value and a safe investment. In addition, government bonds could become a useful tool of fiscal policy.
- 8 The recent financial panic has raised an all-important question in the mind of the public: where is a safe place to put my money? When even the safety of bank deposits at large international banks is called into question, few viable options remain. Recent news reports about the booming sale of house safes so that people could stash away large amounts of cash show that there is unmet market demand for the safety of one's savings. Government bonds could help meet that demand. Since the government is seen to be the lender of last resort, and the

ultimate backer of the financial system, it follows naturally that there would be a demand for direct “sovereign” obligations backed by the full faith and credit of the government. Indeed, this demand could only grow over time, as pensions and retirement savings build as a result of population aging and the fact that people are living longer and spending more years living off their retirement savings.

- 9 Development of a government bond market would also bolster the overall bond market in Hong Kong and our status as a financial center. It would also fit in well with the recent Beijing policy to further develop the RMB bond market in Hong Kong and to establish the SAR as a center of RMB settlement for trade purposes.
- 10 Government bonds could also serve as a useful tool that adds to the overall flexibility of fiscal policy management. Thus, when necessary government spending could be financed with bond issues as well as a drawdown of fiscal reserves, and budget surpluses could be used to retire bond issues as well as being added to fiscal reserves. In fact, the issue of government bonds should not be equated with deficit spending, for the government could well issue bonds and add to fiscal reserves at the same time. Finally, it goes without saying that the issue of government bonds should be conducted within the overall fiscal policy framework dictated by the Basic Law that bars persistent deficit spending.

The Crisis in PRD Manufacturing

- 11 Most Hong Kong manufacturers have their production facilities located in the Pearl River Delta (PRD), yet the severe difficulties they are facing have a huge impact on Hong Kong. The reason is that manufacturing and the economic activity it generates in the form of export-import trade, logistics, and related industries that takes place in Hong Kong accounts for no less than 25% of our GDP, making it by far our most important GDP component.
- 12 Our manufacturers have long suffered the problems of a rising RMB, escalating costs, and unfavorable policy change on the Mainland, especially the Labor Contract Law. But the big blow has come in recent months in the form of the credit crunch, weak export orders, and heightened credit risks posed by financially strapped buyers. The Government should be highly commended for putting much effort recently into helping our manufacturers in dealing with their immediate problems. However, PRD manufacturing faces long-term challenges and a sustained effort is required going forward to prevent widespread factory closures

that could have severe repercussions on Hong Kong's economy. Although for the weaker manufacturers to close up shop is part of the normal process of attrition, the greater danger is that even the healthy manufacturers could fall by the wayside in the coming months because of the severely distorted market environment created by the global credit crunch.

- 13 PRD manufacturing cannot reverse the current sharp decline on its own until we see a thaw in the credit crunch and a rebound in export orders. Unfortunately both of those conditions seem unlikely to emerge in the foreseeable future. But there are two things that the Government could do to help. First, as local and foreign banks alike in Hong Kong are hobbled by the credit crunch, the Government should work actively with the Mainland authorities to help our manufacturers in the PRD gain access to lending from the Mainland state banks.
- 14 Secondly, the Government should move to lighten the tax burden on PRD manufacturers. One area of concern is that, due to a shift in Mainland policy, many PRD manufacturers have been switching to adopt *import processing* in lieu of the traditional *contract processing*. But the current Hong Kong tax treatment is much less favorable for the former. In order to facilitate our manufacturers in completing the necessary adjustment in their mode of operations to meet the new Mainland policy, the Government should move to grant *import processing* essentially the same tax treatment that currently applies to *contract processing*. A second area of concern is that in the past couple of years the Government has tightened its tax grip on PRD manufacturers, particularly through the use of the "totality of facts" approach in the application of the source rule on profits, and expanded use of its discretionary power in reopening tax cases up to their six-year limits. In the current environment, the Government's priority should clearly be on helping manufacturers survive rather than increasing the tax bite on them.

Identifying Impetus to Growth

- 15 With the end of easy credit and excess leverage, it appears that the global economy has now entered an era of slower growth. In these circumstances, it is imperative for Hong Kong to look hard for economic impetus to sustain growth. Otherwise Hong Kong could be faced with a stagnant or even declining living standard in the coming years.
- 16 There has not been a lack of suggestions for Hong Kong to pursue new areas of

growth, some of them involving the creation of brand new industries that make use of cutting edge technology. But there are in fact existing industry sectors in Hong Kong with yet untapped potential. These industries could deliver much more immediate results in bolstering economic growth if quick and decisive actions are taken. Infrastructure is one notable example, and on this note, the public is right to be wondering impatiently as to why the much heralded Ten Infrastructure Projects are taking so long to be implemented, when they are needed urgently to jumpstart an economy in recession.

- 17 Another “old” industry sector that could help sustain growth is the convention and exhibition industry, in which Hong Kong enjoys clear leadership position in the region. Unfortunately the future of this important industry which is a proud symbol of Hong Kong’s status as an international business hub is under threat due simply to a lack of space. International fairs and exhibitions have been growing in size, and our competitors in the region have invested heavily in facilities to serve this lucrative business, but not Hong Kong. If nothing is done, by 2015 Hong Kong would lose many of the major fairs that it currently hosts and the billions of dollars in revenue that go with them. While the Policy Address has pledged to move on with Phase III of the Hong Kong Convention and Exhibition Centre (HKCEC), there is lingering uncertainty about this project. Yet time is exactly the kind of luxury that the industry simply cannot afford.

Minimum wage

- 18 In his Policy Address, the Chief Executive has given the green light to proceed with the legislative work to introduce a minimum wage. Given that a minimum wage is to be introduced, there is no reason for this process to be delayed just because the economy is presently in a downturn, as some have suggested. After all, the legislative process would take time and by the time the minimum wage is ready for implementation the economy could well be in a completely different phase of the business cycle. Besides, while there are strong social justice arguments for a minimum wage, its actual level must be set only after the most careful deliberations so as to minimize disemployment and other prospective adverse effects. To proceed with this discussion during a recession when the public mood is somber would actually provide the proper context for debate, and it is ultimately conducive to a judicious choice of the minimum wage level.

Healthcare Reform

19 The latest financial downturn highlighted the vital importance of stable funding for health care services. The long overdue restructuring of our health care system now finally underway will at best take several years to take full effect. It must not be impeded due to any delays in putting in place new long term supplementary funding attributable to the current unfavorable economic climate. Allocating resources for this should be given the highest priority.

Miscellaneous Issues

20 The BPF greatly applauds the Government's decision to inject \$1 billion in last year's Budget for the Samaritan Fund. But since the Samaritan Fund plays an indispensable role in augmenting our public healthcare system, it justifies a more permanent and predictable funding source. An annual subvention or other funding scheme of a recurring nature is needed for the proper operation of the Samaritan Fund.

21 As the commercial property market has cooled down in the face of the financial crisis, this perhaps creates a good opportunity to deal with a housecleaning issue, namely the headquarters of the Hong Kong Monetary Authority. The acquisition of the HKMA office premises by the Exchange Fund was an anomaly and ownership should be transferred to The Financial Secretary Incorporated. As market prices have come back down to the levels more comparable to the purchase price paid by the Exchange Fund this may be the opportune time for action.

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