

**Commission on Strategic Development
Committee on Economic Development and
Economic Cooperation with the Mainland**

**The Hong Kong economy: developments since 2003,
and a review of the structural and cyclical issues impacting on
the economy and the labour market**

INTRODUCTION

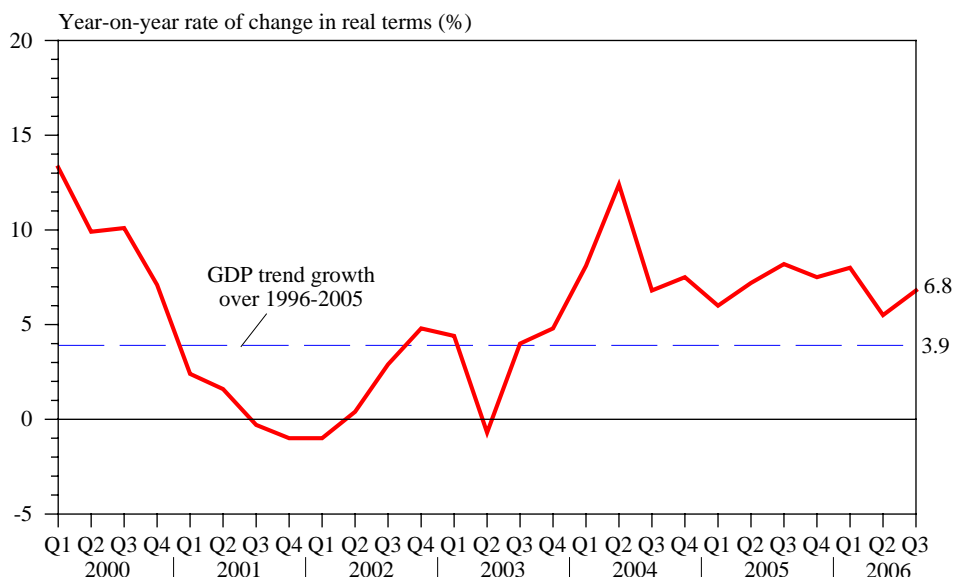
This paper takes stock of developments in the Hong Kong economy in the current upturn since mid-2003, examines the various structural and cyclical issues at play and how they have been shaping the economy and the labour market, including the economic restructuring process, employment and skill mismatch issues, and income distribution.

MACROECONOMIC DEVELOPMENTS SINCE 2003

Strong and broadening upturn

2. The Hong Kong economy has been on a strong upturn since it emerged from its cyclical trough in mid-2003. Following robust real GDP growth of 8.6% in 2004 and 7.3% in 2005, the economy grew briskly further by 6.8% in the first three quarters of 2006 (*Chart 1*).

Chart 1 : Economic growth distinctly above trend over the past 12 quarters



3. The economic recovery since 2003 was initially driven by growth in exports. Exports of goods and services taken together recorded double-digit growth for all three years in 2003, 2004 and 2005. They increased by a further 9.5% year-on-year in real terms in the first three quarters of 2006. The strength in Hong Kong's external trade has benefited from not only the favourable global economic environment, but also the rapid economic expansion and international trade in the Mainland. Hong Kong's robust external trade growth is a manifestation of Hong Kong's competitiveness as a global trading hub as well as a trade management centre for the Asia-Pacific region.

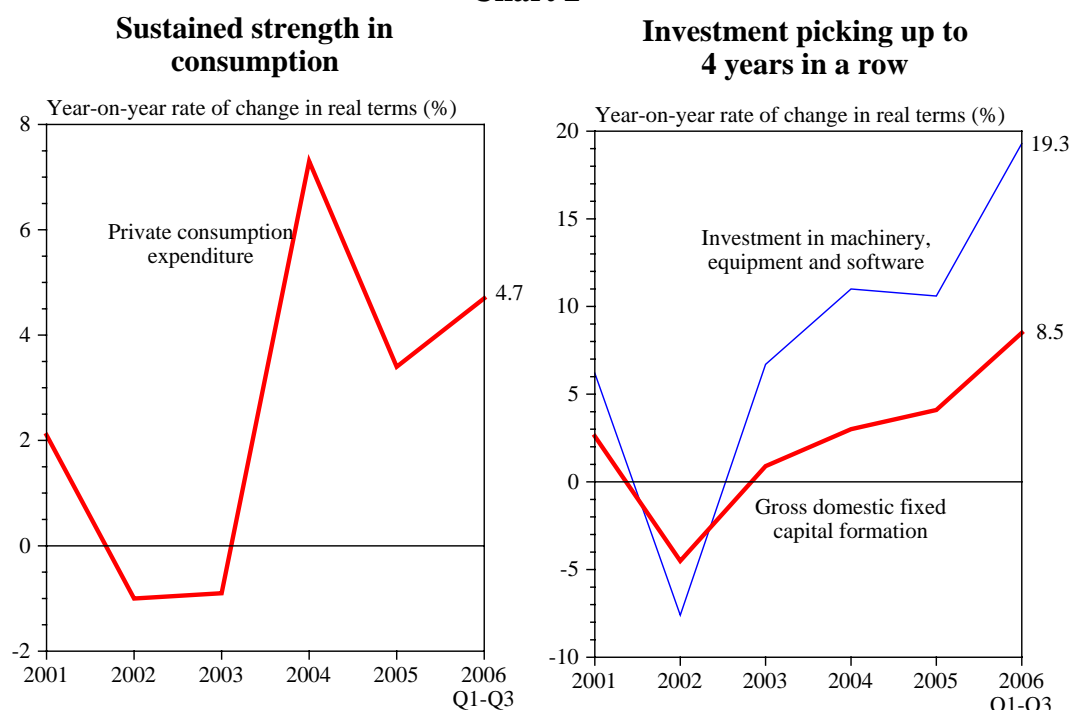
4. And as the economic recovery becomes more entrenched, the economic expansion broadened to other sectors. The financial services sector, in particular, has grown rapidly. Over the past three years (comparing the first three quarters of 2006 with the same period in 2003) when overall GDP grew cumulatively by 25%, output in financial services has expanded by 63%.

Increasing role of domestic demand in driving the economy

5. Investor and consumer confidence gradually built up as the

recovery gathered momentum and the increasing strength of domestic demand has in turn made the economic expansion much more broad-based and solid (**Chart 2**). In the first three quarters of 2006, private consumption expenditure rose notably by 4.7% in real terms over a year earlier, as a result of better job prospect and rising household income. The wealth effect arising from asset price appreciation also partly contributed to the rise. Business investment in machinery, equipment and software continued to fare well, surging by 19.3% in real terms in the first three quarters of 2006, further up from 10.6% in 2005 and 11.0% in 2004, underlining the strength of business confidence and also sustained expansion in the corporate sector.

Chart 2



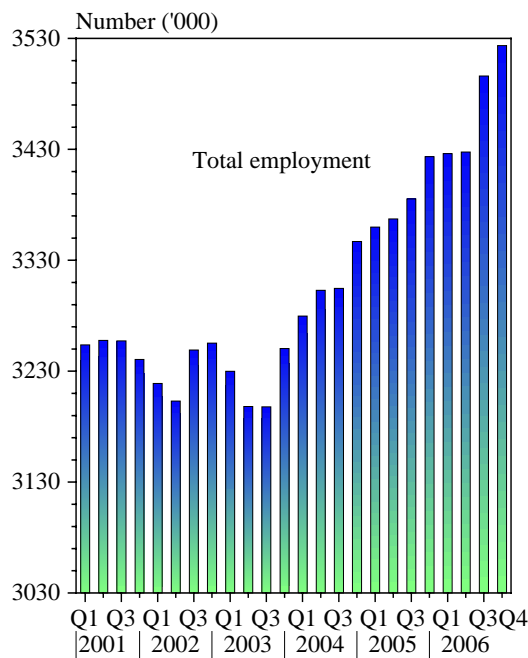
Extensive improvements in labour market

6. Another distinct feature of the recovery is the significant job creation both in terms of scale and coverage. An impressive total of some 334 000 additional jobs have been created since the trough in mid-2003, bringing total employment to successive record highs during the past year and thus leading to marked improvements in employment conditions in almost all segments of the labour market (**Chart 3**). As a result, the seasonally adjusted unemployment rate declined to 4.4% in the fourth quarter of 2006, the lowest level since the beginning of 2001 and down

more than four percentage points from the high of 8.6% in mid-2003. The number of unemployed persons fell from a high of 309 100 in mid-2003 to 157 100 by end-2006. The long-term unemployed (unemployed for more than 6 months) also fell markedly, by 55% over the same period (*Chart 4*). Labour incomes and job vacancies are on the rise. Broad-based improvements in the labour market in turn have helped instill confidence back into the economy, a key factor underpinning the recent upturn in domestic demand.

Chart 3

Employment rising to successive new highs



Unemployed and long-term unemployed down markedly

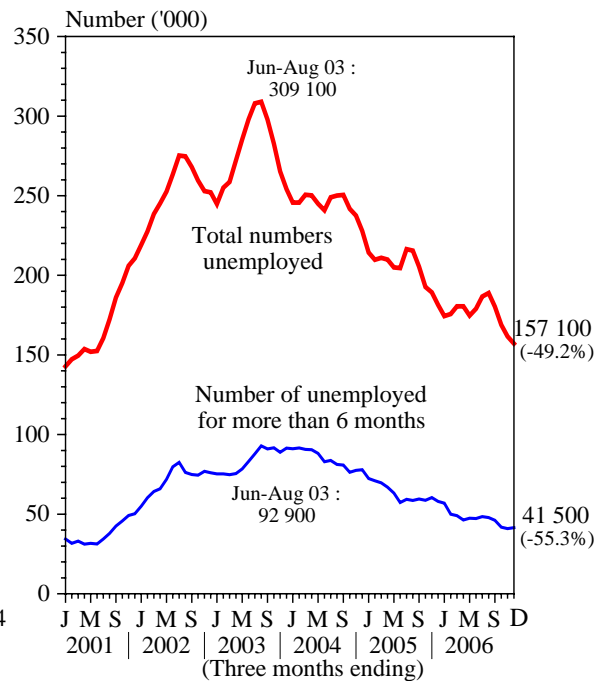
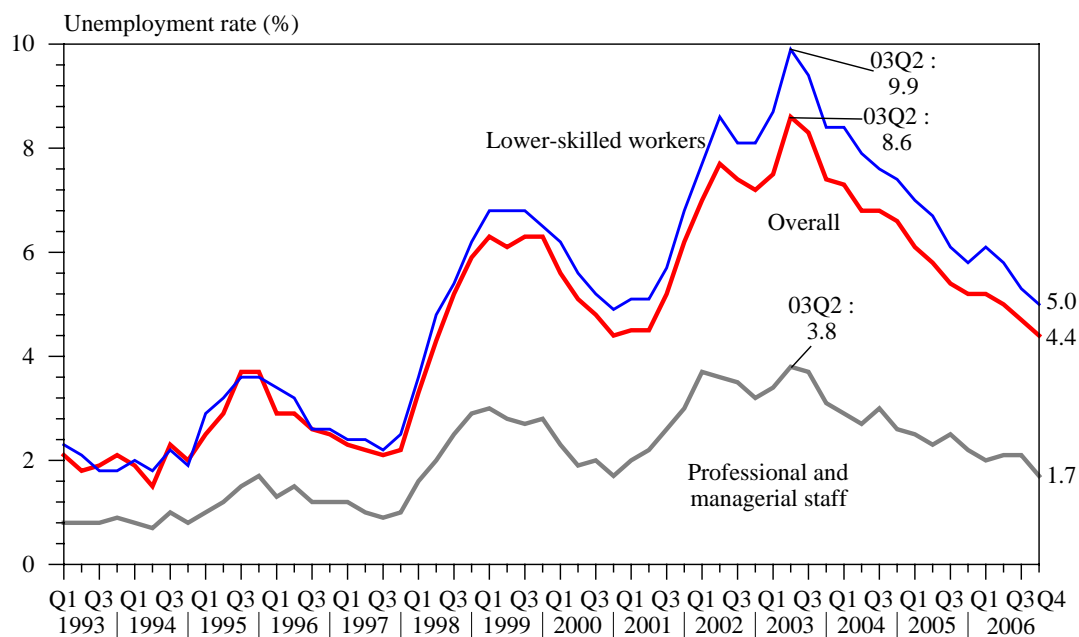


Chart 4 : Extensive improvements in labour market



Moderate inflation

7. Another key feature of the current economic situation is that inflation has remained benign even after three consecutive years of very strong economic expansion. On the domestic front, upward pressures on local business costs have remained largely in check, with unit labour cost being cushioned by rising productivity, and unit rental cost increases also stabilizing lately. External cost pressures are likewise muted, even though commodity prices, particularly oil, rose significantly in the past few years while the US dollar depreciated. The Composite Consumer Price Index notched up by 2.0% in 2006, following a 1.0% increase in 2005. With sustained strong growth in labour productivity keeping down the pressure on local costs, the benign inflation environment can be expected to continue. The recent substantial fall in oil prices should also help.

8. With the strong GDP growth outturn of 6.8% for the first three quarters of 2006, the economy should have no difficulty in attaining the 6.5% growth forecast earlier for 2006 as a whole, marking the third consecutive year of high growth with low inflation.

STRUCTURAL ISSUES

Globalization and rapid economic growth in the Mainland brings opportunities as well as challenges to Hong Kong.

9. Being a small open economy, Hong Kong must adjust quickly to the rapid changes in the global and regional economic environment. Building on its world-class physical, financial and business infrastructures, Hong Kong has been able to leverage on the vibrant Mainland economy and intensified the economic integration process. This has been seen in various spheres such as financial services, trade and logistics, and tourism.

10. However, rapid technological advances and the bringing down of market barriers are leading to keen market competition globally. For example, Hong Kong faces intensifying competition from other up-and-coming cities in the region. As a mature economy, Hong Kong's competitive strength lies in quality rather than in cost. Hong Kong must therefore keep moving up the value chain in order to create value and stay ahead of the competition.

Rapid economic restructuring process poses challenges to the ability of the labour force to constantly upgrade itself.

11. On the other hand, the need to speed up economic restructuring towards a knowledge-based economy and high value-added activities has created challenges to the labour market, particularly in terms of increasing skill mismatch and income distribution issues. There is a general belief that a large proportion of the local labour force is unable to cope with the demands of Hong Kong's restructuring. The current still relatively high unemployment rate for the unskilled despite three years of rapid economic expansion, is seen as evidence of a serious skill mismatch problem. One common perception is that there exists a group of lower-skilled and less educated people who are unable to benefit from the economic recovery. These issues will be examined below.

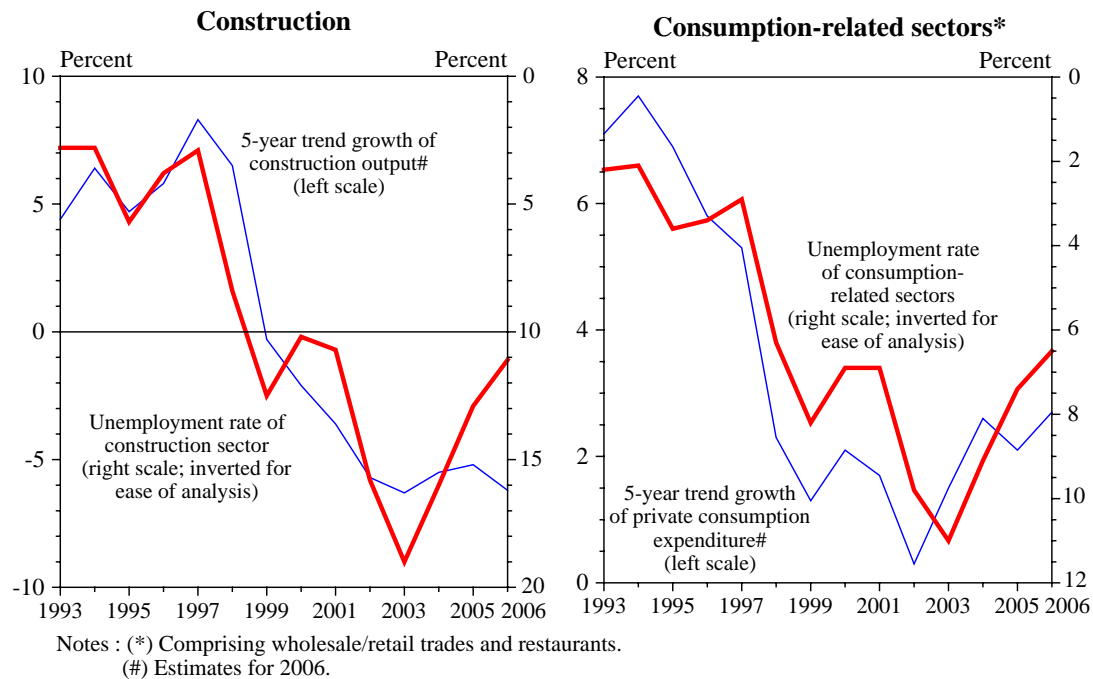
Perception: High unemployment rate reflects a serious skill mismatch problem

Reality: A substantial proportion of the current unemployment problem is due to the weakness of the construction industry and less-than-desired recovery in consumption-related sectors

12. Notwithstanding the marked improvement in labour market conditions over the past three years, the unemployment rate for lower-skilled workers, now at 5.0%, is distinctly above that of 1.7% for higher-skilled workers and the overall average of 4.4%. It is also higher than the level in 1997 by more than 2 percentage points. This is widely taken as evidence that workers at the lower segment generally are lacking the skills and competencies to benefit from the improving economic and labour market conditions. However, by analysing the relationship between the unemployment rate and the vacancy rate over time (i.e. the Beveridge curve analysis, see *Annex* for details), there is little evidence to support the view that there has been a marked increase in the skill mismatch problem in Hong Kong's labour market in recent years.

13. Further analysis shows that a considerable part of the relatively high unemployment problem for the lower-skilled workers is in fact attributable to weak performance of the consumption-related and construction sectors (*Chart 5*). Construction investment is still in the doldrums (down by around 6% per annum between 1997 and 2006), and private consumption has yet to fully recover from the prolonged weakness during 1997-2003 (with an average meagre growth of less than 2% per annum between 1997 and 2006 even with the revival over the past three years). These sectors together now account for 43% of the total unemployment numbers, compared with a share of 36% in 1997. In other words, if the construction sector could finally turn around and if the consumption-related sectors could improve more, the unemployment situation for the lower-skilled workers should see further improvement, and the gap between the unemployment rates of the higher-skilled and lower-skilled would narrow.

Chart 5 : Persistent weakness in construction and consumption has adversely affected the employment conditions of workers at the lower segment



Perception: Low-skilled workers unable to benefit from economic recovery

Reality: Long-term unemployment has declined markedly since mid-2003, signifying that many of these workers could be absorbed back into the workforce

14. The economic recovery over the past three years has led to extensive job gains as well as notable declines in long-term unemployment across all age groups and education attainment categories (**Charts 6 & 7**). In Q4 2006, of the 157 100 unemployed people, 41 500 were long-term unemployed (i.e. jobless for more than six months). Comparing Q4 2006 with the economic trough of 2003, the number of unemployed fell by 49% while the long-term unemployed fell by 55%. This suggests that a substantial proportion of the long-term unemployed who faced greater difficulties in finding jobs in the past can also regain employment and be gradually absorbed back into the workforce as the economy revives.

Chart 6 : Long-term unemployment rate by age group

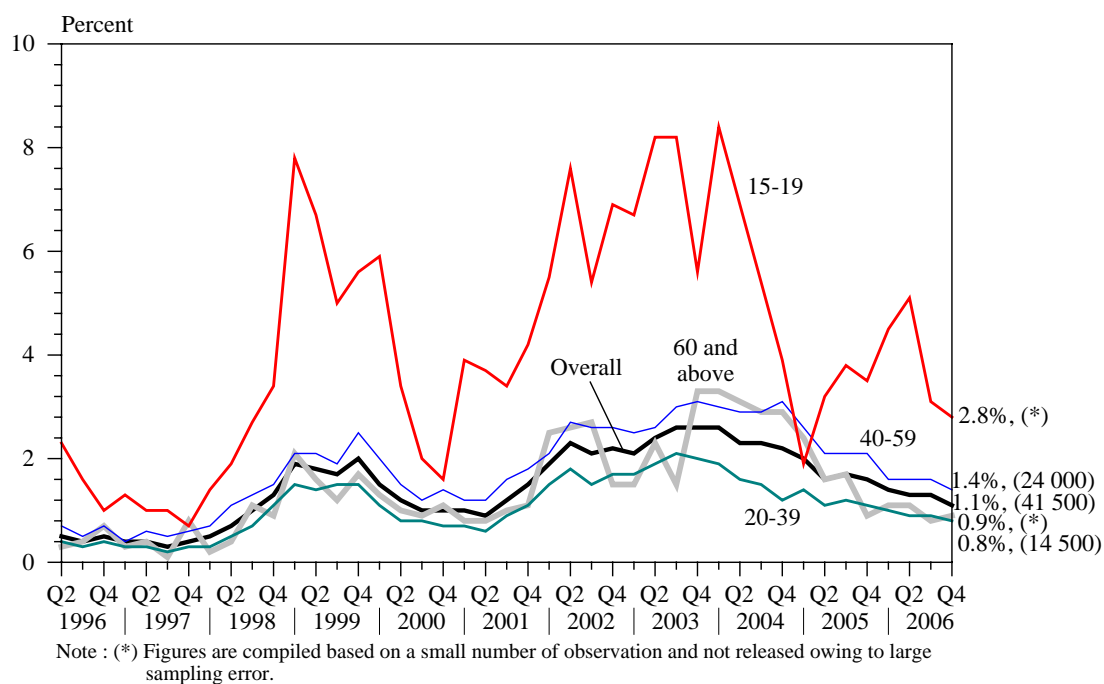
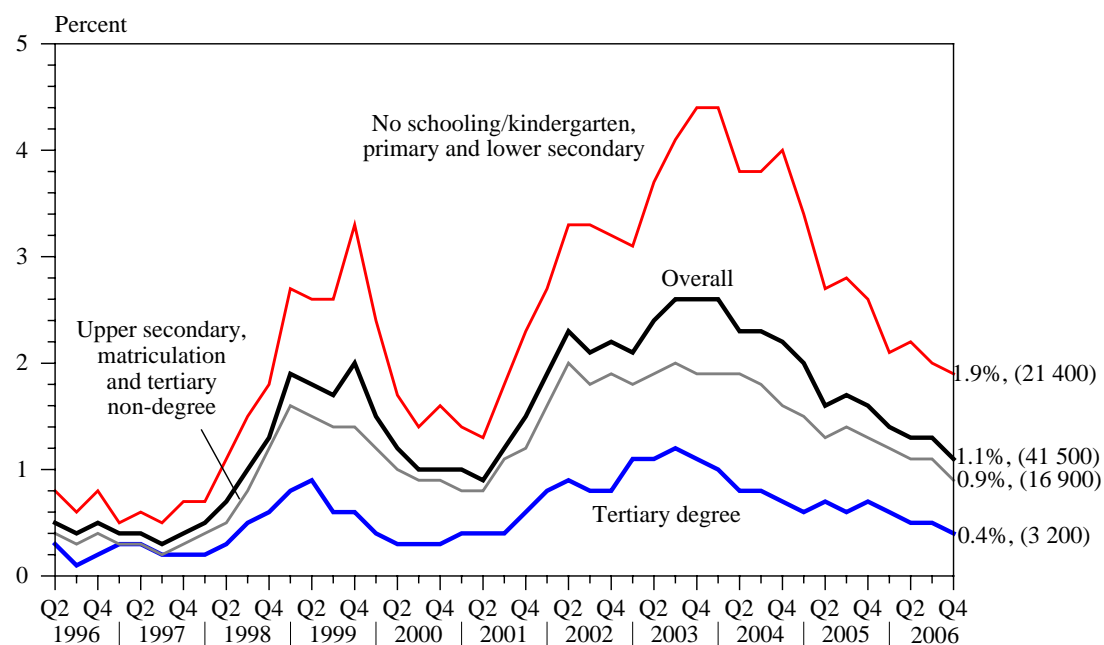


Chart 7 : Long-term unemployment rate by educational attainment



Perception: Existing workforce is unable to fit in with the need to develop into a knowledge-based economy

Reality : Job upgrading has been happening on a very substantial scale over the past ten years

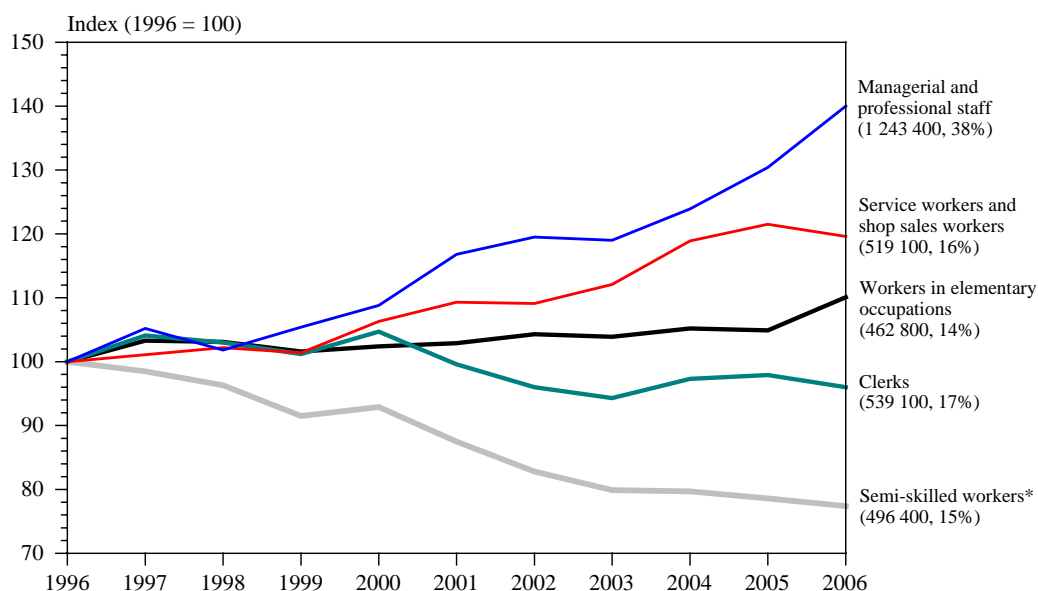
15. On the whole, the local workforce has adjusted well to the structural transformation of the Hong Kong economy. This can be seen from the substantial increase in the share of workforce with tertiary education, from 21% in 1996 to 31% in 2006, reflecting not only the outcome of Government's hefty investment in higher education, but also the keen efforts of many workers to upgrade themselves to fit in with the needs of knowledge-based economy (***Table 1***). Mirroring the marked improvement in the quality of workers, there is likewise a considerable expansion in the higher-skilled segment of the local labour market. On the other hand, both the demand and supply of lower-skilled workers showed relatively modest growth over the past decade. In 2006, 38% of our employed persons belonged to the managerial and professional level, compared with 30% a decade ago (***Chart 8***).

Table 1 : Number and share of workers having tertiary education in workforce

	<u>No. of workers with tertiary education*</u> (‘000)	<u>Share in workforce*</u> (%)
1996	606	21
2001	792	26
2006	1 008	31

Note : (*) Excluding foreign domestic helpers.

Chart 8 : Substantial job upgrading



Notes : Figures in brackets represent the number of employed persons (excluding foreign domestic helpers) in 2006, and the percentage shares refer to the proportion of employed persons engaged in the respective occupations.

(*) Semi-skilled workers include craft and related workers and plant and machine operators and assemblers.

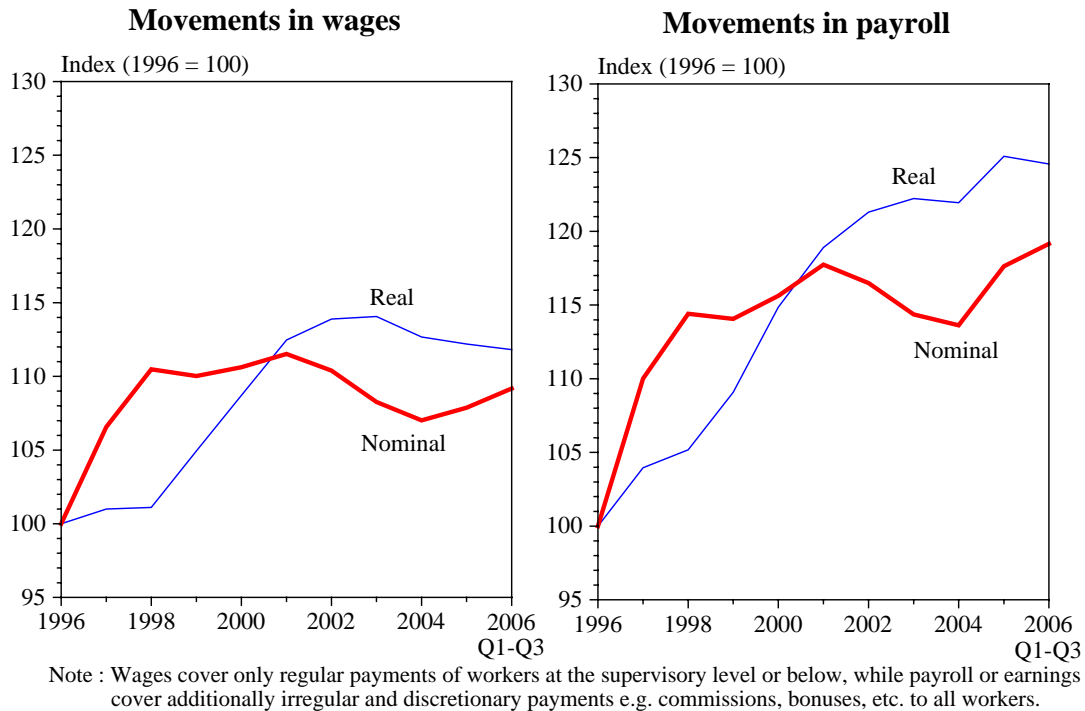
Perception: Income growth of the lower segment of the labour market has lagged significantly behind in the current economic upturn, resulting in widening income disparity

Reality: Ongoing economic upgrading has led to faster increases in income for the higher-skilled. Income of the lower-skilled also benefited from economic growth, albeit relatively less, but suffered more during economic downturn.

16. There has been a general uptrend in overall labour earnings and wages in the past decade, particularly when they are measured in real terms (**Chart 9**), reflecting the growth in productivity for the economy as a whole.

17. As a result of the structural transformation of the economy towards higher value-added activities and the concomitant shift in labour demand towards workers with better knowledge and skills, it is inevitable that workers at the upper segment of occupational hierarchy experience larger income increases than those at the lower segment. Improvements in technology and IT, and the rapid growth of the high-value added sectors such as financial services are helping to drive the income of workers with better knowledge and skills much higher. The resultant differences in income growth rates between different occupations and sectors are also price signals in a market economy that encourage individuals and firms to invest in human capital. Meanwhile, lower-skilled workers, whilst registering smaller pay rises during economic upturns, tend to be more susceptible to the risks of unemployment and income cuts during economic downturns. As shown in paragraph 18 below, apart from the structural factors, the economic downturn during 1998-2003 was in fact a key factor leading to the relative decline in the income of the lower-skilled workers.

Chart 9

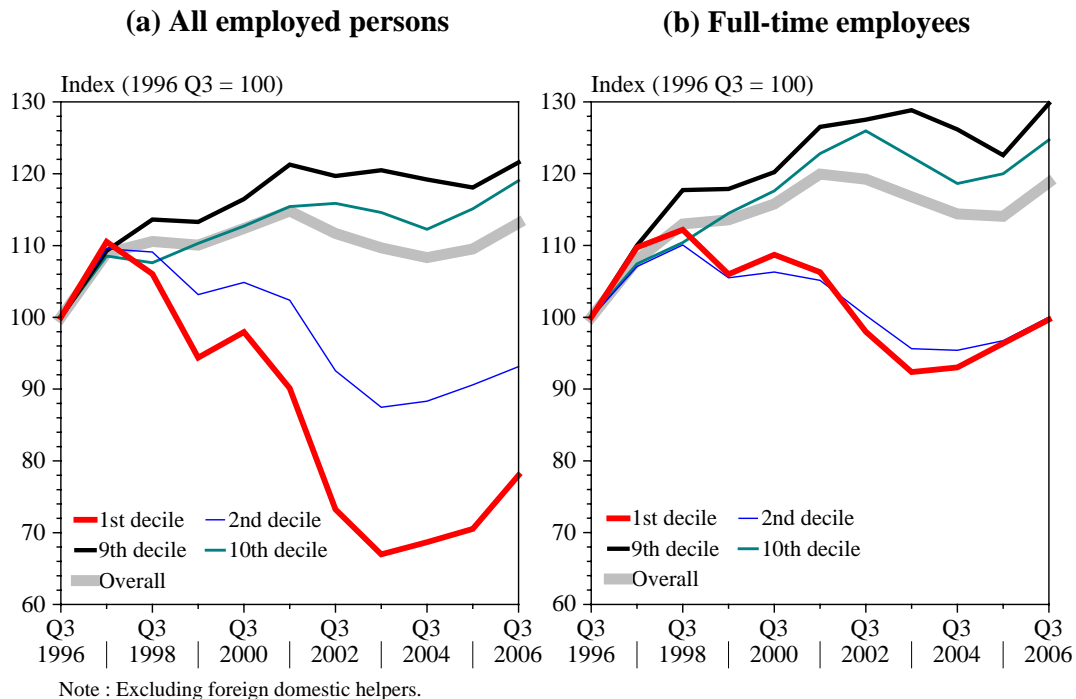


18. **Chart 10(a)** shows that comparing Q3 2006 with Q3 1996, overall average employment earnings generally followed an uptrend, though suffering declines between 1998 and 1999 and between 2001 and 2003 amidst the economic downturn. Employment earnings of the lowest two decile groups however showed marked deterioration over the past decade due to the sharp fall-off in incomes between 1997 and 2003. A large proportion of the people in these two groups has lower skills and qualifications, and is therefore more prone to unemployment, underemployment and income reductions during an economic downturn. There has also been an increasing proportion of voluntary part-time workers in the labour force whose low income status is due to their shorter hours of work (the rise in part-time workers was highlighted in an earlier paper titled “Creation of Employment” – CSD/EDC/7/2006) and the increase in part-time workers tends to exacerbate the relative decline in income of these two groups. **Chart 10(b)** shows that when only the income of full-time employees are analysed (thus taking away the effect of part-time workers), the income declines for workers in the lowest two deciles are much smaller during the economic downturn.

19. In any event, workers at the lowest two deciles in both **Charts 10(a) & 10(b)** have witnessed strong income rebounds since 2003,

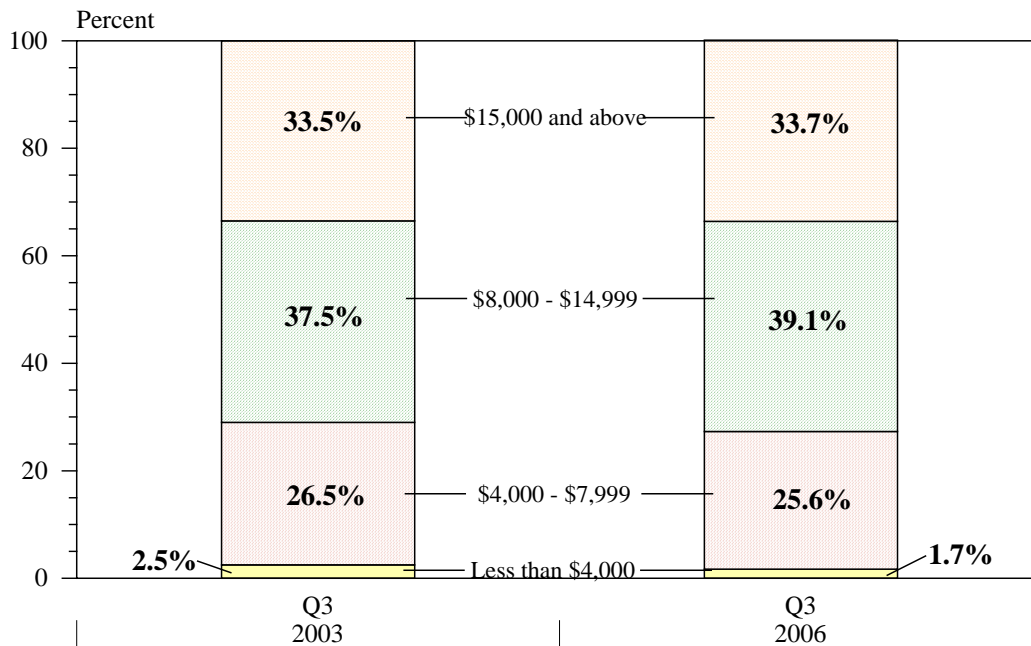
same as the other decile groups. The lowest two deciles in the **Chart 10(a)** actually experienced a faster growth during the economic upturn than other deciles, reflecting probably the additional contribution of a fall in unemployment and underemployment to income growth for these workers. Average incomes of full-time employees in the lowest two deciles in Q3 2006 have in fact returned to where they were 10 years ago. Generally speaking, the average employment income of workers have seen substantial increases over the decade, reflecting the fact that productivity growth in the economy has resulted in real income gains for the vast majority of the workers.

Chart 10 : Average employment earnings



20. **Chart 11** shows the improvement in income for many workers during the economic revival in the past three years from another perspective. It shows not only a significant fall in the proportion of jobs earning less than \$4,000 or less than \$8,000, but also an increase in the proportion of workers earning \$8,000 or more a month.

Chart 11 : Share of full-time employees by monthly employment earnings



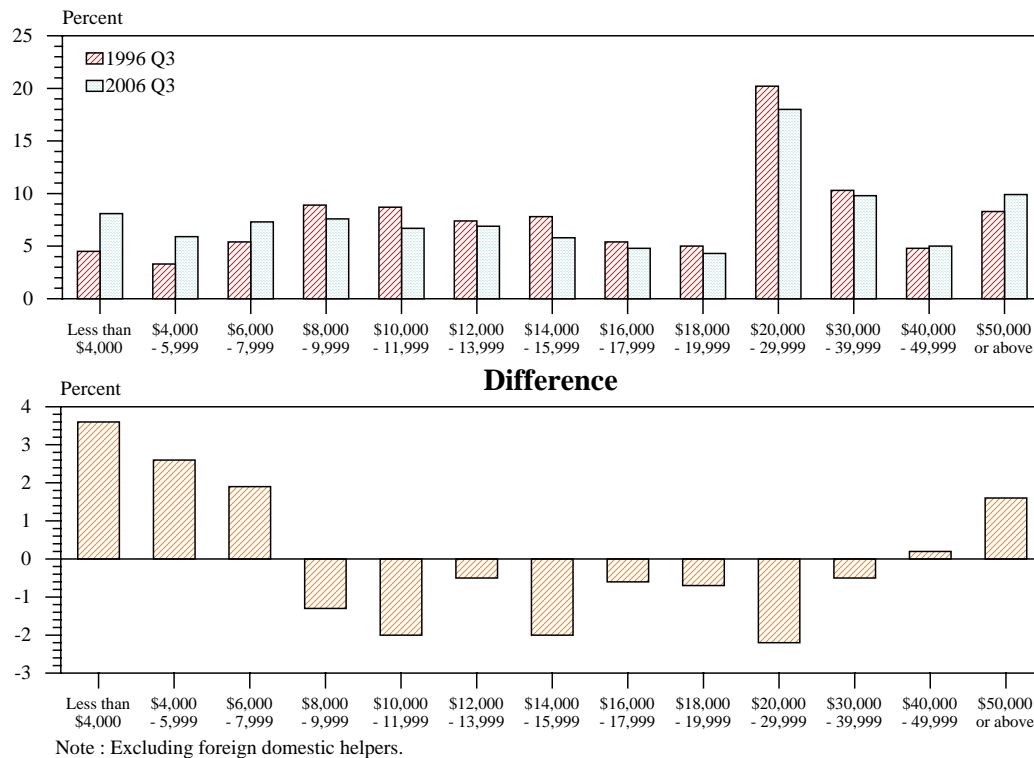
Note : Excluding foreign domestic helpers.

21. It is useful to digress at this juncture to a discussion of changes in household income. A very commonly quoted evidence of widening income disparity in Hong Kong is the rise in the Gini coefficient, from 0.476 in 1991 and 0.518 in 1996 to 0.525 in 2001. It should be noted that the Gini coefficient is calculated using household income. This is a different concept as compared with the employment income distribution for individual workers as analysed in this paper.

22. **Chart 12** shows the changes in the distribution of household income over the past decade. It highlights visible increases in the proportion of households at both the upper and lower ends of the income distribution.

23. But it should be noted that household income is affected not only by the differential employment income growth for workers with different skill levels, but also by changing demographic structure, social factors and household composition. For example, the average household size in Hong Kong has been falling over time (due to a range of reasons such as the splitting up of extended families into nuclear families, higher divorce rates, the increase in young people living away from their parents, etc.) and this affects the household income distribution patterns, particularly for the lower-income households.

Chart 12 : Share of all domestic households by monthly household income



24. Using the households with less than \$4,000 in monthly household income as an example, it is found that the number of such low-income households increased from 85 300 in Q3 1996 to 187 100 in Q3 2006. As a proportion of all households in Hong Kong, they increased from 4.5% to 8.1%. But on further analysis, it is found that over 60% of the increase in these low-income households over the past decade was attributable to the rapid rise in the number of elderly, retired households (with all members aged 60 or above who have retired and hence are not seeking work in the labour market). A relatively small proportion of these low-income households are economically active households. Further analyses of these economically-active, low-income households show that they had low income because a large proportion of them were unemployed or underemployed. They grew in both absolute and relative terms during the economic downturn up to 2003, but have been falling markedly over the past few years in tandem with the economic recovery (*Table 2*). This suggests that promoting economic growth and generating more job opportunities are an effective way in lifting the income of these households.

Table 2: Number and share of low-income households[#]

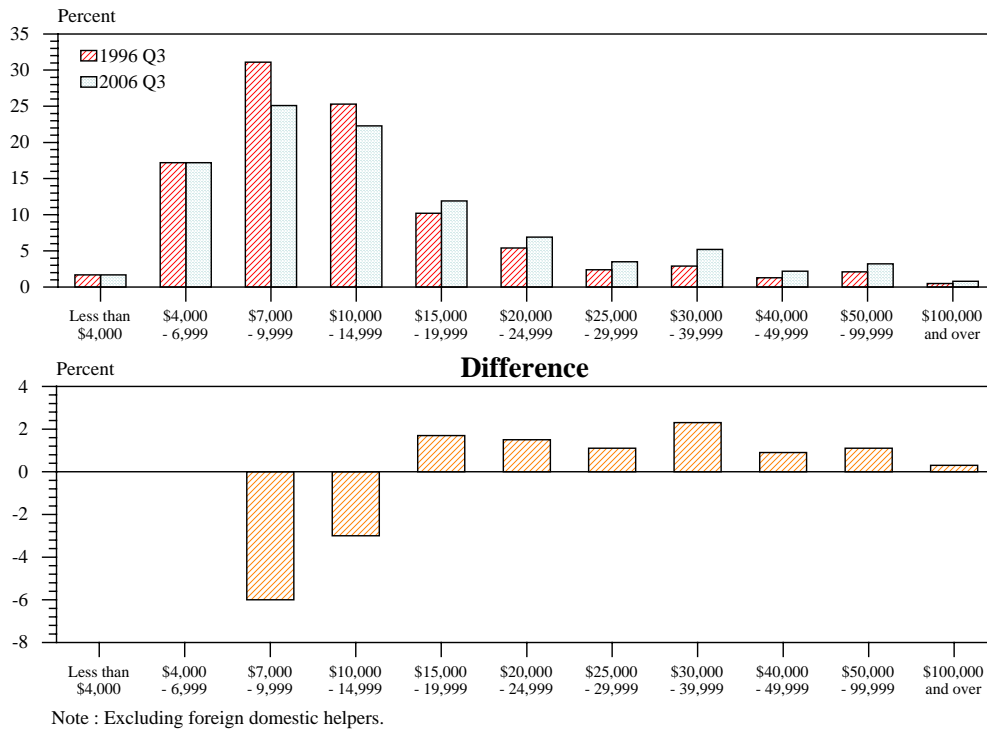
	<u>Elderly households</u>	<u>Economically inactive households</u>	<u>Economically active households</u>	<u>Total</u>
Q3 1996	61 000 (3.3)	14 800 (0.8)	9 400 (0.5)	85 300 (4.5)
Q3 2003	121 400 (5.6)	32 600 (1.5)	52 700 (2.4)	206 700 (9.5)
Q3 2004	123 300 (5.5)	33 300 (1.5)	38 000 (1.7)	194 600 (8.7)
Q3 2005	126 200 (5.5)	34 600 (1.5)	31 400 (1.4)	192 200 (8.4)
Q3 2006	124 400 (5.4)	38 100 (1.6)	24 600 (1.1)	187 100 (8.1)

Note : (#) Defined as households with monthly household income of less than \$4,000.

() Share in all domestic households.

25. In view of the heavy influence of demographic and social factors on household income, it is useful to analyse the effect of economic factors on income distribution by focusing on employment earnings of full-time employees as shown in *Chart 13*. This shows a general fall in the proportion of lower-income workers but an increase in that of higher-income workers over the past decade.

Chart 13 : Share of full-time employees by monthly employment earnings



Perception: Pace of economic restructuring towards high value-added activities is too slow

Reality: Substantial shift in activities to financial services; trading and logistics; and high knowledge content sectors, resulting in significant uplift in labour productivity

26. In tandem with the process of job upgrading, the Hong Kong economy has restructured itself quite successfully towards higher value-added service activities over the years (**Chart 14**). Along with the shift of activities towards high value-added sectors, productivity growth between 1997 and 2005 was remarkable at 2.8%, which compared quite favourably with the neighbouring economies (**Chart 15**). In certain key sectors such as financing and trading, rapid productivity improvement at around 10% was seen over the past five years, again attesting to Hong Kong's strength and competitive edges in these growth areas (**Table 3**). Strong productivity growth is the key to sustaining Hong Kong's economic growth over the long term.

Chart 14 : The rising share of services in HK's economy

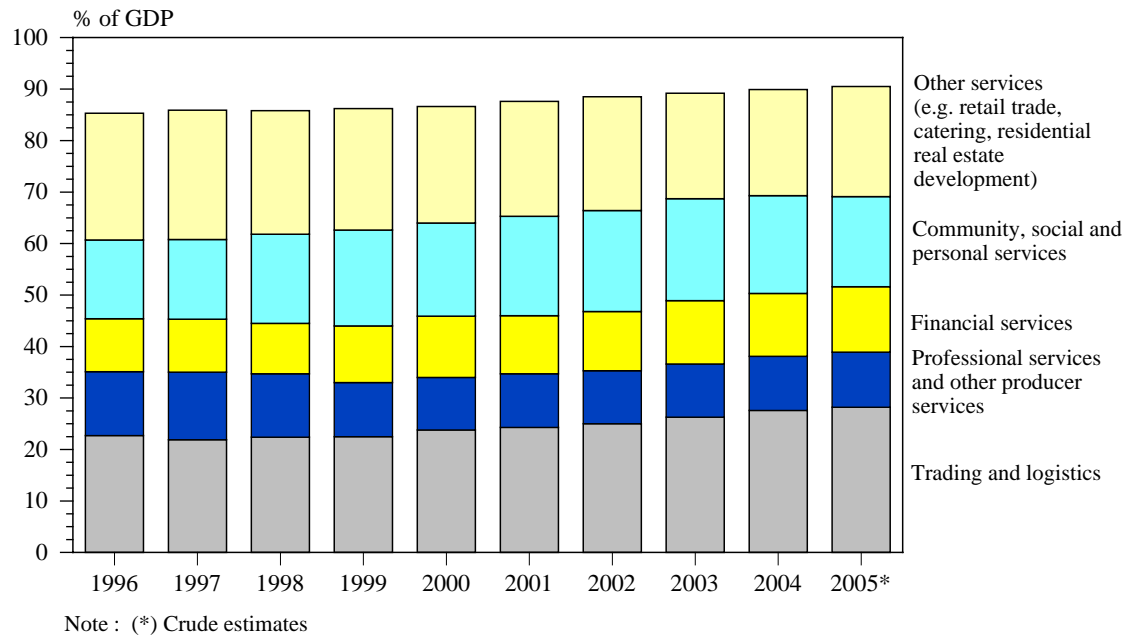


Chart 15 : Rapid productivity growth in Hong Kong

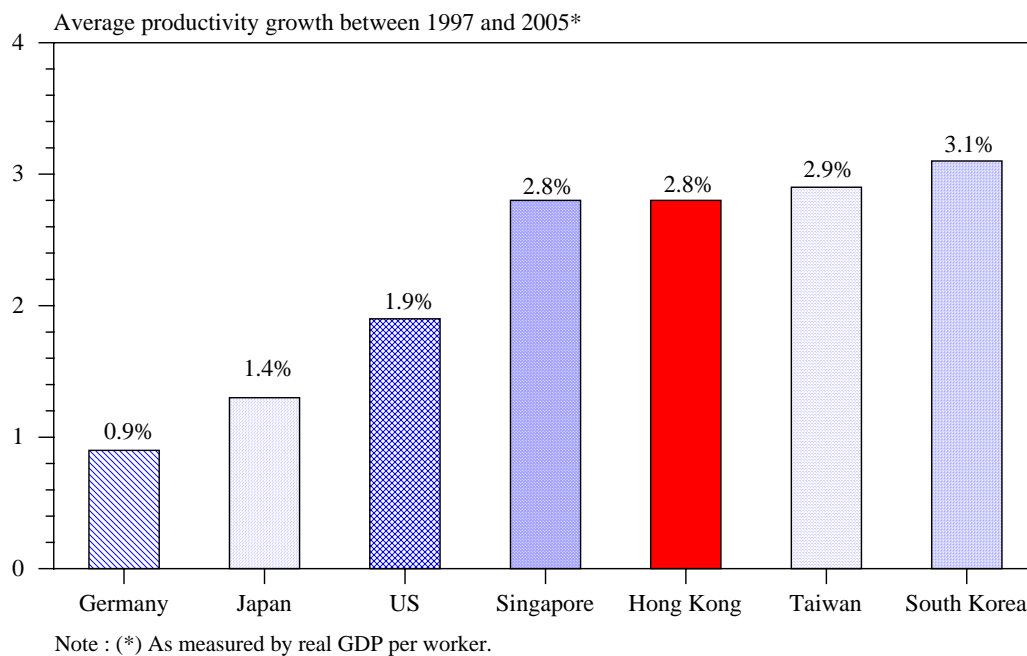


Table 3 : Labour productivity growth by sector

	Average productivity growth between <u>2000-2005</u> (%)
Financing	10.3
Trading	9.9
Logistics	5.6
Communications	14.9
Overall	3.0

CONCLUSION

27. The key issues highlighted in this paper include:

(a) The Hong Kong economy has performed very well in the past three years with average growth of 7.5%, low inflation and a distinct fall in the unemployment rate from 8.6% in mid-2003 to 4.4% by end-2006. The financial services and the trade and logistics sectors have shown particularly significant growth, both in business volume and in productivity, reflecting that the Hong Kong economy has indeed been able to move up the value chain rather successfully.

(b) Given the powerful forces of globalization, the rapid development in the Mainland, and the small open nature of the local economy, Hong Kong must continue to restructure itself into a knowledge-based economy and a sophisticated services hub.

(c) This restructuring process has produced an average productivity growth of 2.8% between 1997 and 2005, which compares favourably with many other developed economies. In reality, this means that the number of workers belonging to higher-skilled and high-income categories has been growing rapidly over the years. On the other hand, the number of lower-skilled workers grew slower or even decline over time. These reflect the adjustment the labour market is going through.

(d) A “Beveridge curve” analysis suggests that the scale of the skill mismatch or structural unemployment problem is probably not serious. A considerable proportion of the unemployment problem of the lower-skilled workers in Hong Kong today is due to the weakness in the construction industry and the less-than-adequate recovery in the consumption-related

sectors. The fall by more than half in the number of long-term unemployed since mid-2003 shows that many of these workers could actually be re-employed as the economy improves.

(e) Nevertheless, the economic rebound since 2003 has led to improvements in employment earnings for both the higher and lower income workers. Yet in the earlier economic downturn, employment earnings of the lower-income workers suffered more as these workers were more likely to become unemployed, underemployed or have wage cuts.

(f) Analysis of household income distribution has to be made in the proper context as this is subject to the influences of various demographic, social and economic factors. For instance, the rapid increase in households with less than \$4,000 in monthly household income reflects much more an ageing and changing family structure phenomenon than economic factors.

STRATEGIC ISSUES FOR DISCUSSION

28. Against the above background and information, Members are invited to consider the following strategic issues:

- (a) Is the recent strong growth momentum of the Hong Kong economy sustainable?
- (b) What are the most important structural issues that would affect long-term economic development? And what are the associated effects on the labour market and income distribution?
- (c) In the light of the structural issues in (b), what should be the Government's appropriate policy responses?

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January 2007

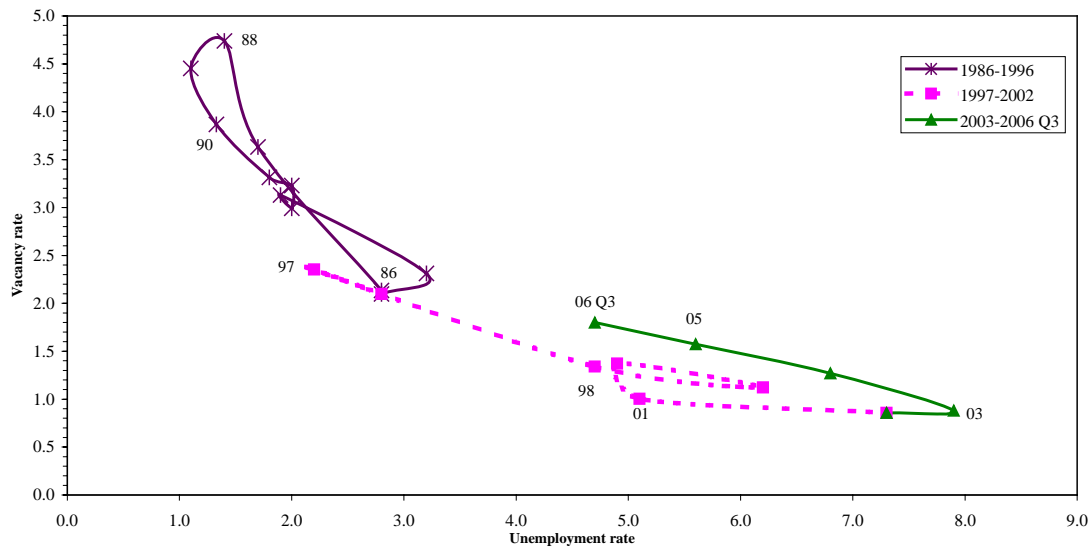
Annex

Beveridge curve analysis

A commonly adopted method of analyzing the issue of structural unemployment is by way of a Beveridge curve, which depicts the relationship between job vacancies and unemployment and reflects the underlying process of job matching between employers and job seekers. Generally speaking, movements along a given, convex Beveridge curve are associated with cyclical shocks, while shifts in the curve itself are associated with changes in parameters underlying the efficiency of the job matching process, including changes in demographic structure, regional labour mobility and skills mismatch, advancement in information technology, etc. Specifically, an outward shift in the curve is usually interpreted as a sign of increasing skill mismatch and vice versa.

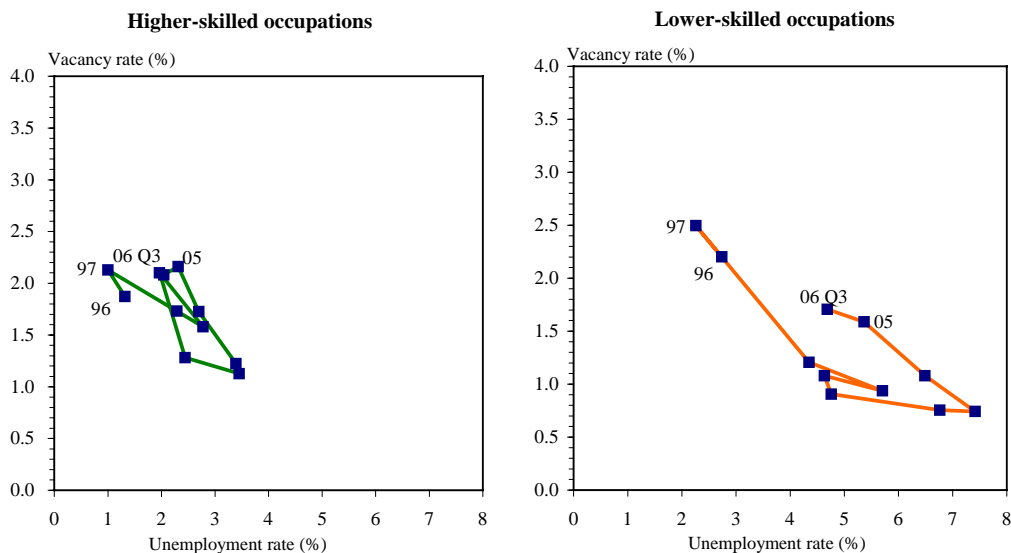
The Beveridge curve for the Hong Kong economy between 1986 and Q3 2006 is shown below. Apparently, there has been a fairly stable and negative relationship between the unemployment rate and vacancy rate since 1986, yet with no clear evidence of any major outward shift of the curve itself. Analytically, the Beveridge curve can be separated into two main parts, with the Asian financial crisis serving as the dividing line. At the upper part of the curve are the pre-crisis years, mostly involving a combination of higher vacancy rates and lower unemployment rates. The post-crisis years, characterised by higher unemployment rates and lower vacancy rates, are found mostly at the lower part. Yet as a result of the economic revival since 2003, there has been a fall in unemployment rate and a concurrent rise in the vacancy rate, thereby contributing to a 'V' turn of the curve.

Beveridge curve for the entire economy, 1986 - 2006 Q3



The Beveridge curve can be further analysed by breaking down workers into different skill levels. However, owing to the lack of data for the years before 1996, it is not possible to analyse the unemployment-vacancy relationship over a longer time frame, which makes it difficult to delineate the shifts in Beveridge curve caused by structural factors from those caused by cyclical factors and external shocks. This notwithstanding, the fact that both construction investment and private consumption have yet to fully recover from the earlier downturn, as pointed out in paragraph 12 of the main paper, suggests that cyclical factors are still at play and contributing to the relatively high unemployment rate for lower-skilled workers, particularly those engaged in such sectors as construction, retail trade and restaurants.

Beveridge curve by occupation category, 1996-2006 Q3*



(*) Excluding the construction sector, owing to the lack of respective vacancy data.