A Case Study of Economic Ecology: The Hong Kong Economy's Plunge into a Deep Recession in 1998*

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June 2000

*I would like to thank Gary Wong for his able research assistance.

Abstract

This paper argues and provides statistical evidence that the very serious recession that Hong Kong underwent in 1998 was not the direct result of the Asian Financial Crisis but rather the result of the "ecological consequences" of misguided housing policy adopted by the Hong Kong SAR Government. By selling public housing cheaply to tenants, the attractiveness of Home Ownership Scheme housing was reduced dramatically. Price declines of HOS housing spread to housing of a more superior quality because the latter depends on HOS owners trading up. Lacking buyers from among HOS owners, the owners of these units could not trade up either. As a result the entire housing market and economy plunged into deep recession.

JEL Classication Number: E32, R21, R31

I. Introduction

This paper seeks to find an explanation for the Hong Kong economy's unprecedented plunge into deep recession in the wake of the Asian Financial Crisis. Hong Kong had gone through so many ups and downs through its history, and until 1998 not a single year since 1961 was there recorded negative economic growth(See Table 1). Among the crises that Hong Kong had gone through are: the Great Proletariat Cultural Revolution in 1966 through 1968[1]; the two major oil crises of the seventies; the plunge of the Heng Seng Index from over 1700 in 1973 to less than 200 in 1975; the unprecedented interest rate hikes of 1981-82, when the prime rate momentarily shot up to 20 per cent; the Tianmen incident of 1989, etc. Hong Kong had gone through true financial and banking crises, in the early 60s and from 1982 through 1986, with multiple bank failures, and it was in the context of widespread panic and currency depreciation that the current linked exchange rate system was set up in 1983. But Hong Kong's growth engine never failed, until 1998.

Table 1: Hong Kong's Economic Growth 1961-1999(GDP % change)

1961	n.a.	1971	7.1	1981	9.2	1991	5.1
1962	14.2	1972	10.3	1982	2.7	1992	6.3
1963	15.7	1973	12.4	1983	5.7	1993	6.1
1964	8.6	1974	2.3	1984	10.0	1994	5.4
1965	14.5	1975	0.3	1985	0.4	1995	3.9
1966	1.7	1976	16.2	1986	10.8	1996	4.5
1967	1.7	1977	11.7	1987	13.0	1997	5.0
1968	3.3	1978	8.5	1988	8.0	1998	-5.1
1969	11.3	1979	11.5	1989	2.6	1999	2.9
1970	9.2	1980	10.1	1990	3.4		

Source:Gross Domestic Product 1961-1999, Government of HKSAR

It is true that the Asian Financial Crisis of 1997 was a serious one and had plunged many otherwise economies into deep recession. But given Hong Kong's tight links with China and the United States, both of which registered strong growth in 1998, and Singapore's tight links with the ASEAN countries, all of which had been directly or indirectly affected by the Asian Financial Crisis, Hong Kong should have fared better than Singapore. Yet Singapore's economy in 1998 registered a 1.3 per cent growth, as compared with Hong Kong's negative 5.1 per cent. Hong Kong should in any case be in much better shape than debt-ridden South Korea. But by the second half of 1999 South Korea had rebounded to well over the pre-crisis level. Having declined by 5.8 per cent in 1998, the South Korea economy bounced back by 10 per cent in 1999. In contrast, Hong Kong's economy shrank by 5.1 per cent in 1998, and grew by a mere 3.0 per cent in 1999.

Hong Kong's trade figures started to improve markedly in 1999 and by the

[1] The Cultural Revolution started on the Mainland but spread to Hong Kong quickly. People were killed in street riots. Bombs were set off. Property prices slumped.

first quarter of 2000 Hong Kong appears to be well on its way to recovery, with a 14 per cent year-on-year growth. But the strength of the external sector had scarcely benefited domestic consumption through late 1999. Most of Hong Kong people continued to feel the crunch of the recession.

To understand the predicament of Hong Kong people we have to understand the cause behind the unprecedented recession that hit Hong Kong so suddenly. What really caused such dramatic changes in the first quarter of 1998? One could easily blame the currency turmoil in South East Asia spilling over to Hong Kong, but this is really not convincing. As a matter of fact, in the first quarter of 1998 there was one interest rate drop, and the currency turmoil had shown signs of stabilizing. There was even a brief period of property price increase in March, following the interest rate decline and the announcement of a stimulative budget. To put things in perspective, Hong Kong's economic performance in the first quarter of 1998 was worse than that of Malaysia, and much worse than that of Singapore or Taiwan. A *transmission mechanism* whereby major declines in the values of the Indonesian rupiah and the Thai baht caused the property bubble to burst and the Hong Kong economy to lose its characteristic vigor and legendary resilience is simply lacking.

My simple hypothesis is this. The economic decline was the direct and immediate result of misguided housing policy, particularly its drive to increase ownership in the property market. The Chief Executive in his first Policy Address of October 1997 explicitly called for increasing the homeownership ratio from 50 per cent to 70 per cent in ten years, and tried to achieve it through an ambitious yet flawed public housing privatization program. *The recession was a result of the working of "economic ecology," as a microeconomic policy worked through the economic system to produce a gigantic macroeconomic disaster.*

II. The Basic and Non-Basic Sectors and the Richer-Pays-More "Housing Subsidy Policy" of April 1987

In the eighties the Hong Kong economy took advantage of the opening up of the Chinese economy and started moving the bulk of manufacturing processes into China, particularly the Pearl River Delta. Superficially there is a "hollowing out" of the economy. But despite the hollowing out the economy was marching along quite well, on the basis of what some commentators called the "virtual economy." Indeed, borrowing the terminology from regional economics, Hong Kong's external sector, the so-called "basic sector," has suffered only a temporary setback during the Asian Financial Crisis. This sector includes the export of goods and services, and earnings from investment overseas, and offshore trade. Hong Kong is the brain centre directing so much happenings in the region and around the world. Yet not everyone works in the basic sector. For each individual who works in the basic sector, perhaps four or five people work in the non-basic sector. The non-basic sector, i.e., the sector that depends on the domestic market, draws its strength from the basic sector and depends on the basic sector for its survival.

In order for more people to share the material benefits achieved in the basic sector, the economy needs a mechanism to transmit the economic benefits to the rest of the economy. The property market provides such a mechanism. In particular, when people get richer, they tend to move to bigger houses, and in so doing benefiting real estate agents, banks, lawyers, retailers, decorators and interior designers, furniture makers, insurance agencies, restaurants, etc. It is on the basis of a very strong basic sector that Hong Kong had enjoyed its property market boom for decades.

The rather spectacular property market boom from 1987 to 1997 that Hong Kong enjoyed, however, is not only a result of strength in the basic sector. One key factor that is unique to Hong Kong is the implementation of a new public housing policy. The so-called "Housing Subsidy Policy," first introduced in April 1987, expressly sets out to reduce the implicit subsidy to the richer tenants in public housing estates by making them pay higher rent. Although the spirit of the policy was clear at the outset it had been refined a few times. In essence, the policy requires those tenants who have been accommodated for over ten years and who have a household income three times that of the maximum eligibility limit to pay double rent, while those who have breached stipulated income and asset thresholds are required to pay market rent[2].

Such a policy alerted the complacent public housing tenants that they could not take low rent for granted. Given that they had enjoyed long periods of very low rent amidst high inflation, they had accumulated considerable savings, which were ready to be tapped on to buy properties. In a survey conducted by the Housing Authority in 1993, some 24 per cent of all home purchases in the market place were traceable to public housing tenants. Since public housing tenants are supposed to be poor people hardly able to pay market rent this figure is quite disturbing but at the same time it shows that the Housing Subsidy Policy is right.

The continual pouring of money from the richer public housing tenants into the market buoyed up home prices. First Home Ownership Scheme Housing(a low cost homeownership program administered by the Housing Authority) owners found that they could sell their homes at a handsome profit. Such handsome profit allowed them to place an attractive bid for the next higher category of homes. The owners of the latter, in turn, being able to sell at a high price, are also able to pay a higher price for better still housing. The effect goes on. Figure 1 shows that property prices rose spectacularly from 1987 through 1997.

III. Tenant Purchase Scheme

As Figure 1 shows, a dramatic reversal of this chain of events appeared to have taken place in December 1997.

On 8 December 1997 the Government announced a Tenant Purchase Scheme that would allow public housing tenants in designated blocks to buy their existing units at as low as 12 per cent of the estimated market value. Since public housing tenants were the primary source of buyers for HOS housing and the structure of the more recent vintages of public housing has become quite similar to HOS housing, the effect on HOS housing market was immediate. Both prices and turnover fell

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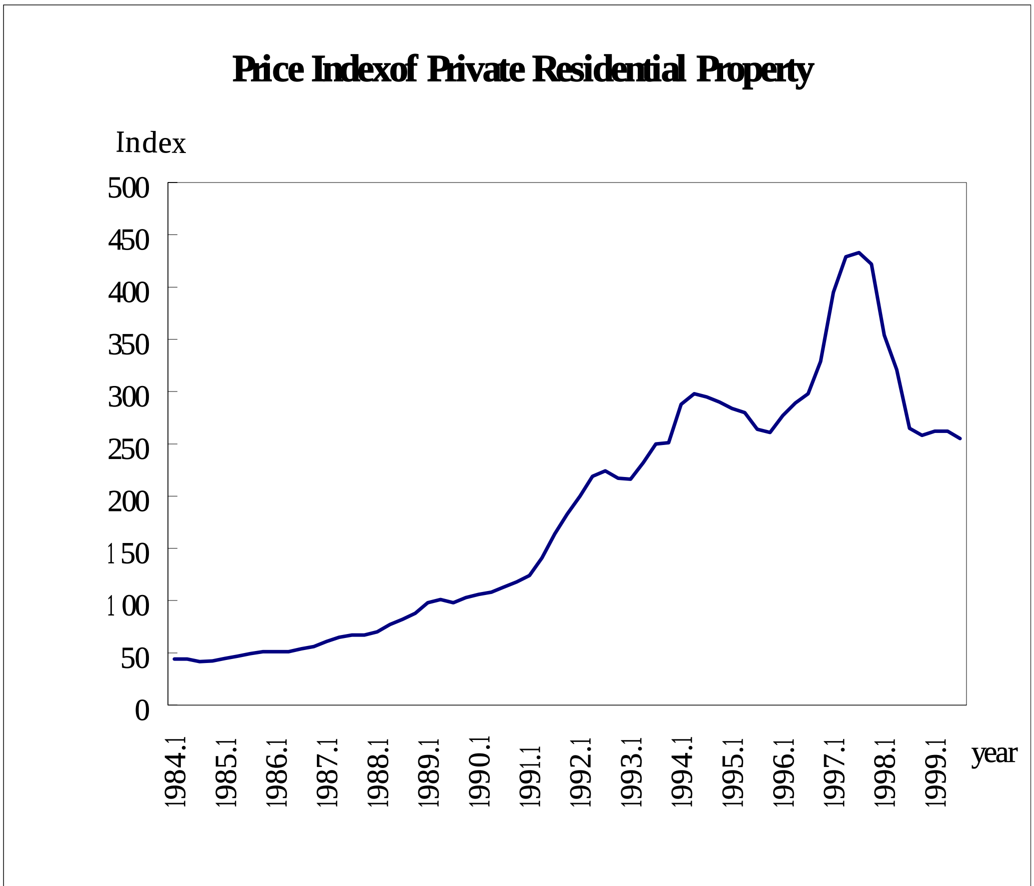
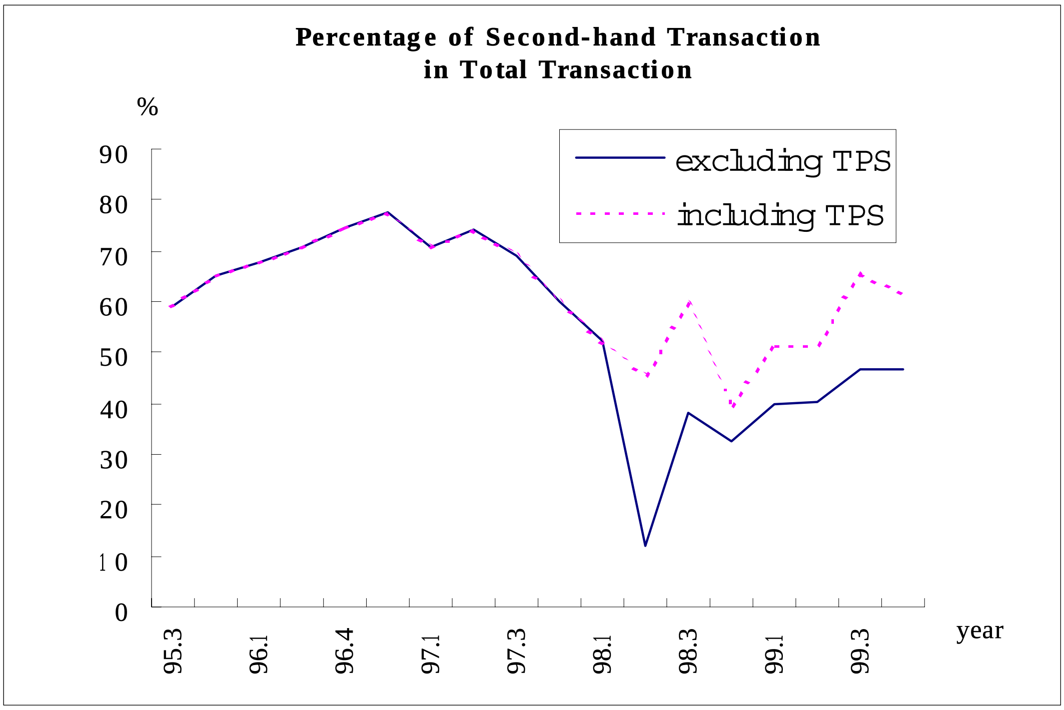
[2] " Safeguarding Rational Allocation of Public Housing Resources: A Consultation Document" published by the Hong Kong Housing Authority in December 1995.

precipitously. Because HOS owners could not sell their units at good prices, they also could not pay good prices for higher-tier housing. The owners of the latter, without the HOS owners as their potential buyers, also had a hard time buying still higher-level homes. Even luxury homes are affected. As a result the entire housing market was paralyzed.



Source: Rating and Valuation Department.

Figure 1.



Source: Census and Statistics Department, Centaline Property Agency Ltd., Housing Authority

Figure 2

By the time the SAR Government announced the nine-point rescue package on June 23 1998 Hong Kong' s housing prices and stock prices had both fallen by some 40 to 50 per cent from their recent peak in 1997. It is fashionable to talk of this major asset price decline as the bursting of the bubble and trace it to the Asian Financial Crisis. Yet it is most difficult to explain why the deep depreciation of the Thai baht and the Indonesian Rupiah has that much effect on Hong Kong's home prices. After all, not a single bank had failed in the financial crisis. Our banks were also extremely cautious, not only in routinely valuing property prices well below market levels but also in providing loans at no more than 70 per cent of the appraised prices. There was, moreover, during the peak or the recent lows, no overbuilding. Although supply had indeed increased quite substantially relative to the immediate past, largely in response to sharp price increases, there was no overhanging excessive supply in 1998.

It is important to note that even at the peak of the property price cycle, the greater majority of buyers were genuine users. However "unaffordable" the property prices were, the majority of the buyers were ordinary people who spent their life savings on what were supposed to be good inflation hedges. They were able to pay such high prices because they were mostly already homeowners and thus were able to pay a substantial down-payment with the equity realized through selling their existing homes. It must be noted that in Hong Kong's market the average home had seldom been for the entry-level buyer. The entry-level buyers had always been paying much more modest and affordable prices for much more modest homes. The Home Ownership Scheme housing flats were such kind of entry-level housing.

To be fair, Hong Kong's homes were very expensive by international standards, but that does not automatically mean they were a bubble. Hong Kong's tax rates were among the lowest in the world, and that tends to be reflected in much higher land prices. Compared to most other places, Hong Kong is politically and socially much more stable, and its bright future is almost guaranteed by China's rapid economic development and its fine tradition of respect for the rule of law. Just as a very high rental yield during the early eighties had reflected a deep uncertainty discount, so the very bright future that Hong Kong faces means that Hong Kong' s property prices perhaps rightly should reflect a premium based on these favorable factors. Even more important, the big savings accumulated by many public housing tenants through years of very low rent and economic upward mobility continued to provide impetus to the housing market at large.[3] The currency crisis in South East Asia did not mitigate any of these favorable factors, and should not warrant the dramatic decline in property prices since July 1997.

To be fair, Hong Kong's home prices in the middle of 1997 were perhaps too high and could be due for a major correction. Hong Kong's home-buyers knew that prices could fall. While it is totally legitimate for market participants to form their own opinions about whether prices were too high, however, it is totally wrong for the government to imagine what is the right price and attempt to engineer a price decline to reach "more acceptable levels." If the government does this, it will have given up its role as the custodian of the free market and will have become anti-market and unnecessarily interventionist.

IV: The Statistical Evidence

Table 2 shows that the introduction of the Tenant Purchase Scheme has an additional and very significant dampening effect on second hand transactions in the housing market over and above the effect of the Asian Financial Crisis, which occurred in the third quarter of 1997. I use the volume of transactions in existing homes as the dependent variable, and I use the difference between the spot exchange rate and the one-year forward rate to proxy the financial crisis. This CRISISDUMMY variable is non-binary, but normalized to have a minimum value of zero and a maximum value of unity. PPIMR is a price appreciation variable. In general, if prices rise faster second hand transactions will also rise.

Table 2: Dependent Variable: Second hand transaction volume : TRANSACT2 (1996M3 to2000M2)

Variable	**Coefficient**	**T-ratio**
Constant term	10261.0	12.067***
CRISISDUMMY	-2949.1	-1.7952*
TPSDUMMY	-3965.3	-2.8409***
PPIMR	33.289	1.5030

[3] Watanabe(1998) presented figures showing that public housing tenants saved much more than HOS owners, private housing tenants, and private housing owners, in absolute and relative terms.

R-bar squared =0.49601
DW-statistic = 2.0709 The Cochrane-Orcutt AR(1) procedure was used to correct for serial correlation.
*** means statistical significance at 1 per cent level
* means statistical significance at 10 per cent level

Table 3 shows the results of a regression exercise that seeks to explain changes in private sector domestic demand in Hong Kong, which is simply the sum of private consumption and investment. The unit of the dependent variable is percentage change. S1 and S3 are seasonal dummies for the first and the third quarters. GOVE90R is the rate of change of real government expenditures on goods and services. Such expenditures should have an impact on private sector domestic demand through the multiplier effect. Similarly, EXPORT90R, and EXPORT90R(+1), which are the rates of change of real exports, current and leading one quarter, have an impact on private sector domestic demand through the multiplier effect. Because production precedes actual exports the lag structure is advanced one quarter relative to that of government expenditures. *A priori*, I expect that both exports and government expenditures have positive effects on domestic demand. Because GOVE90R(-1) does not have a statistically significant coefficient it was dropped. Finally, the real interest rate[4] and inflation have negative effects on domestic demand. We can see that all the estimated coefficients have the expected signs.

Table 3: Dependent Variable: NETDOMDER, 1984 Q2 to 1997 Q4

Variable	Coefficient	T-ratio
Constant term	7.0249	2.8052***
S1	-8.9173	-2.9421***
S3	-7.7852	-5.8722***
GOVE90R	0.26317	1.9948**
EXPORT90R	0.18427	1.6075
EXPORT90R(+1)	0.16797	2.4505**
REALIMRA (-1)	-0.31523	-1.4794
GDPDEFRA (-1)	-0.23405	-1.1353

R-bar squared=0.61719
DW-statistic = 2.0674
*** means statistical significance at 1 per cent level
** means statistical significance at 5 per cent level

[4] This is the standard mortgage rate, equal to the prime rate +1.75 up to February 1996, but declining smoothly to a weighted mortgage rate applicable at the start of 1999, minus the quarter-to-quarter GDP implicit deflator inflation rate annualized..

Based on the parameters thus estimated, using data from 1984 Q2 to 1997 Q4, I forecast the effects on the rate of change or domestic private demand. Along with the actual values of change, the forecast values are tabulated below:

Table 4: Forecast for NETDOMDER for 1998 Q1 to 1999 Q3

Observation	Actual	Prediction	Error
1998 Q1	-9.4982	-4.1557	-5.3425
1998 Q2	5.1774	3.3680	1.8094
1998 Q3	-7.2065	-1.3093	-5.8972
1998 Q4	-3.9714	-0.6435	-3.3279
1999 Q1	-8.9805	-3.1268	-5.8537
1999 Q2	8.6339	5.8449	2.7890
1999 Q3	4.8060	0.4650	4.3410

Source: Based on regression results reported in Table 3

According to the forecast, which uses the realized values of the rates of change of government expenditures, real exports, the real interest rate, and the inflation rate, the actual decline in quarter 1 1998 was much larger than the predicted value. The difference can be attributed to the implementation of the TPS. Actually, the effect of the TPS may be even more serious than this, because the SAR government had adopted a very stimulative budget since 1998, giving generous tax rebates, an unprecedented mortgage interest deduction from taxable income, interest-free home purchasing loans, etc. Moreover, competition among the banks has driven mortgage-lending rates to unprecedented low levels relative to the prime rate. Not counting these positive effects on the economy, according to my estimates, by the end of the first quarter of 1999, TPS had resulted in a loss of 17.46 per cent of domestic demand. Largely as a result of various stimulative measures adopted starting to take effects the cumulative loss was reduced to 11.5 per cent by the end of quarter 3 in 1999.

Table 3a shows the results of a regression using a similar statistical model but adding an additional CRISISDUMMY to capture any independent effect of the financial crisis that may have effects other than through exports and real interest rates. The definition of CRISISDUMMY is as explained above. We can see that the variable carries the right, negative sign. It is not very significant, but we will use the equation to do a forecast, which is presented in Table 4a. We can see that adding the CRISISDUMMY does generally reduce the negative errors of the forecasts, but it also increases the positive errors. Thus it explains part of the economic declines but is overly optimistic in terms of explaining the recovery. That is, given the subsiding of the financial crisis after 1999Q1, the model says the economy should have recovered faster, but the economy did not behave as predicted.

Table 3a: Dependent Variable: NETDOMDER, 1984 Q2 to 1997 Q4

Variable	**Coefficient**	**T-ratio**
Constant term	7.0875	2.8043***
S1	-8.7331	-2.8381***
S3	-7.6637	-5.6434***
GOVE90R	0.25724	1.9267*
EXPORT90R	0.18491	1.6002
EXPORT90R(+1)	0.15887	2.2242**
REALIMRA (-1)	-0.31721	-1.4765
GDPDEFRA (-1)	-0.24168	-1.1600
CRISISDUMMY	-1.4681	-0.50375

R-bar squared0.61102
DW-statistic = 2.0539
*** means statistical significance at 1 per cent level
** means statistical significance at 5 per cent level
* means statistical significance at 10 per cent level

Table 4a: Forecast for NETDOMDER for 1998 Q1 to 1999 Q3

Observation	**Actual**	**Predication**	**Error**
1998 Q1	-9.4982	-5.0188	-4.4794
1998 Q2	5.1774	1.9839	3.1935
1998 Q3	-7.2065	-2.6994	-4.5071
1998 Q4	-3.9714	-0.9596	-3.0118
1999 Q1	-8.9805	-3.6761	-5.3044
1999 Q2	8.6339	5.5848	3.0491
1999 Q3	4.8060	0.2956	4.5104

Source: Based on regression results reported in Table 3a

Many people blamed the Tung Administration for setting a yearly production target for housing units and called this central planning. Yet there is nothing intrinsically wrong with such a strategy. Given that the Government is *the* producer of buildable land and the largest supplier of such land in Hong Kong, there is a need to have a vision as to how much land is to be released each year. A land release strategy based on a production target that is set in the light of demographic trends and economic growth projections seems logical and should be superior to any other kind of strategy.

It is not clear how the Government came up with the annual production target of 85,000. What is clear, however, is that behind this annual production target is the intention to bring down home prices, and this would be wrong. A total of 85,000 units, with 50,000 units coming from the public sector and 35,000 units coming from the private sector, as proposed by the government[5], would be a significant departure from the trend average of about 70,000 per year over the past ten years. It could be justified only if the population increase and income growth were both expected to be much faster than before. The maturing of the Hong Kong economy suggests that trend economic growth over the next ten years should be much more modest than that of the past. This immediately calls into question the wisdom of increasing the supply of private sector housing to the extent proposed.

Although the effects of the TPS, neatly described as a disruption to the ecology of the housing market, are explained in sequential order, they actually took effect immediately. This is like a train engine pushing a series of linked carriages: even though the force comes from the engine at the end of the chain there is virtually no difference in the timing of the motion of the first carriage as compared with the last. Moreover, we have good reasons to believe that the prices of luxury homes, which corresponds to the theoretically last "carriage" affected, would fall even more than the entry-level homes do. Luxury homebuyers are almost always already homeowners and such owners depend entirely on their ability to sell their existing homes before they could buy better ones. On the other hand the entry-level homebuyers have never owned homes before and have all along depended on their cash savings for their buying power.

The injury from the collapse of home prices is deep and wide. Some homeowners have lost all their equity and have become net debtors. Some have actually lost both their homes and their jobs, and have been pushed to the brink of bankruptcy because their lenders will continue to chase after them for the balance of the amount loaned to them upon selling the collateral properties at very low prices. These impoverished homeowners, ironically, were among the most productive within Hong Kong's labor force and had more than the fair share of commitment and trust in Hong Kong's future. Many of them have never had the benefit of receiving subsidized housing from the Government. The great risk to Hong Kong is that they may be so disheartened that they dared not buy homes again in the future, even if they regained the ability to do so. Rather than putting money into their homes in Hong Kong, they may simply ship their savings out of Hong Kong. The result would be massive and continuing capital flight, while the dream of realizing the 70 per cent homeownership target becomes more and more remote.

The collapse in turnover in the housing market is particularly damaging for the Hong Kong economy. Because a number of key sectors depend on housing turnover for their business, the collapse in turnover virtually eroded the basis of their survival. Foremost among those taking the brunt of the shock is the property brokerage sector. Others also hit seriously include decorators, movers, lawyers, bankers, stockbrokers, retailers, sellers of construction materials, and of course real estate developers. As the values of properties fall, the banks had to curtail their lending activities--the worst thing to happen at a time of high interest rates. As a

[5] Mr. Tung Chee-wa recently announced in passing while speaking to reporters that the policy of 85,000 units production target per year "was gone in 1998"—notwithstanding a member of the Executive Council maintaining the contrary just a week before he made those remarks.

result other sectors are also hit. In a matter of four months, Hong Kong's unemployment zoomed, from an average of 2.5 per cent in the November 1997 to January 1998 period, to an average of 4.2 per cent in the March to May 1998 period. By February 1999-April 1999, the unemployment rate reached a high of 6.3 per cent. The rise in the unemployment rate was, however, not entirely due to a loss of jobs. As Table 5 indicates, there was positive employment growth even in 1998. Hong Kong's labor force was growing rather rapidly partly as a result of population growth and partly as a result of rising labor force participation, which is most noticeable among women. Apparently wives were trying to find employment to supplement family income.

Table 5: The Labour Market in Hong Kong 1992-1999

Period	Labour Force ('000)	Unemployment Rate (seasonally adjusted)%	Underemployment Rate(%)	Employment	Employment Growth
1992	2 792.3	2.0	2.1	2736.5	-0.4
1993	2 856.4	2.0	1.6	2800.1	2.3
1994	2 929.0	1.9	1.4	2872.8	2.6
1995	3 000.7	3.2	2.1	2905.1	1.1
1996	3 093.8	2.8	1.7	3007.7	3.5
1997	3 216.0	2.2	1.2	3144.7	4.6
1998	3 358.6	4.7	2.5	3201.0	1.8
1999#	3 476.8	6.1	3.0	3259.5	1.8

Preliminary estimates
Source: Census and Statistics Department

The effects of the TPS on employment can be inferred from Table 6, which clearly shows that employment growth is positively and significantly related to changes in the volume of transactions in homes(HMDEEDSC). Given that the volume of home transactions had fallen after the introduction of the TPS, employment growth must have been significantly reduced by the TPS.

Table 6: Dependent Variable: Change in Employment in Millions (1984Q3 to 1997Q3)

Variable	Coefficient	T-ratio
Constant term	0.02631	4.2338***
S1	-0.04087	-3.9369***
S3	-0.03128	-2.5946***
EXPORT90C (-1)	0.35402E-06	1.5606
HMDEEDSC	0.12518E-05	2.0350**

R-bar squared = 0.28736

DW-statistic = 2.3706

*** means statistical significance at 1 per cent level

** means statistical significance at 5 per cent level

As the economy took a tailspin downturn, the SAR Government's fiscal revenue plummeted. Land sales of course turned in far less revenue than originally forecast. Appeals to sharply reduce land premiums to be paid for conversion of land use and for upzoning jumped, while any land premiums to be collected for similar purposes fell. Meanwhile, profits tax, stamp duty, even salaries tax, all declined sharply. As a result, the Government ran a fiscal deficit in 1998/99, and was able to avoid another deficit in 1999/2000 only because of the huge capital gains achieved subsequent to the incursion in the stock market in August 1998.[6]

V: Rescue Actions

The SAR Government's first budget, announced on February 18, 1998 was a significantly stimulative one and was designed as a rescue package. It gave a tax relief to everyone. The basic personal allowance was raised by 8 per cent. An unprecedented deduction for home mortgage interest payments up to $100,000 per year for five years is given to all owner-occupiers. The profit tax rate was reduced from 16.5 per cent to 16 per cent. The rate of stamp duty on stock transactions was cut from 0.3 per cent to 0.25 per cent. Rates chargeable on properties were reduced from 5 per cent to 4.5 per cent. These and other measures on the revenue side were expected to cost $13.6 billion in 1998-99 and nearly $100 billion up to 2001-02. These measures, together with a symbolic interest rate cut in February, prompted the property market into action, as both turnover and prices recovered noticeably. However, the revival was short-lived, largely because the fundamental problems, namely an excessively large housing production target and a disappearance of buyers of HOS housing as a result of the Tenant Purchase Scheme.

The continual and sharp rise in unemployment prompted the government into rescue action again, as a high level committee was formed to deal with the situation. The proposed 12-point package, announced on June 3, 1998, included stepping up the training programs, accelerating hiring procedures for civil servants, and bringing forward the infrastructure program. At about the same time, the Housing Authority announced it would allow tenants of retail premises in public housing estates, whose leases were due to expire in 6 to 31 months, to apply for a reassessment of rent. The measures, while providing some relief, were however not expected to be very effective, mainly because they did not address the fundamental problem of weakening demand.

Came June 22, 1998. The Government was about to auction two pieces of land the next day. The Financial Secretary and then the Chief Executive together with a panel of top government officials suddenly announced a nine-point rescue package, the most controversial and striking component of which being a halt to all land sales through the end of the fiscal year in March 1999. Market reaction was positive, as the number of viewers for homes put on sale jumped. The stock market, though, reacted coolly. The atmosphere in the financial market was so

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[6] The government bought over HK$100 billion worth of shares in August 1998 while the Hang Seng Index was around the 7000 level. Today(August 2000) the Hang Seng Index is around 17000.

pessimistic that people were skeptical about the effectiveness of the proposed measures and took a wait-and-see attitude rather than going on a buying spree.

VI. What should be done?

Many people blame the linked exchange rate system of Hong Kong for the poor performance (see for example the numerous editorials in the Hong Kong Economic Journal). There is no doubt that the linked exchange rate system has something to do with the severity of the crisis. In this regard, Singapore's system of implicitly linking to a basket of currencies is much wiser. I have argued for a basket link and invented a mechanism for an easy and transparent system to produce just that back in 1990(Ho, 1990). But another problem is that the Hong Kong Monetary Authority had kept Hong Kong's interest rates high—much higher than US interest rates--for too long. I have argued elsewhere, the damage of very high interest rates may not be salvaged even if interest rates fall steeply later on, because once a firm or an individual has gone bankrupt, lower interest rates would not help(Ho, 1998). Singapore, on the other hand, aggressively reduced interest rates at the onset of the Asian financial crisis.[7]

Another serious policy error made by the SAR Government, as this chapter shows, is the way the Housing Authority privatized its public rental housing stock. As yet the SAR Government has not yet recognized its mistake. The Housing Authority continued to expand the Tenant Purchase Scheme. The Government, clearly in an attempt to revive the property market, had expanded the quotas for home purchase loans while cutting back the construction of Home Ownership Scheme Housing. It is ironic that many of those homeowners given interest-free loans to buy homes had become negative equity holders.

In order for the housing market to recover it is necessary for the Government to formally revise downward its long-term housing production target, and put forth a credible, revised land sale program that is consistent with the revised target. The Government has to rework its public housing sale program so as to push the better-off public housing tenants to the HOS or the private housing market. The public housing privatization scheme must exclude all households not meeting the prevailing criteria for eligibility for public housing. Privatized public housing units should also be subject to a resale restriction such that they can be resold only to buyers meeting the criteria for public housing.

Does this mean that I recommend going back to a so-called "high land price" policy? Not at all. As a matter of fact, I must point out that no government can successfully implement a "high land price" policy against economic fundamentals. Can Indonesia today implement a high land price policy and keep the economy humming along? Could Macau have implemented a high land price policy and actually attract real buyers who paid prices anywhere comparable to Hong Kong' s land prices? Hong Kong's land prices were high because people were willing to

[7] From September 15, 1998 through December 10, 1998 Singapore reduced interest rates five times, bringing the prime rate from 7.5 per cent to 5.5 per cent. In contrast, Hong Kong's prime rate started to drop from 10 per cent on October 19 1998, but remained at 9.25 per cent on December 7.

pay for those prices. Would making land available cheaply have transformed Hong Kong' s economy into one that was stronger than it had been? Had Hong Kong done so, Hong Kong would have needed much higher tax rates to finance its government functions. If the Hong Kong Government had always supplied so much land that land prices never rose, Hong Kong belongers would have been deprived of the opportunity of using their homes as their primary store of value. Hong Kong people probably would have remitted their savings away to some offshore places that promised better returns. If Hong Kong's home prices had been stagnant, the drive to save more to buy better and more expensive homes would have been averted. The economy would have been much less vibrant.

Some people say that elsewhere people pay low housing prices and high taxes. In Hong Kong people pay low taxes and high housing prices. The total burden is no different. Some people also say that Hong Kong people actually pay high taxes because they pay so much for the land cost. Indeed land costs, land premiums, stamp duties on housing transactions, etc., boil down to a tax of another form. The crucial question is: which kind of tax provides better incentives for people to work hard and to create wealth? In the late 19th century, the American economist Henry George advocated a single tax on land as the least distorting of incentives. My conjecture is that he is right. According to him, as society progresses, land values increase, and it is right for the government to collect the increase in site values. This is exactly what the Hong Kong Government has been doing. When the developmental value of land has increased to a certain level, developers often want to redevelop their land at higher densities. In Hong Kong such requests are often entertained, subject to planning considerations, provided that they pay the necessary premiums. Is this a good system? Hong Kong's long history of economic success suggests yes.

Such a policy is not quite the same as a " high land price policy." A high land price policy may be defined as one that is designed with the intention of drawing the largest possible revenue from land sales and from land redevelopment levies. This is not what I would recommend. My recommendation is only that for any year land should be supplied as long as the marginal value to society of supplying it is larger than the full marginal cost. The full marginal cost includes the cost of preparing the site and providing the necessary infrastructure links to service it as well as the cost of possible instability added to the housing and the financial market. On June 22 1998, when the Government announced a moratorium to land sales for the rest of the fiscal year, the latter cost was likely to be extremely great. Given that the availability of credit in the banking system is already low, land sale would be badly timed because, like an open market operation made by a central bank, it would suck in liquidity from the market and thus would amplify the credit crunch. For this reason I applauded the halt to land sales. But over the long run something more fundamental has to take place. The government has to reverse the public housing privatization programme.

VII: Conclusions

The Hong Kong is finally recovering. Tourists are coming back, and exports are rising. Foreign investment, too, is expected to pick up rather quickly in the next few years, to take advantage of much lower costs and Hong Kong's unique geographic location and free economic environment. However, local Hong Kong people are suffering. For many Hong Kong people, lifetime savings have been lost. Some have lost their homes. They also face the prospect of higher taxes, as there is fear that a structural fiscal deficit may have occurred. That is, it is feared that the current fiscal deficit may not disappear even after the economy has picked up.

A basic question that our policy makers must face squarely is: should Hong Kong depend on land rent as a primary source of revenue? The SAR Government has made a handsome profit from the shares it purchased in August 1998. But a windfall gain like this is not a reliable source of revenue. Already the Financial Secretary has indicated he would consider introducing the sales tax "to broaden the tax base." There is the fear that if taxes are raised land prices would fall further. Raising taxes, clearly, will also undermine Hong Kong's competitiveness. The public housing privatization program has destroyed wealth rather than created wealth. The Hong Kong story makes an important point and policy makers around the world should take heed: micro-level public policy can have big macro-level and enduring effects. Look carefully before you leap. Learn to understand economic ecology. If the picture about how to go ahead is not clear, take heed from Deng Xiao-ping: grope the stones beneath as you feel your way across the river.

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