

Joint HKU/CUHK/CPU Academic Seminar on ‘After SARS: Education and Research Agenda for the Future’

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Economic Recovery Group

“Economics of SARS in Context”

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Three challenges for the Hong Kong economy

- The Hong Kong economy is confronted with three types of challenges (in order of immediacy):
- **(1) Uncertainty**: unanticipated shock in the form of SARS;
- **(2) Downwave**: serious cyclical downturn of the advanced capitalist economies led by the US; and
- **(3) Structural transformation**: of HK into a “knowledge intensive” economy in the aftermath of the pre-1997 economic bubble and in face of keen inter-city competition from the Mainland.

(1) Uncertainty of SARS as a special shock

- **(1) Uncertainty** of SARS as a special shock: unlike an earthquake, the chance of recurrence is relatively high. Second wave—this winter? It is not very infectious, but could be quite deadly. Other viruses in a 40-year epidemiological cycle?
- How should we “insure” against it? Catastrophic insurance? Any particular role(s) for financial markets?
- Should we “over-react” to SARS after the over-reaction of the economy and the outside world? Or flexi-mode?

(1) Financial markets after SARS

- Financial markets and SARS---local advantages and opportunities:
- Advantages shown in the fight against SARS: professionalism, quality advantages, transparency;
- Opportunities from both demand and supply sides:
 - Insurance;
 - Capital markets: bonds;
 - Equity markets: QDII, Hong Kong as the “agent” providing not just funds, but also regulatory framework and functions that help to reduce the costs of enterprise reforms in China.

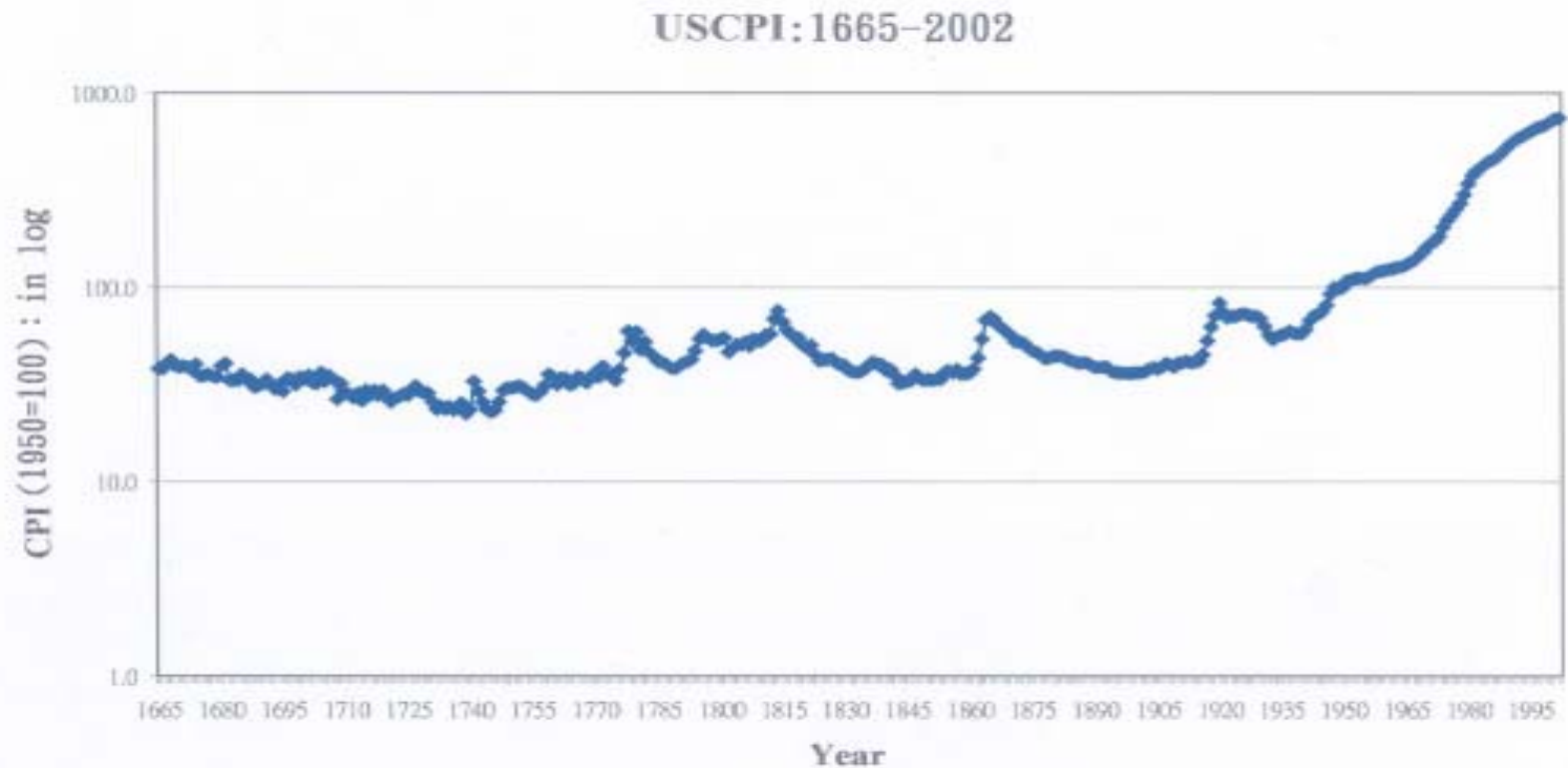
(2) Downwave in the US?

- **(2)** We may be facing an “abnormal” cyclical downturn---**a downwave**. The US economy seems to be having serious troubles, as the rebound is unusually lacking in energy even after 13 rounds of interest rate cuts that result in 45-year lows.
- Is the US caught in a “liquidity trap” or even entering into the “downwave” of a long cycle under the weight of the “debt trap”?

(2) Downwave in the US?

- The following three figures show the domestic and international dimensions of the problems generated by the upwave, to which the economy is now reacting, albeit in an “unnatural” way because of the intervention of the Fed and the Bush fiscal package.
- How are we going to deal with the worldwide repercussions? Normal expansionary policies may be counter-productive for a small open economy like Hong Kong.

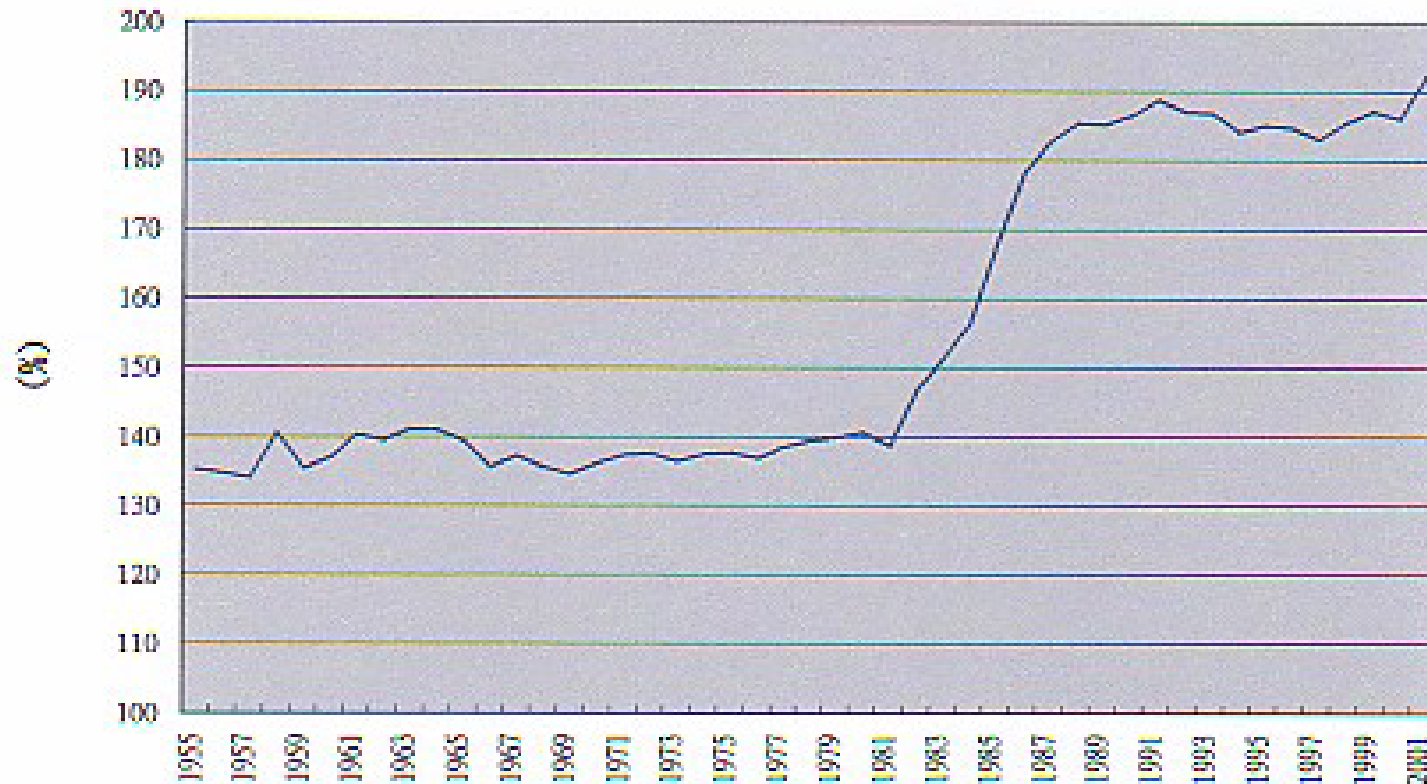
(2) Long waves of US CPI



Source: Robert Sahr, "Inflation conversion factors for dollars 1665-est.2013".

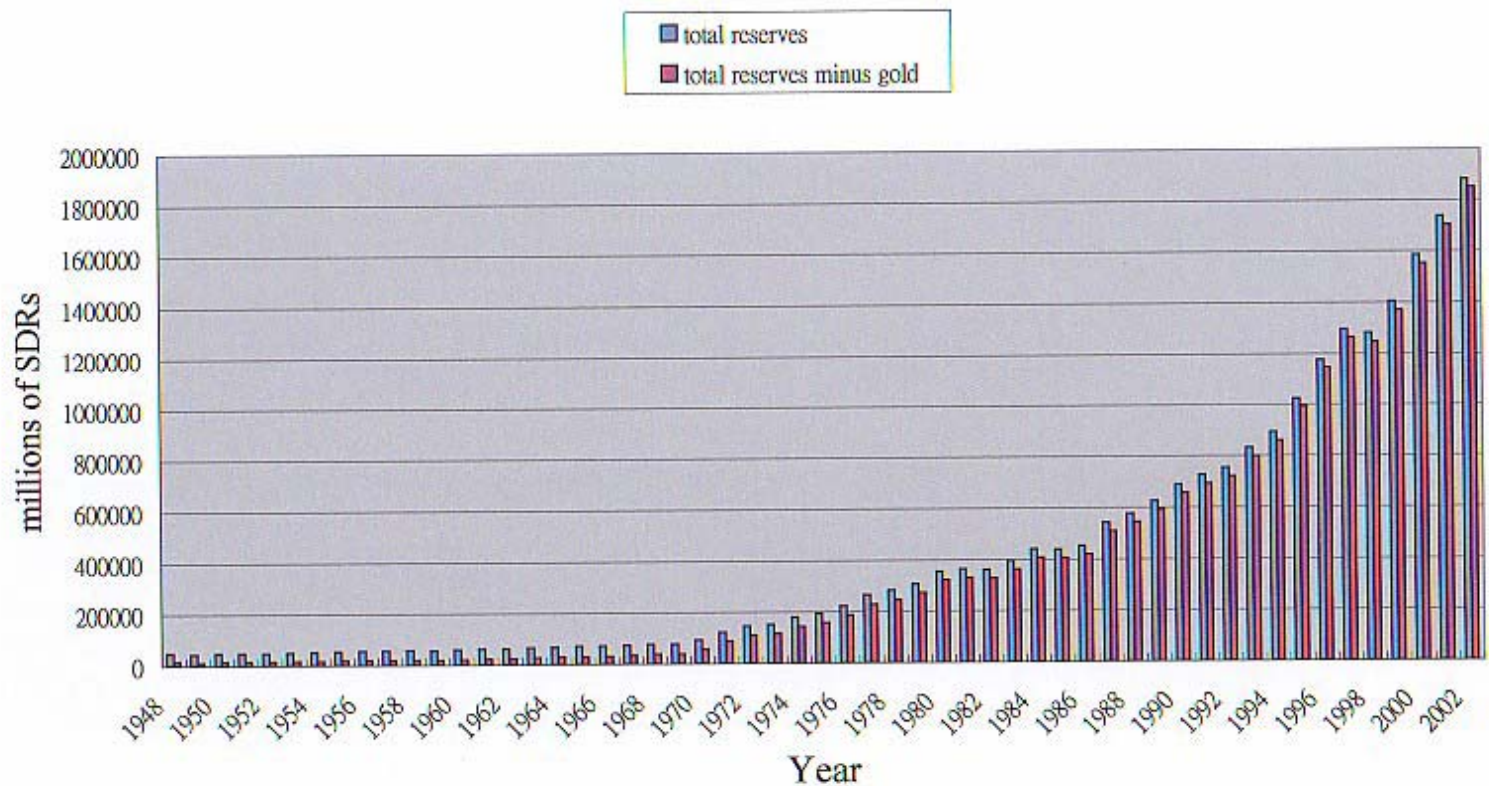
(2) US debt cycle (source: IFS, IMF)

Debt to GDP ratio in the US: 1955–2001



(2) Surge in international reserves in post-1970s (source: IFS, IMF)

International reserves in the world : 1948-2002



(3) Structural transformation and inter-city competition

- **(3)** Hong Kong is in the process of **structural transformation** into a “knowledge intensive” economy in the aftermath of the pre-1997 economic bubble and in face of keen inter-city competition from the Mainland.
- SARS has shown Hong Kong’s unique qualities. Should we further nurture and develop them? Should Hong Kong be positioned as the “Switzerland of Asia”? Or the “dragon head” of the PRD? Or both?

(3) Structural transformation and inter-city competition

- Irrespective of whether it is competition or cooperation (like CEPA), Hong Kong can only benefit substantially from a position of strength. Otherwise, resource flows could result in a net drain and a long-run decline of the local economy.
- The competition is in any case “unequal”: city governments on the Mainland do not believe in “laissez faire”, as many of our government officials do.

(3) Structural transformation and inter-city competition

- Which should be the locomotives of the economy? The four “pillars”? Additional sectors based on “quality advantages”, credibility and transparency?
- Pharmaceuticals? Medical services?
- Financial, commercial, industrial and educational software? Jewelry centre? Microelectronics? Environmental products and services?
- What should the roles of the private sector, the educational and research institutions and the government be in the new positioning?

Facing the challenges

- Of the three challenges, the first two are highly uncertain and largely out of our control. The third requires time and efforts.
- Although we have to be aware of irreversibility in economics (e.g. bankruptcy and destruction of assets), normal macroeconomic “fine-tuning” or counter-cyclical policies could be ineffective, if not an outright waste of resources, in tackling the three challenges.

Facing the challenges

- If the US does enter the downwave and the US dollar falls substantially, like in 1986-1994 or worse, the Hong Kong dollar would further depreciate (already by over 20% in real terms since 1998). However, the fall in demand could be troubling.
- As the following table (from the Census and Statistics Department, HKSARG) on Hong Kong's international investment position (IIP) shows, we still have resources that we *might* harness. The problem is “who would use them for what”? How should we increase local investment opportunities?

Hong Kong's International Investment Position for 2002

Friday, 20 June 2003

International Investment Position by Broad Component(at end of period)

HK\$ million

Broad Component	2000	2001	2002
Assets	8,899,295	8,350,623	8,024,646
Direct investment abroad	3,027,809	2,749,237	2,375,752
Portfolio investment	1,394,320	1,603,059	1,903,241
Financial derivatives	131,063	136,672	170,070
Other investment	3,507,266	2,994,734	2,702,778
Reserve assets	838,839	866,922	872,805
Liabilities	7,169,749	6,282,662	5,378,571
Direct investment in Hong Kong	3,550,840	3,269,653	2,643,871
Portfolio investment	1,194,477	912,493	727,408
Financial derivatives	97,582	94,022	157,997
Other investment	2,326,849	2,006,494	1,849,295
Net International Investment Position⁽¹⁾	1,729,547	2,067,961	2,646,076
Direct investment	-523,031	-520,416	-268,119
Portfolio investment	199,843	690,566	1,175,833
Financial derivatives	33,481	42,650	12,073
Other investment	1,180,416	988,240	853,484
Reserve assets	838,839	866,922	872,805
% to GDP	134%	163%	210%

Note: (1) Net international investment position is the difference between total external financial assets and total external financial liabilities.

Facing the challenges

- We should take into full account the difficulties and our strengths, and formulate reactions with calmness and far-sight.
- We should perhaps find clues from I Ching (易經): after dropping from the sky (亢龍有悔), we better be a “low-lying and nurturing dragon” (君子終日乾乾，夕惕若，厲無咎) instead of a “flying dragon” (飛龍在天).