THE LESSONS
OF EAST ASIA

Hong Kong
A Unique Case of Development

Leung Chuen Chau

The World Bank
Washington, D.C.
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FOREWORD

Policymakers everywhere are searching for lessons from East Asia’s enormous success in economic development. A number of recent cross-country and thematic studies have sought to identify and analyze the policies behind this success. Among them is *The East Asian Miracle*, a recent World Bank publication, which draws in part on the Lessons of East Asia project. Study teams, including in-country nationals, examined in some depth the experiences of the highly successful East Asian economies and the public policies underpinning them.

Several clear contributions emerge from this set of country studies. The research:

- Highlights considerable variation in approaches within the group of East Asian economies. For example, some economies chose a substantial degree of government intervention; others did not. The studies dispel the notion that there is a single or uniform East Asian model of success.

- Demonstrates that a core set of good economic policies—such as macroeconomic discipline, outward orientation, and human resource development—laid the foundation for East Asia’s success. Pragmatic policymaking—understood as being nonideological and reversible—seems to be at the heart of these policies and merits replication.

- Dispels some of the myths about the more idiosyncratic interventions, such as "picking winners" in industry, which sometimes produced the desired result and sometimes did not. Because presence or absence of institutional features seems to have affected the outcomes of these interventions, applications to other regional contexts must be approached cautiously. A dominant finding of the studies is that serious diversions from macroeconomic equilibrium were largely avoided, even by strong interventionists. At the same time, the later generation of industrializers were more successful when they avoided these industrial policies.

A question not easily answered is why East Asian governments adopted fundamentally sound policies and were apparently able to achieve better results from their active policies and to incur lower costs from errors. In this connection, the studies touch on such dimensions of policymaking as the role of the state, leadership, and the bureaucracy. It is one thing to describe the institutional features accompanying a successful episode, however, and quite another to know why and how those features came about. For instance, why did East Asian leaders apparently hold themselves more accountable for economic performance than has been the experience elsewhere? How did the governments manage to gain sufficient national consensus to put difficult policies into effect? These aspects of political economy cannot be ignored. Our analytic tools, however, are severely limited in penetrating these issues, in assessing their impacts, and in assigning credit to them. These country studies are only one step, although a significant one, in deepening our understanding of the experience of East Asia. It is hoped that they will prompt additional work on the institutional foundations of rapid growth.

Gautam Kaji
Vice President
East Asia and Pacific Region
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Danny M. Leipziger
Country Studies Director
The state also fulfills important socio-economic functions, in particular through its public housing and education programs. Half the population live in state-owned housing, which is of a steadily improving standard. Tertiary education has expanded rapidly and the government is committed to making a college education affordable for all families. Industry-specific training schemes were organized by the government and financed by a business training levy. These policies have had beneficial economic consequences, most notably through improvements in the territory’s stock of human capital.

In the past decade, Hong Kong has benefited greatly from the economic reforms and open door policy in China. Manufacturers have a new supply of cheap labor (through sub-contracting arrangements) and a mass market to serve, bilateral trade has expanded rapidly and the financial sector has grown more sophisticated by servicing foreign direct investment in southern China. Entrepôt trade has revived as a valuable source of income and growth. As industrial activities have been relocated to China, Hong Kong has become more of a service center, specialising in marketing, design and finance.

Institutions and Governance

Successive administrations in Hong Kong have remained committed to market-led policies as the best means for promoting growth. Philip Hadon-Cave, Financial Secretary from 1971 to 1981, coined the term “positive non-interventionism” to describe the government’s strategy. Senior officials share a strong belief in economic orthodoxy and have rejected all pressures to use activist fiscal policies to smooth the business cycle. There is a common feeling that demand management would be ineffective given the economy’s openness and that any attempts to raise taxes or increase the role of government would dull work incentives. In contrast to the other NIEs, there have been no reversals of development policy in Hong Kong.

Hong Kong’s legal and administrative framework has proved conducive to the expansion of private enterprise. Property rights are defined and low taxes guaranteed. Local and foreign producers have an equal and free access to all markets. The government has preserved social and political stability, has maintained an efficient civil service, and respects the independence of the legal system. An Independent Commission Against Corruption was established in 1974, reporting directly to the Governor, and has been effective in enhancing the creditability of the law and containing corruption among public servants.

Cultural Dimension

While the other Asian NIEs have attempted to upgrade into capital-intensive industries, Hong Kong continues to prosper through small-scale, labor-intensive manufacturing and import-exporters. The success of these activities is based on the dynamism of Hong Kong’s “merchant-entrepreneurs,” essentially a class of arbitrageurs who are motivated by the prospect of making a quick profit and move easily between different activities. They favor family business or partnership for the sake of prompt decisions and, as manufacturers, prefer unsophisticated projects that offer quick returns. These individuals, a product of Hong Kong’s long history of trading, provide the flexibility and adaptiveness that is characteristic of the local economy. They were ideally suited to exploit the opportunities provided by the economic reforms in China.
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I. INTRODUCTION

Hong Kong embarked on its export-led industrialization in the early 1950s, ten years before any of the other East Asian NIES. At the time, the economic outlook was not optimistic. With no natural resources or agriculture to fall back on, Hong Kong was not eligible for aid due to its status as a colony. Industrialization was a must, but affluent markets were thousands of miles away. Yet, after more than three decades of rapid growth, it has emerged as the richest economy in Asia after Japan. Section I looks at various facets of its economic achievements, and identifies the main sources of its growth.

The four Asian economies, South Korea, Taiwan, Hong Kong, and Singapore, are often referred to collectively as the four "Tigers", or "Little Dragons" on the ground that they share a common cultural heritage and have followed a common development strategy. While the role of the cultural factor is controversial, they certainly did not share a common development strategy. As discussed in Section II, Hong Kong is particularly different because its government chose to play a small and passive role.

Section III looks at Hong Kong's phases of economic development, each with its own leading edge activities and patterns of growth. From this, we deduce a Hong Kong model of growth. Specifically, we argue that the rapid growth was driven by a class of merchant entrepreneur who specialized in finding and exploiting price discrepancies.

In the context of this model, Section IV evaluates the role of policies and institutions. We conclude that local institutions and the policy mix were particularly conducive to commerce-based development. Government housing policies have also contributed, in an unintended and most unexpected manner, to rapid growth.

Defining Success

Between mid-1949 and mid-1954, half a million refugees from mainland China settled in Hong Kong, increasing the population by 27 per cent. Entrepot trade, which was Hong Kong's life blood, flourished in those years, as Hong Kong became the only contact between China and the nonsocialist world. But in 1951, following China's entry into the Korean conflict, the United Nations imposed an embargo on trade between China and the Western world. Entrepot trade in Hong Kong came to a standstill. Hong Kong had to reshape its economy. With its long heritage of trading, virtually no farming because of its small area and hilly terrain, an abundant supply of labor, and a small domestic market, labor intensive manufacturing producing for export was the obvious way out. Four legendary decades followed. More and more LDCs, both from Asia and elsewhere, pursued export oriented industrialization after the 1960s. Economic growth slowed down markedly in the West after 1973 and there was an increase in protectionism. But Hong Kong still kept growing, as fast as ever.

Economic and Social Progress

Growth rates of per capita income are extremely high by any standard (see Table 1). In 1961-81 economic growth in Hong Kong was faster than in any other Asian country, and much faster than that of Western industrialized countries (Chen, 1984, 5-7); Hong Kong's growth rate also tops the list of
countries covered in a recent study by Syrquin and Chenery (1989, 39-41). Only in the 1980s, with political uncertainties at home, did the growth rate slip behind that of other countries in the region. But the economy is extremely resilient. It has never contracted after 1952, and only once has the growth rate stayed under 6 per cent for two consecutive years. Typically, a year of slow growth was followed by years of robust expansion. Unemployment was eliminated by the end of 1950s. At the time of the March 1961 census, it stood at 1.7 per cent. After that it was never a serious problem. Since 1987, there has been a serious labor shortage, with the unemployment rate below 2 percent. Furthermore, this rapid growth with full employment was achieved, until recent years, with relatively stable prices. During the first 30 years there were only two spurts of high inflation: 1973-74 and 1979-81, and both were caused largely by the external oil shocks. These years aside, the rate of inflation averaged less than 5 percent a year over 1961-80. The supply of food and goods from China at stable administered prices and the widespread provision of public housing contributed greatly to this price stability.

Table 1: Growth Rates of Key Indicators in Hong Kong

<table>
<thead>
<tr>
<th>Indicator</th>
<th>1953-60</th>
<th>1959-73</th>
<th>1973-82</th>
<th>1982-91</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>4.5</td>
<td>2.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Labor force</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing emp.</td>
<td>7.7</td>
<td>8.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>9.4</td>
<td>9.2*</td>
<td>9.6</td>
<td>6.2</td>
</tr>
<tr>
<td>Per Capita GDP</td>
<td>6.2</td>
<td>6.8*</td>
<td>7.0</td>
<td>5.1</td>
</tr>
<tr>
<td>Wages for manufacturing workers</td>
<td></td>
<td></td>
<td>6.8</td>
<td></td>
</tr>
<tr>
<td>Retail prices</td>
<td>0.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer prices</td>
<td></td>
<td>10.1</td>
<td>7.9</td>
<td></td>
</tr>
<tr>
<td>Private consumption</td>
<td></td>
<td>9.7</td>
<td>6.6</td>
<td></td>
</tr>
<tr>
<td>Government consumption exps.</td>
<td></td>
<td>11.1</td>
<td>5.0</td>
<td></td>
</tr>
<tr>
<td>Gross Investment</td>
<td></td>
<td>8.9</td>
<td>4.4</td>
<td></td>
</tr>
<tr>
<td>Domestic exports</td>
<td>13.2</td>
<td>8.2</td>
<td>6.8</td>
<td></td>
</tr>
<tr>
<td>Re-exports</td>
<td></td>
<td>15.1</td>
<td>22.6</td>
<td></td>
</tr>
<tr>
<td>Domestic demand</td>
<td></td>
<td>10.4</td>
<td>5.7</td>
<td></td>
</tr>
<tr>
<td>Electricity production</td>
<td>13.4</td>
<td>14.1</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


With a 6 percent growth averaged over the entire period, per capita income in Hong Kong doubled every 12 years and quadrupled in one generation. According to a UNDP study, per capita GDP in Hong Kong, adjusted for purchasing power parity, ranked in the top quintile among 130 countries. In Asia, it was second only to Japan (UNDP, 1990, 128-9). As both direct and indirect taxes in Hong Kong are considerably lower than the richer countries in the sample, Hong Kong residents are even better off in terms of disposable income. Coupled with a high savings rate and unabated appreciation of its real estate, it has become a wealthy city.

As for the distribution of income, the available evidences suggests a marked widening in income dispersion during the first decade of industrialization, followed by a large reduction between 1961 and 1971 (see Table 2). Since then, the degree of inequality in the distribution of household income has remained essentially unchanged. The Gini coefficient is currently higher than in most countries of the region. However, the average size of household fell from 4.5 in 1971 to 3.4 in 1991, and household size became more strongly correlated with income in later years (Chau, 1992). If household income is adjusted for size, there would be some reduction in inequality for 1981 and 1991. Furthermore, proportionately more immigrants from China entered Hong Kong during 1970s and 1980s than in the 1960s. Most of them were unskilled people from rural areas who found employment in low paying jobs. Their presence lowered the income share of the poorest quintile, thus contributing to greater inequality, although they themselves were much better off than before.¹

A more direct measure of the spread of well being and the presence of trickle-down is the level and pattern of consumption by lower income groups. Among residents in public housing estates and manual workers there was a marked improvement in the standard of living, both absolutely and relatively, from the mid-1960s to 1980. They were spending proportionately less on food, and yet their per capita food consumption rose from about two-third of the national average in 1963/4 to 20 percent above the overall average in 1979/80.

Another measure of well-being is government expenditure on social services, which increased rapidly after the mid-1970s. As a percentage of GDP, it went up from about 5 percent in the early 1970s to 7 percent in recent years. This has resulted in rapid social progress, as shown in Table A2. Over a brief span of 25-30 years, the infant mortality rate was cut by 80 percent, and life expectancy is now longer than in many Western countries. No less revealing, among teenagers of working age, the proportion of girls was significantly more than 50 percent in 1976, but the difference was eliminated by 1981 and reversed by 1986. It is likely that the earlier discrimination was practiced by low income households out of economic necessity; its disappearance is a sign of increased affluence and enlightenment.

¹ A detailed analysis and documentation of these developments are found in a forthcoming article by the author, see Chau, 1992.
<table>
<thead>
<tr>
<th>Type of household</th>
<th>Percent of recipients</th>
<th>Mean income ($)</th>
<th>Shares of quintile groups (%)</th>
<th>Gini Ratio</th>
<th>Maximum equalization percentage</th>
<th>Median in income/GDP per capita (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>I</td>
<td>II</td>
<td>III</td>
<td>IV</td>
</tr>
<tr>
<td>1957</td>
<td></td>
<td>365</td>
<td>5.7</td>
<td>9.7</td>
<td>11.7</td>
<td>16.7</td>
</tr>
<tr>
<td>1966 Land household</td>
<td>98.2</td>
<td>709</td>
<td>4.7</td>
<td>8.4</td>
<td>12.3</td>
<td>16.6</td>
</tr>
<tr>
<td>1971 All households</td>
<td>100.0</td>
<td>1,039</td>
<td>5.6</td>
<td>10.1</td>
<td>13.6</td>
<td>19.3</td>
</tr>
<tr>
<td>1976 Land household</td>
<td>99.1</td>
<td>2,026</td>
<td>5.3</td>
<td>10.0</td>
<td>14.2</td>
<td>20.4</td>
</tr>
<tr>
<td>1981 All households</td>
<td>100.0</td>
<td>4,042</td>
<td>4.6</td>
<td>10.1</td>
<td>14.7</td>
<td>22.7</td>
</tr>
<tr>
<td>1986 All households</td>
<td>100.0</td>
<td>7,304</td>
<td>5.0</td>
<td>10.0</td>
<td>14.3</td>
<td>20.9</td>
</tr>
<tr>
<td>1991 All households</td>
<td>100.0</td>
<td>13,998</td>
<td>4.7</td>
<td>9.6</td>
<td>14.5</td>
<td>22.1</td>
</tr>
</tbody>
</table>

With data from Household Expenditure Survey

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent of recipients</th>
<th>Mean income ($)</th>
<th>Shares of quintile groups (%)</th>
<th>Gini Ratio</th>
<th>Maximum equalization percentage</th>
<th>Median in income/GDP per capita (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1963-4</td>
<td></td>
<td>683</td>
<td>4.4</td>
<td>8.9</td>
<td>12.2</td>
<td>17.8</td>
</tr>
<tr>
<td>1973-4</td>
<td></td>
<td>1,930</td>
<td>4.1</td>
<td>10.9</td>
<td>15.9</td>
<td>22.1</td>
</tr>
<tr>
<td>1979-80</td>
<td></td>
<td>4,574</td>
<td>6.2</td>
<td>10.9</td>
<td>15.1</td>
<td>21.3</td>
</tr>
</tbody>
</table>

Table 3: Output and Employment Structure in Hong Kong

<table>
<thead>
<tr>
<th>Economic Activity</th>
<th>Percentage Distribution of GDP Current Factor Cost by Economic Activity</th>
<th>Distribution of Working Population by Industry (percentage)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Agriculture and fishing</td>
<td>2.0</td>
<td>0.8</td>
</tr>
<tr>
<td>2. Mining and quarrying</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>3. Manufacturing</td>
<td>30.9</td>
<td></td>
</tr>
<tr>
<td>4. Electricity, gas and water</td>
<td>2.0</td>
<td>1.3</td>
</tr>
<tr>
<td>5. Construction</td>
<td>4.2</td>
<td>6.7</td>
</tr>
<tr>
<td>6. Wholesale, retail and import/export</td>
<td>19.6</td>
<td>20.4</td>
</tr>
<tr>
<td>trades, restaurants and hotels</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Transport, storage and communication</td>
<td>7.6</td>
<td>7.5</td>
</tr>
<tr>
<td>8. Financing, insurance, real estate</td>
<td>14.9</td>
<td>22.8</td>
</tr>
<tr>
<td>and business services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Community, social and personal</td>
<td>18.0</td>
<td>12.5</td>
</tr>
<tr>
<td>services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Activities not adequately defined</td>
<td>0.6</td>
<td></td>
</tr>
<tr>
<td>11. Ownership of premises</td>
<td>9.6</td>
<td>10.9</td>
</tr>
<tr>
<td>12. Nominal sector (imputed bank service charge)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

GDP At Factor Cost: 100.0 100.0 100.0

Sources of Growth

The expansion of manufacturing was the driving force of the economy in the early years (see Table 3). Its share of the labor force was crudely estimated at about 36 percent in 1954, half of whom were in traditional handicrafts (Sczcpanik, 161). This share went up steadily and peaked in 1971, accounting for almost half of the working population, a proportion seldom found in other cities. By this time, most of the cottage industries had disappeared. In that year, the sector contributed 30 percent of Hong Kong’s GDP. From then on, its relative importance has steadily declined. Manufacturing employment, cyclically adjusted, started to decline absolutely around 1987. From 1980 on, more and more manufacturing activities were relocated across the border in the Quangdong province of China. An estimated three millions Chinese laborers are currently working for Hong Kong manufacturers.

Hong Kong has always been a very open economy. Founded by traders a century and a half ago, it remains essentially a city of merchants. Some 75 percent of its manufactured products are sold overseas (see Table 4). In the 1960s and 1970s commodity trade was about 150 percent of GDP, and fairly stable. In recent years, with outward processing and the revival of entrepot trade, the ratio has gone above 230 percent. Typically, the top 4 industries have accounted for more than 70 percent of total exports. All of them are labor intensive, light industry activities. Clothing, for example, has long been the mainstay of Hong Kong’s exports, its share changing little over the years. This is most unusual for a product sold in fiercely competitive international markets and subject to all kinds of trade restrictions. Likewise, market concentration is high, with more than 60 percent of exports going to the top 5 markets. Particularly dominating is the United States, which has always accounted for more than a third of the total.

Apart from rapid industrialization, the most notable trend revealed in Table 3 is the phenomenal growth of the finance and business sector in the 1970s and 1980s. Its employment share quadrupled over the period. The take-off of financial services started in the late 1960s and gathered momentum in the 1970s, so it conveniently took up the slack left by the slow down in manufacturing growth. Expansion in the 1970s was a spin off from the world-wide development of the financial industry (which ushered in the globalization of capital markets) and innovative changes in financial services made possible by new electronic and telecommunication technology. Hong Kong was able to benefit because it had many attractions of its own: political stability, no exchange controls, a stable currency fully backed by international reserve assets, a well-defined and well administered legal system, non-interventionist government with low taxation, and a geographic location midway between New York and London.

In the 1980s the financial sector received a big boost from the reforms and open door policy in China. Major banks competed to establish a foothold at this door step of China. The number of banks in Hong Kong went up from 74 in 1977 to 165 in 1989, of which 134 were foreign banks. There were also 238 deposit taking companies, and 158 representative offices of foreign banks. They provide a full range of financial services domestically and offshore. By 1991, Hong Kong had become the second largest financial center in the Asia-Pacific region in terms of loan syndication, fund management, gold trading and stock market capitalization (Jao, 1991, 166-7). For local business, the mature financial sector helps to stimulate savings, attract capital and allocate investible funds. Between 1975 and 1989, bank loans to manufacturing increased 30-fold, and for real estate, 53-fold. In addition to outside capital, foreign banks can help to further overseas business connections, transmit managerial knowledge, market and technological information.
Table 4: Structure of Domestic Exports from Hong Kong

<table>
<thead>
<tr>
<th>Year</th>
<th>Clothing</th>
<th>Textiles</th>
<th>Plastic Products</th>
<th>Electronic Products</th>
<th>Footwear</th>
<th>Watches &amp; Clocks</th>
<th>Electrical Appliances</th>
<th>US</th>
<th>UK</th>
<th>West Germany</th>
<th>Australia</th>
<th>Japan</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>1959</td>
<td>34.8</td>
<td>18.1</td>
<td>7.0</td>
<td>-</td>
<td>4.3</td>
<td>-</td>
<td>-</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1964</td>
<td>36.6</td>
<td>16.0</td>
<td>11.0</td>
<td>2.4</td>
<td>3.9</td>
<td>-</td>
<td>-</td>
<td>27.7</td>
<td>21.9</td>
<td>6.6</td>
<td>2.6</td>
<td>2.7</td>
<td>0.9</td>
</tr>
<tr>
<td>1970</td>
<td>35.1</td>
<td>10.3</td>
<td>11.3</td>
<td>9.5</td>
<td>2.4</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1974</td>
<td>38.2</td>
<td>11.9</td>
<td>9.1</td>
<td>12.0</td>
<td>1.4</td>
<td>2.2</td>
<td>-</td>
<td>32.4</td>
<td>12.1</td>
<td>10.7</td>
<td>5.7</td>
<td>4.6</td>
<td>0.4</td>
</tr>
<tr>
<td>1980</td>
<td>34.1</td>
<td>6.7</td>
<td>7.9</td>
<td>13.9</td>
<td>0.9</td>
<td>9.6</td>
<td>2.9</td>
<td>33.2</td>
<td>10.0</td>
<td>10.8</td>
<td>2.9</td>
<td>3.4</td>
<td>2.4</td>
</tr>
<tr>
<td>1985</td>
<td>34.6</td>
<td>6.0</td>
<td>8.2</td>
<td>20.8</td>
<td>7.4</td>
<td>3.5</td>
<td>-</td>
<td>44.4</td>
<td>6.6</td>
<td>6.2</td>
<td>3.4</td>
<td>11.7</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>39.4</td>
<td>7.5</td>
<td>3.6</td>
<td>25.9</td>
<td>8.5</td>
<td>1.5</td>
<td>-</td>
<td>29.4</td>
<td>6.0</td>
<td>8.0</td>
<td>5.3</td>
<td>21.0</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Census and Statistics Department: Hong Kong Trade Statistics; Hong Kong Review of Overseas Trade, various issues.
Tourism is big business in Hong Kong. In 1991 there were more than six million visitor arrivals. They stayed in 31 thousand hotel rooms and spent an average of US$820. The industry has contributed between 5 and 7 percent of Hong Kong's GDP in recent years (Yang, 1990, 401). Being labor intensive, it has created many jobs. It is also a big customer for Hong Kong's transport and communication facilities. The industry began its sustained growth in the 1960s. Between 1961 and 1980 tourist arrivals grew at 13 percent annually. Visitors were attracted by Hong Kong's reputation as a "shoppers' paradise" — a result of low taxation, free port status, large volume, its concentration of good food, and Shanghaiese tailors who could deliver a custom made suit in 20 hours. More important, with China closed to tourism, Hong Kong became its proxy. In the 1980s, the open door policy of China helped to sustain this momentum. Particularly after 1987, the large number of Taiwanese visiting China have passed through Hong Kong, to comply with their government's policy. Also, with spreading affluence, Southern China itself has become an important source of tourists for Hong Kong.

As Table 1 showed, the growth of exports slowed down markedly after 1973. Thus domestic demand has done more than its share in maintaining the momentum of growth. Consider first private consumption, which in early 1970s accounted for 61 percent of GDP, about a third larger than exports. It has increased at a considerably faster rate than GDP. It has also become more stable. The components registering the greatest gain in the 1970s and 1980s were: furniture and furnishing, rent and housing costs, clothing, recreation and other services. All of them have very high domestic value added contents. Gross investment increased at a slower rate than GDP. It is not clear how out-processing has affected this statistic. At any rate, investment in machinery and equipment has a high import content. That is obviously not true of construction. Table 3 shows a sharp jump in the proportion of workers employed in construction between 1971 and 1981. The proportion fell moderately in 1991, but remained well above that in 1971. Wage rates increased much faster in this sector than for the rest of the economy. Property prices went through two prolonged booms: from 1975 to 1981, with a five-fold increase in housing prices (compared with a 72 percent increase in consumer prices); and from 1985 to 1992, when housing prices rose 5.4 times (compared with a 79 percent increase in consumer prices). The wealth effect produced by these booms is not directly reflected in the national income statistics, but its incidence contributed to the buoyancy of the economy. Government expenditures and public and private investment in infrastructure also registered higher than average growth from 1970s onward.

External Circumstances

During the 1950s and 1960s, Western countries enjoyed a long period of sustained growth. This, along with trade liberalization, provided ready markets for Hong Kong's exports. Until the mid-1960s, Hong Kong faced little competition from other nations in the region, which were often plagued by turmoil or political uncertainty. Periodic unrest in Southeast Asia led to capital flight, a great part of which ended up in Hong Kong.

Politics and policies in China were by far the strongest external influence on Hong Kong. After 1951, China adopted a closed door policy. Emigration to Hong Kong was largely stopped, so Hong Kong was spared the disruption of massive rural-urban migration that has affected many cities in developing countries. From then, until the late 1960s, China provided Hong Kong with a steady supply of foodstuffs, goods, and construction materials at stable and relatively low prices. As I pointed out in an earlier study,

"Thus, instead of having to contend with an inelastic domestic supply of foodstuffs and increasingly expensive imported food, as the rapidly growing urban centers in developing countries typically face,
Hong Kong was blessed with a perfectly elastic supply of foodstuffs from the vast rural hinterland of China ... at administered stable prices* (Chau, 1983, 196-7).

After 1972, China started to raise its export prices, but much less than world prices (Chau, 1983, 195). China's adoption of economic reform and an open door policy in the late 1970s led to an era of integration which has benefited both economies tremendously. Bilateral trade increased at an annual rate of about 40 percent in the 1980s. Entrepot trade involving China re-emerged as a valuable source of income and growth. Increasingly, China was a big market for Hong Kong's own exports, and in 1985 it became the number one trading partner. The Pearl River Delta area has become the workshop for Hong Kong's manufacturers, greatly increasing the scale and profitability of many enterprises. Hong Kong has also acted as the middleman for foreign investment in China, including syndicated loans. This has spurred the growth of finance and business services. Since early 1993, the shares of major enterprises in China were offered for subscription in Hong Kong, and listed on the Stock Exchange. At the same time, as a result of rapid growth in recent years, many of China's enterprises have started to invest in all sectors of the Hong Kong economy.

II. PUBLIC POLICY AND ECONOMIC STRUCTURE

Hong Kong is noted for three main features: an open economy, small government, and non-intervention. The last one, in particular, is considered to be most unusual for an economy of Hong Kong's size. Non-intervention was particularly remarkable in the 1950s and 1960s, but it has remained a tenet of government policy. Philip Haddon-Cave, who was Hong Kong's Financial Secretary from 1971 to 1981, coined the term "positive non-interventionism" to characterize the Government's attitude to the economy:

"This involves taking the view that, in the great majority of circumstances it is futile and damaging to the growth rate of the economy for attempts to be made to plan the allocation of resources available to the private sector and to frustrate the operation of market forces which, in an open economy, are difficult enough to predict, let alone to control." (1984, xiv).

As a corollary, companies have to pay for their own mismanagement and mistakes, and consumers have to pay the full cost of publicly provided services. The word positive means that the Government will not reject every proposal for intervention as a matter of principle, but has strong bias against intervening.

The primary role of government is therefore to provide public services and economic infrastructure which only the government can sensibly provide. Social responsibility to the needy is accepted, but the work ethic must not be weakened by social policies and redistributive fiscal policies (Haddon-Cave, xv). The public sector must be kept as small as possible, to leave more resources to the private sector to react to volatile trading conditions (ibid., xvi). To this end, the government tries to stick to a certain guideline for its expenditure/GDP ratio. Another objective is to minimize price distortions. Finally, the government is committed to a balanced budget, not year by year, but over a business cycle.

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2 This outcome may not be intentional. It was China's national policy before 1978 to freeze its wages and price level.
In general, policy makers after Haddon-Cave have upheld these principles. They have made no attempt to guide the direction of Hong Kong's industrial development, despite considerable pressure in the early 1980s for the government to take a more active role. There has been little change in tax rates in the 1980s. The relative size of the public sector, which was rising in 1970s, has stabilized. Since 1985 the budget has regularly been in surplus.

The Macro Environment

The Government's stance of non-intervention finds its best expression in Hong Kong's macroeconomic setting. For most of the time the authorities have had no means or intention of pursuing a discretionary monetary policy. They have eschewed a counter-cyclical budgetary policy. There is practically no marketable public debt.

Monetary System. There is no central bank in Hong Kong. The currency is issued by 2 major private banks. Before 1972 the Hong Kong dollar was linked to sterling at a fixed rate of exchange, and all notes were fully backed by sterling assets. This arrangement produced an automatic adjustment process, on classical Gold Standard lines. A balance of payments deficit caused contraction of the domestic money supply, falling prices and rising exports, which restored the external balance. There was no room for monetary policy. All things considered, the system worked reasonably well.

The sterling exchange standard came to an end in mid-1972, when sterling started to float. For two years or so the Hong Kong currency was pegged to the US dollar. The link did not last, as the dollar itself became unstable. The Hong Kong dollar was floated in November 1974. For the first time, the authorities could pursue monetary policy to maintain internal economic stability. They made some attempt to influence the growth of credit, but lacked the instruments for effective credit control. As foreign currency-denominated certificates of deposits were designated as liquid assets, the government lost control of credit expansion. It had no public debt instruments with which to intervene directly in the money market. And the fixing of lending rates was in the hand of the Association of Banks, in which the government was not even represented (Youngson 1982, 130-1). From 1977 on, the economy was plagued by excessive credit expansion, a falling exchange rate, and rising inflation. In the words of Jao, "In those years, monetary policy adhered to neither rule nor discretion; it succeeded in controlling neither the price of the money (exchange rate) nor the quantity of money" (1988, 44).

Political events intervened. In July 1982, the British government and the Chinese government started to negotiate on the future of Hong Kong. The progress of that negotiation swayed the mood of the Territory. The Hong Kong dollar was sold heavily from the second quarter of 1983. The decline turned into a rout on September 23 and 24, when the exchange rate fell 15 per cent against the US dollar. On October 15 the Hong Kong dollar was linked to the US dollar at a fixed exchange rate of US$1 = HK$7.8. The link has persisted until today, and discretionary monetary policy was once again removed from Hong Kong.

Budget and Fiscal Policy. Tax rates in Hong Kong are low, simple, and stable. Individuals pay taxes on their salaries on a sliding scale, but the total tax burden is restricted to a standard rate which has varied between 15 and 17.5 percent in post-war years. Property income and profits of unincorporated businesses are taxed at the same standard rate. Corporate profits are taxed at a marginally higher rate. Indirect taxes are few and well-concealed from ordinary consumers. In all, total tax revenue has amounted to about 11 percent of GDP in recent years. The government also receives sizeable non-tax revenue, primarily from land sales, which has amounted to more than 70 percent of tax revenue since
the 1970s. As a ratio of GDP, public expenditure was very stable from the mid-1960s to early 1970s, at between 11-12 percent. Then the ratio started to rise rapidly, reaching 17 percent in 1986-87. Due to the relative price effect (Ho, 1988, 19), the ratio at constant prices was much more stable, rising only from 13 to about 16 percent. On the whole, the ratio is considerably lower than in other Asian NIEs. On the other hand, as Hong Kong needs to spend little on defence, proportionately more can be devoted to other services. The share of social services — education, health, housing, and welfare — in total expenditures has also been increasing, reaching 45 per cent in recent years.

Unlike most other countries, a budgetary surplus has been the rule in Hong Kong. From 1946 to 1990, only 7 deficits were recorded. They were the results of highly unfavorable internal or external circumstances. Significantly, there was no difference in budgetary balance before and after 1958, the year when the British government allowed Hong Kong to decide its own budget. A balanced budget has been a guiding principle for the government. This was made explicit by Haddon-Cave (1988, xviii). Quite unlike in other countries, government departments have tended to over-estimate their expenditures and underestimate their revenues. With hardly an exception, the realized surplus has turned out to be larger than the budgeted one (or the realized deficit smaller). At times, the unplanned surplus became embarrassingly large. In recent years, the accumulated surplus has amounted to about 80 per cent of annual expenditure.

Given the budgetary procedure and the sources of revenue, surpluses tended to rise in periods of boom and fall in slowdowns or slump. This stabilizing impact was pointed out in the Far Eastern Economic Review in 1970. Most governments would have considered this a compliment. But the Hong Kong government went to great lengths to dissociate itself from such Keynesianism. The official position, as pointed out by Cowperthwaite, who was Financial Secretary before Haddon-Cave, is that Hong Kong is the most open economy in the world and a large part of any increase in expenditure will be leaked out through increased imports. Counter-cyclical budgetary policy will, therefore, be ineffectual (Riedel, 1974, 137).

Industry and Trade

A notable feature of Hong Kong’s manufacturing is the predominance of small enterprises. In 1955, soon after the start of export-led industrialization, average employment per firm stood at 45, which was small by any standard. But the average size fell by more than half by 1975, and continued to fall (see Table 5). Although the drop after 1980 might have reflected out-processing, the trend was firmly established. Small enterprises were able to more than hold their ground during decades of rapid growth, continuous structural adjustment and modernization. This seems to defy both conventional economic wisdom and Marxian dynamics (Lin-Mok-Ho, 947).

A systematic analysis of the competitive strength of small businesses is beyond the scope of this paper. Here we shall only sketch their operation. Typically, they started as "spin-offs" from existing enterprises after employees had gained expertise in the design, production, or marketing of the products concerned. Most of them managed to launch their business without using bank credit, relying instead on extended family and friends (Lin-Mok-Ho, 96). There is little government bureaucracy to cope

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3 For 1982/83, the budgeted and realized surpluses were, respectively, 5.1 billion and 20 billion. At March 31, 1993, accumulated financial surplus stood at 119.6 billion, total expenditure for that financial year was 109 billion.
with in starting a business, in renting a premise, and in hiring workers. Depending on the nature of the business, small firms market their output through two main channels. They may work as subcontractors for larger firms, or they may sell their products to overseas buyers through the multitude of import-export firms. Understandably, the fatality rate of these small concerns is high, as they do not have adequate resources to weather adverse changes in trading conditions. But the costs of both starting and winding up a business are very low in Hong Kong.

Table 5: Hong Kong Manufacturing Establishments and Employment

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Establishments</th>
<th>Number Employed</th>
<th>Average Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>1,478</td>
<td>81,718</td>
<td>55</td>
</tr>
<tr>
<td>1960</td>
<td>5,346</td>
<td>218,405</td>
<td>41</td>
</tr>
<tr>
<td>1970</td>
<td>16,507</td>
<td>549,178</td>
<td>33</td>
</tr>
<tr>
<td>1980</td>
<td>45,409</td>
<td>892,140</td>
<td>20</td>
</tr>
<tr>
<td>1990</td>
<td>49,087</td>
<td>730,217</td>
<td>15</td>
</tr>
</tbody>
</table>

Source: Industry Department, Trade Development Council.

Import and export trade is a large part of the Hong Kong economy. In 1988, for example, almost 300,000 people were engaged in it, some 11 percent of the working population. Given the size structure of manufacturing firms, it is perhaps less of a surprise to find that the import-export business is also dominated by small firms. In 1988, the average number of employees per import-export firm was 5.3; 87 percent of the firms had fewer than 9 employees; and more than half had fewer than 4 employees (Annual Digest of Statistics, 1990, 72). In the words of one observer, many of these small firms consist of the owners assisted by clerical help and a messenger, others are husband and wife teams (Yang, 271). Again, entry and exit is easy. Usually, they are highly specialized in a market and product line and know some overseas buyers personally. When these buyers are in town with their shopping lists, the traders arrange for factory sales staff to meet the buyers at their office. As the traders are on personal terms with both parties, it is easier for them to complete the deal. The small traders are informal, flexible, and capable of meeting the special needs of small buyers, particularly those from countries with complicated trade and foreign exchange restrictions. The small traders help to attract the small overseas buyers to Hong Kong, who in turn, are the lifeblood for many small manufacturing concerns.

The government has played an increasing role in boosting trade activities. Its Trade Department handles bilateral and multilateral commercial relations with Hong Kong’s trading partners. Trade promotion is largely coordinated by the Trade Development Council, established in 1966 as a statutory body. It operates 33 offices throughout the world, organizes regular trade fairs and provides up-to-date trade and economic information to local and overseas businessmen. Support also comes from the government-owned Hong Kong Export Credit Insurance Corporation and a number of trade and industrial organizations.
**Banking, Finance, and Business Services**

It is generally recognized that Hong Kong's smooth move into export-oriented industrialization owed much to the market connections and long-established services involved in its entrepot trade. Trade credit, insurance, shipping and stevedore services, and warehousing were well established. So were various infrastructures, such as telecommunications, airport, and port facilities. Since those early days, all these supports have expanded considerably. For example, the container port now handles more containers than any other port in the world. Though short of space, ultramodern technology and good management have made it extremely efficient. It takes 12 hours or less to load and unload a ship. All the piers and berths are privately owned. These facilities, along with strong financial backing, made Hong Kong's merchant fleet the second largest in the world in the early 1980s.

Before the 1970s, the financial system was simple and relatively primitive. Commercial banks were well developed as a legacy of the entrepot past, and their assets were growing at a faster rate than national income. But there were no other specialized financial institutions such as investment banks. In 1965, when information on the distribution of bank loans became available, less than 20 per cent of bank loans were extended to manufacturing industry. How much of this was available for financing fixed investment is not clear (Riedel, 1974, 109, 124). Small firms, in particular, could not obtain long-term or medium-term bank credit. The stock market was not active, with manufacturing poorly represented on it. Savers had few instruments to choose from.

After 1970, the situation changed rapidly. The number of commercial banks increased sharply, and most of the newcomers were foreign banks, which brought in foreign capital and financial innovations. Between 1971 and 1989 loans and advances for use in Hong Kong increased 51-fold. Increasingly the stock exchange became a channel for financing expansion. Today, large firms can also obtain finance by issuing bonds and commercial paper. Small firms can easily obtain bank credits by pledging their plant and equipment (or residential property) as collateral. For savers, there is now a host of financial products to choose from, denominated in all the major currencies.

**Labor Market**

The industrial labor market in Hong Kong is the closest embodiment of a neo-classical competitive market found anywhere. Constraints to market forces, like labor laws, government intervention, unionism, monopsonistic employers, and inertia, are conspicuous by their absence.

In the 1960s and 1970s, almost half the labor force was engaged in manufacturing. It remains the largest employer in Hong Kong. Most of these workers, particularly in the heyday of industrialization, are relatively young, and unskilled or semi-skilled. About 45 percent of them are females. In short, there is a large number of relatively homogenous and mobile workers. Similarly, there is a large number of employers, most of them small enterprises. Both sides are highly rational, or income maximizing. There is no separation of management and ownership among firms. Information is readily available and travels quickly in a small place with highly developed mass media and telecommunications. Labor unions are weak and generally ineffective. There are no entry barriers between industries. The preconditions for atomistic competition are in place. Labor legislation for industrial workers on such matters as hours of work, rest days, sick and maternity leave, severance payments, and long-service payment made their appearance only after 1968. They are lenient by international standards. For example, before the long-service payment ordinance came into effect in
November 1991, an employer needed to give just a month's notice, or a month's pay in lieu of notice, to terminate employment for most workers. There are no minimum wage laws.

Manual workers are not hired with a contract. There is little job security: "In Hong Kong’s competitive economy geared to exports, lay-off and redundancy are an ever-present shadow over the life of the working class" (England and Rear, 1981, 238). On the other hand, workers will not hesitate to quit for a better job — to "fire the boss", as the saying goes. It is common to pay workers by daily rate or piece rate, but their overall package often consists of basic wages and bonus, fringe benefits, and allowances for food and transport. Although basic wages tend to be fairly stable in the short run for a given grade of labor — which may give an impression of wage rigidity — employers can easily adjust fringe benefits when taking on new workers. The putting-out system (where part of the work is farmed out to workers working at home) and subcontracting give additional flexibility to employers. The prevailing view is that relatively unobstructed market mechanisms are at work in determining wages and employment (England and Rear, 1981, 176; Lin-Mok-Ho, 91-2, Riedel, 76; Stretton, 116, Chau; 1988a). Market performance bears witness to this verdict. Wages are known to be flexible both upward and downward. Excessive unemployment tends to be quickly eliminated.

The Property Market

The housing and property market is an anomaly in Hong Kong, perhaps in the world. Unlike the rest of the economy, government participation and intervention is extensive and visible. While most goods and services are relatively cheap, private housing in Hong Kong has always been expensive, and increasingly so. It is one of the few things that people in Hong Kong queue up to buy.

All land in Hong Kong is "Crownland" — owned by the Government. All property is therefore leasehold. In the older part of the city, leases used to run for 999 years from the time of leasing. New leases are generally for much shorter duration. The significant point is that the government has always monopolized the supply of undeveloped land (much of which it obtained through reclamation from the sea) for which it enjoys exclusive rights. It releases land for development in an orderly fashion, according to the perceived needs of the economy. The amount of land to be released for various purposes in a financial year will be publicized a year or so in advance. This land is allocated by public auction. The lessee of each piece of land is obliged to develop it within a stipulated period so as to prevent land hoarding. Some land for specialized purposes is leased by special treaty, negotiated directly between the Government and the applicant.

At the end of the Second World War, much of the housing stock in Hong Kong was destroyed or damaged. With massive inflows of people, a severe housing shortage developed. In response, rent control was imposed on all pre-war housing. That control is still in effect, though all but a few of the pre-war structures have long since vanished. In 1970, rent control was imposed on domestic housing completed after the war. Though the ordinance was introduced as a short run measure, with a life of two years, it was consistently renewed, revised, or replaced so that the control is still in effect to-day. It is the stated and sincere intention of the administration to end the control as soon as circumstances allow. For this reason, newly completed domestic housing is exempted from controls.

However, it is public housing that has the greatest impact on Hong Kong property. At present, more households live in public housing than in private housing. Most of them are in rented public housing, but the percentage in 'home ownership estates' is rising. The Hong Kong government takes pride in being the "largest landlord in the world". The public housing program started out as a
resettlement scheme. In late 1953, a series of shanty town fires left 60,000 people homeless. In 1954, the government decided to rehouse them in permanent structures that it would build. Called Resettlement Estates, they were high-rise and very basic shacks, but at rents affordable to the very poor. Since then, thousands of these units have been built to accommodate squatters who lose their home to fire, flood, or government clearance programs. In the early 1960s, a low-cost public housing program was created, with admission by means test. But, as in the resettlement program, there is no income restriction for continued occupancy, so the mobility rate is very low. Standards have been steadily improved since the early 1970s, and are now at a par with middle-income private housing.

Although half of the population live in public housing, and another 10 to 20 percent live in rent-controlled premises, the residential housing market remains highly active, prosperous, and profitable for those engaged in it. There have been three main price booms: 1967-73, 1974-81, and 1990-92 (see Table A3). Such booms were always accompanied by rampant speculation. Over the decades, the appreciation of property prices has far outstripped the rate of inflation. At today’s prices, housing in Hong Kong is probably the second most expensive in the world, after Tokyo. In the summer of 1992, in an effort to cool the overheated property market and to discourage speculation, banks were instructed to limit their mortgages on the purchase of residential premises to 70 per cent of the property price.

Prices and rents for non-residential property have risen as well, but at a more moderate pace (Table A3). Speculation is less common, so the market is less active.

III. THE NATURE OF GROWTH AND PUBLIC POLICY

Economic growth in Hong Kong since the early 1950s can conveniently be analyzed in three distinct phases (see Figure 1).

Industrialization

This phase ran from the early 1950s to the early 1970s, and contained two subphases: 1953-60, and the 1960s. Industrialization in the earlier period was narrowly based, mostly on textiles and clothing. These industries were initiated by external forces, through "the virtually wholesale transfer of capital, machinery, skills, market connections, and entrepreneurial capabilities from Shanghai and other parts of China" (IRI International, 7). After the entrepot trade was derailed by the UN embargo, more resources were put at their disposal. Unemployment was estimated at 150,000, or 15 per cent of the labor force, in mid-1954. This represented a virtually unlimited supply of workers at very low wages for the manufacturers. External circumstances were also favorable. Markets in developing countries had an insatiable demand for cheap textiles. Goods of higher quality could enter industrialized countries unobstructed. There was little need for industrialists to do anything else, so very little diversification occurred in the 1950s (see Table 6a).
### Figure 1: Evolution of the Hong Kong Economy

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Post war recovery</td>
<td></td>
<td></td>
<td></td>
<td>Reemergence of entrepot trade</td>
</tr>
<tr>
<td>Growth of U.S. and European markets</td>
<td></td>
<td></td>
<td>Competition from NICS and other low-cost countries</td>
<td>Increasing international competition</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Trade protectionism</td>
<td>Growing economic links with South China</td>
</tr>
<tr>
<td>Entrepot trade and services</td>
<td></td>
<td></td>
<td>Clothing/textiles</td>
<td>Entrepot trade services</td>
</tr>
<tr>
<td>Textiles</td>
<td></td>
<td></td>
<td>Diversified consumer manufacturing</td>
<td>Financial and business services</td>
</tr>
<tr>
<td>Clothing</td>
<td></td>
<td></td>
<td>Financial and business services</td>
<td>Fashion apparel and textiles</td>
</tr>
<tr>
<td>Consumer electronics</td>
<td></td>
<td></td>
<td></td>
<td>Diversified consumer manufacturing</td>
</tr>
<tr>
<td>Plastics</td>
<td></td>
<td></td>
<td></td>
<td>Tourism</td>
</tr>
<tr>
<td>Excellent port</td>
<td></td>
<td></td>
<td>Low-cost labor</td>
<td>Quality workforce</td>
</tr>
<tr>
<td>Experienced international trade sector</td>
<td></td>
<td></td>
<td>Responsive physical infrastructure (e.g., housing, transportation)</td>
<td>Accessible technology</td>
</tr>
<tr>
<td>Extensive shipping and trade links</td>
<td></td>
<td></td>
<td></td>
<td>Open and stable legal and regulatory system</td>
</tr>
<tr>
<td>Exploit shipping and trading advantages</td>
<td></td>
<td></td>
<td></td>
<td>Forward-looking physical infrastructure</td>
</tr>
<tr>
<td>Labor-intensive industrialization</td>
<td></td>
<td></td>
<td>Export-oriented industrial diversification</td>
<td>Move to higher-value-added manufacturing</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Strengthen entrepot services</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Build new economic links with China</td>
</tr>
</tbody>
</table>

By the late 1950s an increasing number of local businessmen were moving into manufacturing. Most of them had a trading background and knew little about manufacturing. They were ready to venture into any field which promised a profit. Several failed, but enough of them succeeded to diversify the industrial base. Many new industries and new products made their appearance in the 1960s, particularly plastic flowers, toys, wig products, machinery and electronics products. Employment growth accelerated in the first half of 1960s (Riedel, 93). Industrial wages, which had been stagnant until 1959, started to rise. Export growth jumped to 12 percent a year in 1961-65, and 20 per cent in 1966-70. Two new industrial towns, Tsuen Wan and Kwun Tong, were developed during this decade. Product diversification was accompanied by drastic changes in the pattern of trade. In 1957, less than a quarter of domestic products were sold to North America and Western Europe; by 1969, their share had reached 75 percent (Table 6b).

Practically all the manufactured exports from Hong Kong during this period were light industry labor-intensive consumer products: "Hong Kong finds its comparative advantage in exporting unskilled-labor-intensive manufactured goods..." (Rieder 1974, 34). Most of these products were extremely flexible as the wig industry showed. Responding to a swing of fashion favoring wigs and other hair pieces in the mid-1960s, the export value of "wigs and false beards" went up from $71 million in 1966 to a peak of $937 million in 1970, when it accounted for 7.6 percent of domestic exports. Its decline was just as dramatic. By 1973 its export value had dropped to $104 million, and it soon disappeared from the trade statistics. This ability of Hong Kong’s manufacturers to shift into those products enjoying strong demand is widely credited as a main cause of rapid export growth. The study of Lin-Mok-Ho reveals that this "commodity mix effect" accounted for 56 per cent of the export growth between 1964 and 1974 (1980,123-4).

Broad-based Development

The general environment for Hong Kong’s exports became less favorable in the 1970s. After 1973 the West entered a period of slow growth, and, partly as a result, protectionism mounted. With a restricted market, competition from Korea, Taiwan, and other newly industrializing countries intensified. Wages in Hong Kong were much higher than those in Korea and Taiwan. The response was industrial diversification. The relative weight of textiles and clothing fell, while that of toys, clocks and watches rose. Within each category of goods there was a steady process of trading up to higher-value-added products and wider product ranges (SRI International, 9). Foreign direct investment played a big role in this diversification and modernization. In the 1960s it had been largely confined to electronics; now foreign companies invested heavily in watches and clocks, electrical appliances, chemicals, printing, and food processing. Still, export growth slowed from 13.2 percent a year in the 1960s to about 8 percent in the 1970s.

During the 1970s, Hong Kong managed to develop from a financial backwater into one of the major financial centers of the world, an achievement that has been compared to the success of industrialization during the previous decade and a half (Jao, 1984, 167). In 1971, Hong Kong’s financial sector comprised commercial banks specializing in retail banking services. By 1980, there were more foreign bank offices in Hong Kong than any city other than New York and London. In 1981, the category of finance, insurance, and property contributed more to GDP than manufacturing. This change brought in capital, and supported excellent transport and telecommunication facilities. They made Hong Kong an ideal choice as the regional headquarter for multinational companies, and boosted the growth of tourism and business travel.
Table 6a: The Commodity Composition of Domestic Exports for Selected Years, 1954-1970
(percentage of total domestic exports)

<table>
<thead>
<tr>
<th>Items</th>
<th>1954/a</th>
<th>1960</th>
<th>1965</th>
<th>1970</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clothing</td>
<td>26</td>
<td>36</td>
<td>35</td>
<td>35</td>
</tr>
<tr>
<td>Textiles</td>
<td>33</td>
<td>19</td>
<td>17</td>
<td>10</td>
</tr>
<tr>
<td>Miscellaneous manuf. goods</td>
<td>7</td>
<td>14</td>
<td>20</td>
<td>25</td>
</tr>
<tr>
<td>Artificial flowers</td>
<td>-</td>
<td>5</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Plastic toys &amp; dolls</td>
<td>-</td>
<td>4</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>Wigs</td>
<td>-</td>
<td>-</td>
<td>1</td>
<td>8</td>
</tr>
<tr>
<td>Elec. machinery &amp; appliances</td>
<td>-</td>
<td>2</td>
<td>6</td>
<td>10</td>
</tr>
<tr>
<td>Footwear</td>
<td>6</td>
<td>4</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Metal manufactures</td>
<td>6</td>
<td>4</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Others</td>
<td>22</td>
<td>21</td>
<td>16</td>
<td>15</td>
</tr>
<tr>
<td>Total domestic exports</td>
<td>900</td>
<td>2,867</td>
<td>5,027</td>
<td>12,347</td>
</tr>
</tbody>
</table>

(millions of HK$)

/a Hong Kong trade statistics before 1959 do not distinguish domestic exports from re-exports. Figures for 1954 are the author's estimates.

Table 6b: The Market Composition of Domestic Exports for Selected Years, 1954-1970
(percentage of total domestic exports)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>4</td>
<td>29</td>
<td>37</td>
<td>45</td>
</tr>
<tr>
<td>United States</td>
<td>3</td>
<td>26</td>
<td>34</td>
<td>42</td>
</tr>
<tr>
<td>Western Europe</td>
<td>10</td>
<td>28</td>
<td>33</td>
<td>29</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>7</td>
<td>20</td>
<td>16</td>
<td>12</td>
</tr>
<tr>
<td>Federal Republic of Germany</td>
<td>1</td>
<td>4</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Asia</td>
<td>71</td>
<td>24</td>
<td>14</td>
<td>12</td>
</tr>
<tr>
<td>Japan</td>
<td>5</td>
<td>3</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Singapore</td>
<td>14</td>
<td>8</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>14</td>
<td>8</td>
<td>6</td>
<td>-</td>
</tr>
<tr>
<td>Others</td>
<td>15</td>
<td>19</td>
<td>16</td>
<td>14</td>
</tr>
<tr>
<td>Australia</td>
<td>2</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Africa</td>
<td>7</td>
<td>8</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Total domestic exports</td>
<td>2,417</td>
<td>2,867</td>
<td>5,027</td>
<td>12,347</td>
</tr>
</tbody>
</table>

(millions of HK$)

/a Total exports.

During 1972-1981, domestic demand grew at an annual rate of 10.7 per cent, compared with 8.9 per cent for domestic exports. In the second half of the period, there was a noticeable rise in the propensity to consume. Between 1977 and 1981, consumption grew at an average rate of 14 percent per year, compared with 10.7 percent for GDP as a whole. The correlation between income growth and consumption growth weakened, for several reasons: increased household net worth and growing confidence, entry to the labor force of the baby boom generation who had grown up in relative affluence and security, a spread of consumerism, aggressive marketing, and proliferation of new products. Better educated and informed, with more discretionary income at its disposal, the population's appetite for high-quality goods was growing. The trend towards nuclear households and more working women led to the commercialization of work that had once been done in the home; including food preparation, laundry, dress making, and childcare. High incomes, high profits, and windfall gains from property and stock market booms fed conspicuous consumption. Retail outlets sprang up to meet all tastes and budgets: shopping arcades, department stores, supermarkets, fastfood chains, specialty shops, boutiques, hair salons, and gourmet restaurants. Manufacturers began to turn their attention to the home market. A Hong Kong identity and a sense of belonging was building up. A local culture took shape, expressed in literature, pop music, mass media, and, most important of all, the local film industry. From the 1970s on, locally produced films gradually replaced foreign films, and have gone on to become successful exports.

The increase in consumption propensity was not at the expense of investment. Gross domestic capital formation grew at an average rate of 12.3 per year in 1972-81 (Table A1), compared with about 10 percent during the previous decade. Part of this faster growth was driven by construction, with developers turning out huge housing complexes, complete with shopping and recreation facilities. Property development and construction has come to be known in popular writing as one of four "pillars" of the Hong Kong economy, along with manufacturing, finance, and tourism.

The China-Hong Kong Economic Nexus

The 1978 economic reforms in China ushered in a new era for the economic growth of Hong Kong. Essentially, the reforms involved the release of private enterprise, first in the countryside and then in cities; the substitution of market mechanisms for planning and control; and an open-door policy. In spite of several setbacks, the reform program has brought about sustained growth and spreading affluence. During the 1980s, GDP growth averaged 10.1 percent a year, with even faster growth in southern and coastal China. In Guangdong Province, adjacent to Hong Kong, growth and transformation have been spectacular. In the Pearl River Delta, for example, it is estimated that income growth has averaged more than 20 percent a year in the past few years (Chen and Ho, 1993, 27). Millions of migrant workers from other provinces now work in Guangdong, in the factories, on the farms (local farmers have deserted them for nonfarm jobs), and in services. About three million more have settled in the two Special Economic Zones (SEZ) of Shenzhen and Zhuhai. Half a dozen market towns have been elevated by the central government into cities, each with more than a million people. In 1979, Shenzhen, a town of fewer than 100,000 people on the border of Hong Kong, was created the first SEZ, as part of the open-door policy. By 1991, it had grown to a metropolis of two million people, complete with glossy highrise buildings and traffic jams (The Economist, October 5, 1991, "The South China Miracle"). Today, the Province openly aspires to be the fifth "tiger", after South Korea, Taiwan, Hong Kong, and Singapore.
### Table 7a: Hong Kong's Imports from China

<table>
<thead>
<tr>
<th>Year</th>
<th>Import from China (US$mn)</th>
<th>Annual Growth Rate</th>
<th>Percentage of China's Total Export</th>
<th>Percentage of HK's Total Import</th>
<th>Imports for re-export (US$mn)</th>
<th>Annual Growth Rate</th>
<th>Percentage of HK's Total Import</th>
<th>Percentage of HK's total re-export</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>207</td>
<td>-</td>
<td>11.2</td>
<td>20.2</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1966</td>
<td>487</td>
<td>-</td>
<td>20.5</td>
<td>27.4</td>
<td>-</td>
<td>94</td>
<td>-</td>
<td>29.1</td>
</tr>
<tr>
<td>1970</td>
<td>470</td>
<td>-</td>
<td>20.8</td>
<td>16.1</td>
<td>-</td>
<td>97</td>
<td>-</td>
<td>20.2</td>
</tr>
<tr>
<td>1975</td>
<td>1,383</td>
<td>-</td>
<td>19.0</td>
<td>20.3</td>
<td>300</td>
<td>-</td>
<td>-</td>
<td>21.3</td>
</tr>
<tr>
<td>1981</td>
<td>5,276</td>
<td>-</td>
<td>24.0</td>
<td>21.5</td>
<td>1,951</td>
<td>-</td>
<td>-</td>
<td>26.2</td>
</tr>
<tr>
<td>1985</td>
<td>7,568</td>
<td>6.1</td>
<td>27.7</td>
<td>25.5</td>
<td>3,778</td>
<td>23.5</td>
<td>12.7</td>
<td>28.0</td>
</tr>
<tr>
<td>1989</td>
<td>25,215</td>
<td>29.9</td>
<td>48.0</td>
<td>34.9</td>
<td>20,517</td>
<td>43.3</td>
<td>28.4</td>
<td>54.3</td>
</tr>
</tbody>
</table>

**Sources:**

### Table 7b: Hong Kong's Export to China

<table>
<thead>
<tr>
<th>Year</th>
<th>Export to China (US$mn)</th>
<th>Annual Growth Rate</th>
<th>Percentage of China's Total Import</th>
<th>Percentage of HK's Total Export</th>
<th>Re-export (US$mn)</th>
<th>Annual Growth Rate</th>
<th>Percentage of HK's Total Export</th>
<th>Percentage of HK's total re-export</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>21</td>
<td>-</td>
<td>1.1</td>
<td>3.1</td>
<td>19</td>
<td>-</td>
<td>2.8</td>
<td>10.0</td>
</tr>
<tr>
<td>1965</td>
<td>13</td>
<td>-</td>
<td>0.6</td>
<td>1.1</td>
<td>10</td>
<td>-</td>
<td>0.8</td>
<td>3.6</td>
</tr>
<tr>
<td>1970</td>
<td>11</td>
<td>-</td>
<td>0.5</td>
<td>0.4</td>
<td>6</td>
<td>-</td>
<td>0.2</td>
<td>1.2</td>
</tr>
<tr>
<td>1975</td>
<td>33</td>
<td>-</td>
<td>0.5</td>
<td>0.6</td>
<td>28</td>
<td>-</td>
<td>0.5</td>
<td>2.0</td>
</tr>
<tr>
<td>1981</td>
<td>1,961</td>
<td>-</td>
<td>8.9</td>
<td>9.0</td>
<td>1,458</td>
<td>-</td>
<td>6.6</td>
<td>19.8</td>
</tr>
<tr>
<td>1985</td>
<td>7,857</td>
<td>56.1</td>
<td>18.6</td>
<td>26.0</td>
<td>5,907</td>
<td>64.5</td>
<td>19.5</td>
<td>43.7</td>
</tr>
<tr>
<td>1989</td>
<td>13,816</td>
<td>10.5</td>
<td>31.8</td>
<td>25.7</td>
<td>15,208</td>
<td>9.1</td>
<td>18.1</td>
<td>29.9</td>
</tr>
</tbody>
</table>

**Sources:** Same as Table III.1a
Hong Kong is instrumental in bringing about the economic miracle in South China through massive injections of enterprise, capital, and knowhow. It also acted as middleman for investment from other sources, particularly Taiwan and South Korea. In the process, Hong Kong has done very well for itself. First, as China's only major commercial gateway to the West since 1949, it stood to benefit handsomely from its open-door policy. Re-exports to China increased 38-fold in just three years, from 1978 to 1981 (Table 7a). A practically unlimited supply of labor was put at the disposal of Hong Kong manufacturers, at Chinese wages. And as southern China became more affluent, the people there looked to Hong Kong for upmarket goods and services. Just as Hong Kong was "instant China" to the West in 1950s and 1960s (Hughes, 1968, 50), so it is now "instant West" to Mainland Chinese, with rich dividends to the Hong Kong economy in both cases.

The first major move was into outward-processing. Wages for skilled and semi-skilled workers in Guangdong were (and still are) about a tenth of their equivalent in Hong Kong, and factory space costs were even smaller. From 1980 on, manufacturers in Hong Kong, large and small, began to relocate their operations across the border, with the Hong Kong side specializing in 'front office operations' — marketing, finance, design, packaging and quality control. This greatly enhanced the competitiveness of Hong Kong's exports. Many small operators with a handful of workers before the switch now own plants on the mainland with hundreds of workers. It is generally estimated that, in 1992, some 3 million mainland laborers worked directly for Hong Kong entrepreneurs.

At the same time, entrepot trade has re-emerged as a major activity. In the 1980s, re-exports grew at an annual rate of 20 per cent or more, and most of this growth resulted from trade with China. Part of this expansion reflected the spread of outward-processing, so statistically it displaced domestic exports, explaining their slow growth after 1984. But genuine re-exports of raw materials, capital goods, and consumer durables to China were also expanding very rapidly. In value terms, they increased 34-fold between 1980 and 1991 (Table 7b).

China is the largest market for exports of services from Hong Kong. China has become a big buyer of Hong Kong machinery for textiles, plastics, and electronics, all of which involve considerable training and after-sale services (Sung, 1991, 118). At the same time China has become by far the most important destination for Hong Kong tourists and vacationers. This exchange of visits help to promote Hong Kong products. In recent years, Hong Kong based companies began to set up specialty shops, department stores, and supermarkets in big cities all over China.

From the beginning, Hong Kong has been China's largest financier. Three-fifths of all foreign investment in China came from Hong Kong (Washington Economic Report, March 3, 1993, p.3). But the flows of capital have not always been one-way, especially in recent years. From early 1982 to mid-1985, when political uncertainty led to capital outflows and monetary crises in Hong Kong, the Chinese government injected large amounts of capital into the territory (Sung, 1991, 95). In recent years, China has accumulated foreign reserves and its banking system has been a net creditor to Hong Kong's banks since mid-1988. Total net claims stood at HK$52 billion in the third quarter of 1992, or some 6 percent of total bank credits. From 1990 onwards, Chinese enterprises started to invest heavily in Hong Kong property and equity, which boosted confidence and liquidity.

There is little doubt that the continuing prosperity of Hong Kong since 1986 has been built on these economic links with China. It was recently estimated by Hseuh and Woo that up to 25 per cent of Hong Kong's national income came from "China trade" (1992). This economic integration is now taking on new directions. Large corporations in Hong Kong have started to invest in infrastructure
developments, like subways, port facilities, as well as housing complexes, not only in Guangdong, but in Beijing, Shanghai, Chongqing and other big cities. At the same time, state and provincial enterprises in China are queuing up for a listing on Hong Kong's stock exchange. Increasingly, businessmen and academics are thinking in terms of a southern China Growth Triangle, which includes Hong Kong, Taiwan, and the four SEZs in southern China.

When China introduced economic reform in late 1970s and opened its door to the West, any city in Hong Kong's place stood to benefit handsomely. Still, the success in their economic relations was beyond expectation, and cannot be taken for granted. One should not minimize the complexity of doing business in and with a Communist country. Success required great resilience in responding to the changing and growing needs of the Chinese economy for trade, services, technology, and capital. Political risks were added to business risks. Hong Kong was hit by a political crisis in connection with China's decision, in 1982, to regain sovereignty over Hong Kong in mid-1997. To the businessmen, the temptation to move out has been strong. Indeed, for a few years after 1984, when the Joint Declaration between the Chinese and the British governments was signed, it was not clear whether business was running to, or away from, China, and whether the economic viability of Hong Kong could survive the brain drain and capital outflows. But the economy has not only survived, it has prospered. And the emigrants are returning.

IV. MODELLING HONG KONG'S ECONOMIC GROWTH

The economic success of Hong Kong, Singapore, South Korea and Taiwan from the 1960s onward was unparalleled among developing countries. To explain and to generalize their growth experiences, researchers looked for common features. The obvious one is their outward-looking development strategy. Given their small size, however, there was little alternative. Their success has also been attributed to a common cultural heritage, the so-called Chinese factor and Confucian ethic. This argument stresses the adaptiveness and flexibility of businessmen, their work ethic and respect for authority of workers, thriftiness, the emphasis on education, and the role of family in the formation and operation of business. In addition, all four economies had governments which were credited with providing political stability, and a consistent, pro-growth policy and environment.

Such arguments have met strong criticism. To the critics, the Chinese factor is neither necessary nor sufficient for economic growth (Balassa, 1988, S274-6). Others excluded these factors from consideration because they are not subject to policy action (Kuznets, 1988, S35). All that is required, for Asia or elsewhere, is correct policy and a business environment favorable to growth. In the words of Balassa (1988, S288):

---

4 Richard Hughes wrote a book in 1968, at the time of China's Cultural Revolution, prophetically entitled "Hong Kong, Borrowed Place - Borrowed Time".

5 According to Berger, the later day or "vulgar Confucianism" preaches the following virtues: work ethics and self-discipline; hierarchy and obedience; respect for scholarship; familism; thriftiness; and flexibility and adaptability. (Chen, 1988, 25).
"The neutrality and stability of the incentive system, together with limited government interventions, well-functioned labor and capital markets, and reliance on private capital, ... have been the main ingredients of successful economic performance in East Asia".

The problem with this market-plus-incentive view is that it makes growth seem too easy and too accessible. As Chen put it: "If successful economic development is as simple a matter as export-orientation and getting the prices right, there would have been very few low income countries left today" (1988, 25). In other words, the responsiveness of the public to economic incentives and the effectiveness of the response cannot be taken for granted. Chen went on to synthesize economic, cultural, and political considerations into an eclectic model to explain the economic growth of the four economies. The main thread of this argument is presented in Figure 2. Essentially, an autocratic government provides political and policy stability and maintains a well-functioning labor and capital market, reining in the labor unions if necessary. Confucian ethics will motivate people as well as define interpersonal relationships (between family members, business partners, employers and workers and in business transactions), in a way conducive to efficiency. Both the autocratic government and Confucian values help to boost savings. However, this configuration of cultural and institutional forces serves only the production of labor intensive light manufactured goods for which scale economies and technological transformation are not particularly important.

Chen's model is a good summary of the state-of-the-art explanation of economic growth in the four Asian NIEs. But it has real weaknesses. The model does not explain the performance of non-industrial sectors, and growth in all four countries has been broad-based (Hughes, 1989, 132). The model makes no allowance for the significant differences among the four economies: in the degree of government intervention, the industrialization strategy, and monetary and fiscal policy. For example, as pointed out by Hughes, policy makers in Korea and Taiwan had a strong mercantilist bias towards trade surpluses; consumption was suppressed in Singapore, but not in Hong Kong (1988, 132-5).

A Hong Kong Development Model

Hong Kong was founded 150 years ago, by traders. For the next hundred years, it remained a city of merchants, with entrepot trade as its main economic base. Then, from 1951 on, external events changed the base to export oriented manufacturing. Industrialization was initiated by migrant industrialists, largely from Shanghai. But the spread of industrialization, the initiation of a self-sustaining process of industrial development, was the work of local businessmen. Most of them had a background in trading. Though they took on new roles, they have maintained a merchant's mentality, and have operated much like traders. We shall refer to them as "merchant entrepreneurs".

A merchant aims at securing income or wealth by the exchange rather than the production of goods. His sole purpose is to make a profit. He does not have an interest in the goods he handles. If he holds on to a commodity, it is only because he expects to sell it for a higher price later on. His success is measured solely by the amount of profit made. He is, by nature, a maximizer. But he can also explore new markets, search out for new products, or new source of supplies. Often this search is initiated by, in the words of Kirzner, "a discovery of price discrepancies". Guided by this hunch, he may have to search high and low for missing links between inputs, output, and markets, to bring together different groups of people, and to commit his own capital. He will then have to assume risks. He becomes an entrepreneur. Specifically, he performs one or more of the three main types of entrepreneurial activities identified by Kirzner (1984, 52):
Figure 2
A NIC MODEL UNDER EO1

- Development-oriented autocratic government
  - consistent economic policies
    - political stability
      - adaptability to changes
      - prompt decisions in family firms
      - flexibility in business practices
  - economic freedom
    - private enterprise system
      - more educated
        - docile and disciplined
        - industrious
  - controls over trade unions
    - pro-market wage and manpower policies
    - pro-market monetary, fiscal, and exchange rate policies
    - foreign investment
      - public savings
      - public ownership
- Neo-classical interventionism
- consistent economic policies
  - political stability
    - private enterprise system
    - entrepreneurship
      - adaptability to changes
      - prompt decisions in family firms
      - flexibility in business practices
  - economic freedom
  - controls over trade unions
  - pro-market wage and manpower policies
  - pro-market monetary, fiscal, and exchange rate policies
  - foreign investment
    - public savings
    - public ownership

Arbitrage: acting upon the discovery of a present discrepancy between the prices at which a given item can be bought and sold.

Speculative: an arbitrage across time.

Innovative activity: the creation of an output, method of production, or organization not hitherto in use.

Thus, the process may involve fabricating or manufacturing. But if he has no interest in the commodity itself, or in the wants it satisfies; if the discovery excites him solely because of its profit potential, so that when the undertaking ceases to bring in supernormal profits he will not hesitate to dump the project, then he is what I call a merchant entrepreneur.

Given this attitude and motivation, the merchant entrepreneur has certain personal and behavioral characteristics. He is likely to be a non-specialist. A professional training will only dull his capacity for discovery. He is ever alert to business opportunities. Often he is working on several projects at the same time; as Kizner observed, "To recognize that opportunity A exists need not preclude simultaneously recognizing that opportunity B exists" (1980, 13). He is prone to make quick decision and act promptly, otherwise his profits will be eroded by imitators. For this purpose, he must be good at problem solving, so he is likely to be flexible and adaptive. He takes shortcuts. All these, in turn, will have implications for the way he organizes and operates his business. He will prefer family business or partnership for the sake of quick decisions and secrecy. In his dealing with others, he is prone to informal, oral agreements based on trust. Therefore, personal relationship and personal contact are highly valued. As a manufacturer, he will prefer products that are not capital intensive, with a short gestation period, and not too sophisticated. Partly this is dictated by the limited resources he can command in a family business, but more because, as a merchant, he does not like to make long-term commitments.

These qualities can be contrasted with those of an industrialist. The task of an industrialist is to produce. He competes on the strength of the quality of his product, or on cost effectiveness. He takes pride in his product. He prefers to market it under his brand name. He differentiates his product and tries to cultivate consumer loyalty. Market share is a major objective but business survival is most important. These were the attitudes of the immigrant industrialists from Shanghai who initiated modern industry in Hong Kong. Some of them managed to bring the machinery and raw materials that they had ordered for their Shanghai operations. They started out with big factories and modern machinery (Riedel, 26). There was no searching or trial and error. They were doing what they knew best. Even today, the modern textile industry is still in the hand of their successors, who are a pillar of Hong Kong’s manufacturing industry.

The merchant entrepreneurs, on the other hand, were people like those portrayed in a 1968 survey by the Economist (1968, Oct. 19, xix). With resources from a family rice trading business, the young brothers branched into manufacturing. In the late 1950s, they started making rubber sandals, though "they knew next to nothing about them". The venture went well for a while, then started to falter due to import restrictions and was abandoned. Then they heard that there were profits in plastic dolls

---

6 It is more likely for entrepreneurial talent to come from the home of factory owners than from children of professionals, civil servants, or executives employed by large corporations.
and decided to try their hand with them. Again, they "knew nothing whatever about the techniques involved." They went overseas to find out. With bits and pieces of the required machinery and production techniques obtained from various sources, and through improvisation and experimentation, they tried to fill the gap in the production process. Meanwhile, they blithely produced plastic flowers. They started making and exporting dolls in 1963, mostly marketed under labels of leading manufacturers abroad. By 1968, they were doing so well that their main concern was other "unscrupulous Hong Kong manufactures" pirating their products. A similar story was told by Hughes about the start of the plastic flowers industry (1968, 25).

Even when Hong Kong's industrial structure became more diverse, the basic approach of the merchant entrepreneur has remained. Producers in Hong Kong are still known for their flexibility, adaptiveness, and focus on short-run profits. Writing in 1986, Sung noted, "The competitive edge of Hong Kong manufacturing lies in its flexibility and resilience. Hong Kong is successful in the export of products characterized by frequent changes in design ..." (164).

The success of merchant entrepreneurs is not confined to manufacturing. An excellent example is the late shipping magnate, Y.K. Pao. He came to Hong Kong from Shanghai as a young man. He chose shipping, not because he knew anything about it, but because his experience in China predisposed him to mobile assets which could escape confiscation. A man of modest means, he charmed his way to a bank loan for the purchase of his first ship. His subsequent success was due primarily to the niche he found in financing. He ordered ships from Japanese yards at low cost, taking advantage of the export subsidy of the Japanese government. The ships were immediately leased to Japanese shipping firms on long-term contract. With these contracts he obtained bank loans to finance the purchase of those ships. This way he was able to add to his fleet with little of his own money and at low risk. He discovered and exploited an important price discrepancy. He also knew when to leave the business. In the 1970s, he correctly sensed the coming shipping glut and shifted his interest to property, with even greater success. The two other big ship owners in Hong Kong were less fortunate. They were hit hard by the shipping slump of the 1980s. Significantly, both of them had a background in shipping before they came to Hong Kong and considered shipping their career.

It is in the property market and the equity market that the mentality of traders finds its fullest expression. What concerns a trader is not the value of the commodity, as he has no intention of holding on to it; what matters is whether someone will pay a still higher price for it. To the dismay of economists and policy makers, Hong Kong's property prices have several times been pushed way beyond their sustainable level, to be followed by an inevitable bust. As for the stock market in Hong Kong people with modest means speculate in it. They are reflecting a social ethos, a commercial culture which has three elements. (1) A pecuniary standard in which money is seen as the main, if not the sole, measure of success and accomplishment. The rich are admired and respected; getting rich is the goal in life of most people. (2) An alertness for profit opportunity. For many, to get rich is not just an idle dream but a perceived possibility. They keep their ears and eyes open for opportunities of advancement.
An Environment Conducive to Private Enterprise

Hong Kong has been described as grassroots capitalism (Krause, 1988, S49). To this end, respects for property rights and low taxes are most important, so that everyone, local and foreign, has free and equal access to all markets. Information should be freely and cheaply disseminated, and accessible to all parties. Prices must not be distorted — high taxes distort choice by penalizing work (as against leisure) and risk taking. Low transaction costs are particularly important for a trade oriented economy with many small enterprises. They include low costs of entry, exit, business transactions, and the making and enforcing of contracts. The availability of credit to small enterprises is vital, and includes trade credit and short-term funds as well as long-term finance. Finally, good infrastructure is helpful for all business. Because of its large capital requirement and long gestation period, its absence is the main bottleneck to growth in many cities.

Positive Aspects of Non-interventionism

Underneath the government’s policy of non-interventionism is a strong pro-growth stance. The government believes that intervention will only lower the growth rate (Peeble, 1986, 30). It refused to make taxes more progressive on the grounds that they would erode the incentive to invest (Riedel, 1974, 142-3). Non-interventionism entails minimum regulation, a free port, free exchange and flows of capital, and free enterprise in general. Unlike other economies in the region, there has been no policy reversal in Hong Kong. This predictability and continuity in the economic environment greatly reduced uncertainty. On the positive side, the government has preserved social and political stability. It has maintained an effective and efficient civil administration, and an independent legal system that enforces British laws. Property rights are clearly defined and conscientiously protected. An Independent Commission Against Corruption was established in 1974, reporting directly to the Governor of Hong Kong, which proved to be very effective in eliminating the corruption of civil servants. Later, the authority of the Commission was extended to the private sector. It has reduced the cost of doing business and is particularly beneficial to less well-connected small businessmen, and to foreign businessmen not accustomed to the art of bribery.

Public Expenditures and Regulatory Controls

These can be discussed under four headings (Sung, 1988, 156-7).

Infrastructure and institutional support. The government invests directly in roads, railway, subway, airport, and water supply. Given the high density and unfavorable terrain, it has done a good job in keeping traffic moving in the urban area. The efficient container terminals were privately owned and operated, but their developments were planned by the government. All other utilities, like public transport, gas and electricity, telephone and telegraph, are provided by private enterprises. Most of them operate under franchise with pricing under legislative control. In general, they provide adequate services at reasonable prices, and make good profits.

Trade and industrial production received important supports from such government financed bodies as the Trade Development Council, the Export Credit Insurance Corporations, and the Hong Kong Productivity Council which were established in the 1960s. More specific supports for industry were introduced in the 1980s.
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Resource Development

**Land.** Land is scarce in Hong Kong, so most factories are in highrise buildings. In the 1960s two industrial townships were developed. Massive public housing estates guaranteed an adequate supply of workers to these outlying areas. After 1978, the government started to provide land on special terms to high-technology firms that could not be accommodated in traditional factories. Two industrial estates have since been established to provide site and services at concessional terms for purpose-built factories to accommodate modern industries.

**Human Capital.** The public provision of health and educational services has been steadily upgraded. A nine-year compulsory education was instituted in 1978. Tertiary education expanded rapidly. The government also organized industry-specific training, financed by industry levies. From 1980s on, more emphasis was placed on technical training. A second polytech and the third University of Science and Technology were established.

**Capital.** Except for the short-lived Loans to Small Scale Industry Scheme, the government did not arrange finance to the private sector. But its policy of low taxes resulted in abundant savings and an ample supply of loanable funds for private investors. Secondly, instead of competing with the private sector for credit, as is common elsewhere, the conservative fiscal policy brought about sizeable budgetary surpluses year after year. Thirdly, as the government did not have firm control over credit expansion, the supply of bank credit could be quite elastic, so as boom in one sector did not crowd out another sector. In recent years the government also made concerted efforts to attract foreign investment so as to speed up technological transfers.

The Promotion of Industrial Diversification

From the early days there were intermittent calls for the government to be more active in assisting industrial diversification. The recession of 1974-75 made such arguments more persuasive. An Advisory Committee on Diversification published its report in December 1979. It was a major landmark in the government's changing commitment to industrial development. From that date on, the government did make more concerted efforts on technical training, industrial support services, and financing research and development. Since the Hong Kong economy is increasingly being integrated with the Chinese economy, it is probably not an exaggeration to say that the report was out of date as soon as it was published [Chen and Li, 137].

Financial Regulation

From the 1970s onward, the financial system in Hong Kong grew rapidly in size and complexity. The existing regulatory framework and expertise were not adequate for supervising its operations. Though some economists and observers had called attention to loopholes in the Banking Ordinance in the late 1970s, the government was slow to respond. At the same time, the monetary authorities failed to exercise effective control over credit expansion during the floating rate regime of 1974-83 (Jao, 1988, 59). As a result of such negligence, a banking crisis broke out in the early 1980s. Between 1983 and 1986, several major local banks and some deposit-taking companies became insolvent. The government bailed out the failed banks, in an effort to restore confidence in the banking system amidst an atmosphere of political uncertainty. It revised the Banking Ordinance in 1986, to provide for more effective supervision. Subsequently, new or revised regulatory frameworks were introduced to
oversee operations in other segments of the financial market, like the stock market and futures market. Jao argues that "policy errors, negligence or incompetence on the part of the financial and regulatory authorities" were influential causes of the 1983-86 banking crisis (1988, 59). So the government can claim little credit for the expansion of the financial sector.

V. POLICY CONCLUSIONS

By any standard, the Hong Kong government has chosen to play a limited role in shaping the goals and strategy of development, or in regulating and supervising the operations of private enterprises. The policy-mix of a small but effective government, a well-administered legal system, free enterprise, and open economy has been unusually effective in promoting economic growth. By the late 1960s, the overall business climate was so favorable that private capital participated in infrastructure development, and the government could devote its resources to public goods and services. All the preconditions for private enterprises to flourish were in place. Self-sustaining growth was set in motion. Not surprisingly, many observers conclude that the government has had little influence on Hong Kong's prosperity. But we should not just equate limited action with negligible contribution. Specifically, in cases where a market solution is feasible and effective, or where the government cannot claim comparative advantage over private enterprises, non-intervention is a wise policy choice. It was not necessary for the local government to play an active part during Hong Kong's industrial drive mainly because the institutional framework, important infrastructures, including apparatus for world trade, and an initial supply of capital to accommodate private enterprise were already in place. In general, such pre-conditions do not exist among developing nations and active government participation will be necessary to provide them.

Hong Kong was blessed with a succession of favorable external circumstances but these were not indispensable for sustained growth. Importantly, Hong Kong managed to achieve satisfactory growth under unfavorable circumstances. Entrepreneurship must take the credit for this. Under a system of non-intervention and free enterprise, entrepreneurial activities are the key agents that translate positive pre-conditions and opportunities into success. And the growth process of Hong Kong involved a large number of entrepreneurs running a myriad of large and small business in all sectors of the economy. Their number, dedication, business acumen, and versatility has never failed to impress observers from outside. With rising affluence, the state did have to face the issue of income inequality, if social harmony was to endure. To its credit, the government managed to strike the right balance between growth and equity. It chose to redress inequality by working on the expenditure side, through transfers in kind. The basic needs of all but a few were provided for; through an extensive public housing program and a comprehensive education system. Along with rising opportunities, upward mobility is now a reality for all. This was achieved without raising the very low tax rates, or incurring public debts. It has, indeed, been an extraordinary achievement.

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11 Hong Kong Island and southern Kowloon were ceded to Britain by the Ch'ing Dynasty, the territory north of Boundary Street in Kowloon, which makes up more than 80 percent of the total area of Hong Kong, was leased in another treatise for 99 years from 1898. The PRC government made it clear, from the very beginning, that it did not recognize those treatises and pledged to regain sovereignty "when the time is right".
### Table A1: Average Growth Rates in Real Terms of Components of Expenditure on the Gross Domestic Product 1972 to 1981 (%)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Average Annual Growth Rates</th>
<th>10 years</th>
<th>5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Consumption Expenditure</td>
<td></td>
<td>9.9</td>
<td>13.3</td>
</tr>
<tr>
<td>Government Consumption Expenditure</td>
<td></td>
<td>11.1</td>
<td>13.5</td>
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<tr>
<td>Gross Domestic Fixed Capital Formation</td>
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<td>12.3</td>
<td>18.0</td>
</tr>
<tr>
<td>Total Exports of Goods</td>
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<td>10.9</td>
<td>13.6</td>
</tr>
<tr>
<td>Domestic exports</td>
<td></td>
<td>8.9</td>
<td>10.0</td>
</tr>
<tr>
<td>Re-exports</td>
<td></td>
<td>16.9</td>
<td>24.1</td>
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<tr>
<td>Imports of Goods</td>
<td></td>
<td>10.3</td>
<td>15.0</td>
</tr>
<tr>
<td>GDP</td>
<td></td>
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<td>10.7</td>
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<tr>
<td>Per Capita GDP</td>
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<td>7.4</td>
</tr>
<tr>
<td>Real Income</td>
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<td>10.0</td>
<td>10.2</td>
</tr>
<tr>
<td>Per Capita Real Income</td>
<td></td>
<td>7.3</td>
<td>7.0</td>
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<tr>
<td>GDP Deflator</td>
<td></td>
<td>9.0</td>
<td>9.4</td>
</tr>
<tr>
<td>Consumer Prices</td>
<td></td>
<td>9.6</td>
<td>10.8</td>
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<thead>
<tr>
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<th>10 years</th>
<th>5 years</th>
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</thead>
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<tr>
<td>Private Consumption Expenditure</td>
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<td>6.6</td>
<td>7.1</td>
</tr>
<tr>
<td>Government Consumption Expenditure</td>
<td></td>
<td>5.0</td>
<td>5.7</td>
</tr>
<tr>
<td>Gross Domestic Fixed Capital Formation</td>
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<td>4.4</td>
<td>8.6</td>
</tr>
<tr>
<td>Total Exports of Goods</td>
<td></td>
<td>14.6</td>
<td>18.7</td>
</tr>
<tr>
<td>Domestic exports</td>
<td></td>
<td>6.8</td>
<td>6.1</td>
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<tr>
<td>Re-exports</td>
<td></td>
<td>22.6</td>
<td>29.9</td>
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<td>Imports of Goods</td>
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<td>13.6</td>
<td>19.2</td>
</tr>
<tr>
<td>GDP</td>
<td></td>
<td>6.2</td>
<td>6.4</td>
</tr>
<tr>
<td>Per Capita GDP</td>
<td></td>
<td>5.1</td>
<td>5.6</td>
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<tr>
<td>Real Income</td>
<td></td>
<td>6.3</td>
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<tr>
<td>Per Capita Real Income</td>
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<td>5.2</td>
<td>5.6</td>
</tr>
<tr>
<td>GDP Deflator</td>
<td></td>
<td>7.8</td>
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</tr>
<tr>
<td>Consumer Prices</td>
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<td>7.9</td>
<td>8.9</td>
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### Table A2: Welfare Indicators for Hong Kong

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</tr>
</thead>
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<tr>
<td>Infant mortality rate (per 1,000 of live births)</td>
<td>37.7</td>
<td>24.9</td>
<td>18.4</td>
<td>14.3</td>
<td>9.7</td>
<td>-</td>
<td>7*</td>
</tr>
<tr>
<td>Expectation of life at birth</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Male</td>
<td>-</td>
<td>-</td>
<td>67.4</td>
<td>69.6</td>
<td>71.9</td>
<td>-</td>
<td>77*</td>
</tr>
<tr>
<td>Female</td>
<td>-</td>
<td>-</td>
<td>75.0</td>
<td>76.4</td>
<td>77.6</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Hospital beds per thousand of population</td>
<td>3.1</td>
<td>3.7</td>
<td>4.1</td>
<td>4.3</td>
<td>4.2</td>
<td>4.4</td>
<td>4.5</td>
</tr>
<tr>
<td>Population living in inadequate housing (%)</td>
<td>78.0</td>
<td>-</td>
<td>54.3</td>
<td>45.7</td>
<td>38.5</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Households sharing living quarters with other households (%)</td>
<td>-</td>
<td>-</td>
<td>33.2</td>
<td>26.1</td>
<td>24.6</td>
<td>14.9</td>
<td>8.5</td>
</tr>
<tr>
<td>School attendance ratio by age &amp; sex</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6-11 Male</td>
<td>86.7</td>
<td>-</td>
<td>95.5</td>
<td>98.1</td>
<td>98.5</td>
<td>99.5</td>
<td>99.8</td>
</tr>
<tr>
<td>Female</td>
<td>80.0</td>
<td>-</td>
<td>94.4</td>
<td>97.8</td>
<td>98.5</td>
<td>99.5</td>
<td>99.8</td>
</tr>
<tr>
<td>12-14 Male</td>
<td>80.0</td>
<td>-</td>
<td>89.8</td>
<td>90.1</td>
<td>92.0</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Female</td>
<td>79.0</td>
<td>-</td>
<td>80.2</td>
<td>84.5</td>
<td>92.1</td>
<td>92.2</td>
<td>91.8</td>
</tr>
<tr>
<td>15-16 Male</td>
<td>-</td>
<td>-</td>
<td>63.9</td>
<td>70.7</td>
<td>72.4</td>
<td>94.5</td>
<td>95.6</td>
</tr>
<tr>
<td>Female</td>
<td>-</td>
<td>-</td>
<td>51.1</td>
<td>61.7</td>
<td>75.1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>17-18 Male</td>
<td>-</td>
<td>-</td>
<td>42.4</td>
<td>46.2</td>
<td>44.9</td>
<td>53.9</td>
<td>54.3</td>
</tr>
<tr>
<td>Female</td>
<td>-</td>
<td>-</td>
<td>35.2</td>
<td>41.2</td>
<td>45.0</td>
<td>58.3</td>
<td>62/7</td>
</tr>
<tr>
<td>Private consumption at constant prices from national income account (%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foodstuffs</td>
<td>-</td>
<td>34.0</td>
<td>28.1</td>
<td>25.5</td>
<td>19.8</td>
<td>17.4</td>
<td>15.3</td>
</tr>
<tr>
<td>Clothing &amp; other personal effects</td>
<td>-</td>
<td>13.0</td>
<td>20.2</td>
<td>13.5</td>
<td>18.5</td>
<td>20.4</td>
<td>21.7</td>
</tr>
<tr>
<td>Furniture, furnishings &amp; household equipment</td>
<td>-</td>
<td>5.1</td>
<td>4.8</td>
<td>6.2</td>
<td>10.4</td>
<td>12.3</td>
<td>13.1</td>
</tr>
<tr>
<td>Average hours of work per week of employees</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Male</td>
<td>-</td>
<td>-</td>
<td>57.5</td>
<td>53.0</td>
<td>52.0</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Female</td>
<td>-</td>
<td>-</td>
<td>53.3</td>
<td>49.6</td>
<td>47.6</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Median hours of work per week of employees</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Male</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>51</td>
<td>50</td>
<td>48</td>
<td></td>
</tr>
<tr>
<td>Female</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>48</td>
<td>47</td>
<td>45</td>
<td></td>
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* 1988.
Table A3: Growth Rates of Property Costs in Hong Kong

<table>
<thead>
<tr>
<th>Annual Growth Rate</th>
<th>Price Indices</th>
<th>Rental Indices</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Private Flatted Factories (Upper Floors)</td>
<td>Private Offices (Grades A,B,C)</td>
</tr>
<tr>
<td>1976-78</td>
<td>16.5%</td>
<td>15.4%</td>
</tr>
<tr>
<td>1977-85</td>
<td>5.4%</td>
<td>7.0%</td>
</tr>
<tr>
<td>1985-91</td>
<td>18.1%</td>
<td>23.1%</td>
</tr>
<tr>
<td>1978-91</td>
<td>11.0%</td>
<td>14.1%</td>
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</table>
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