

# Assessing the impact of globalisation: Lessons from Hong Kong

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## Abstract

Driven largely by unique economic and political factors, Hong Kong SAR was a globalised economy long before the advent of global value chains in the 1990s. In particular, Hong Kong's role as a link between Mainland China and the rest of the world strengthened over time, as did its status as an international financial centre. The effects of globalisation on Hong Kong are multi-faceted, ranging from higher potential vulnerability to external macro-financial shocks and structural adjustments in the labour market, and to widening income and wealth inequality. The experience of Hong Kong suggests that a sound monetary regime, high flexibility in the labour market and a robust framework for financial supervision can help alleviate the costs and risks associated with globalisation. We conclude by highlighting some future challenges facing the Hong Kong economy amid globalisation.

Keywords: globalisation, international, Hong Kong.

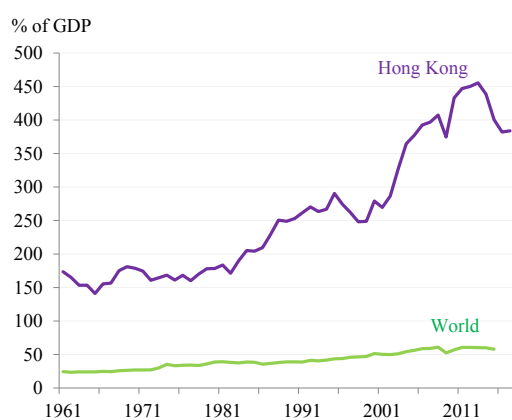
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## 1. Background

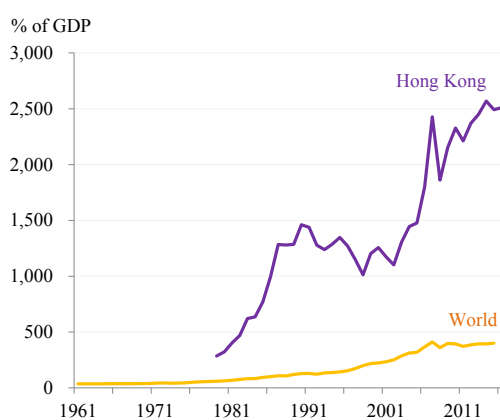
**Hong Kong SAR was a globalised economy long before the advent of global value chains in the 1990s.** As indicated by trade and financial openness, two key dimensions of the degree of globalisation for an economy, Hong Kong has considerably exceeded the world averages since data were available (Graphs 1 and 2). Indeed, Hong Kong may have become integrated into the global economy as early as the 1960s.

Graph 1: Trade openness: exports and imports of goods and services



Sources: C&SD; World Bank.

Graph 2: Financial openness: external financial assets and liabilities



Sources: Lane and Milesi-Ferretti (2017), BIS.

**The globalisation of Hong Kong is driven largely by unique economic and political conditions.** Given its small domestic market and lack of natural resources, it was natural for Hong Kong to evolve into a flexible, adaptive and outward-looking economy in order to maintain its competitiveness. The tendency towards an open economy was reinforced by developments in Mainland China. In particular, before Mainland China opened up in the late 1970s, Hong Kong's political isolation from its motherland and a series of events in Mainland China, including the civil war in the 1940s and the Cold War trade embargos in the late 1940s and 1950s, helped to develop Hong Kong as a unique link between Mainland China and the rest of the world. After Mainland China opened up, Hong Kong's role was further consolidated on the back of Mainland China's economic reforms and financial liberalisation. Leveraging on the key intermediary role between Mainland China and the rest of the world, Hong Kong has become a highly globalised economy.

Although it is difficult to generalise, **Hong Kong's case could shed light on what challenges an economy may face amid globalisation and what the policy implications are.** The rest of the note is organised as follows. Section 2 provides a brief account of the economic transformation in Hong Kong amid globalisation. Section 3 analyses the macroeconomic and distributional effects of globalisation on Hong Kong and the relevant policy implications. Section 4 concludes by discussing the challenges ahead.

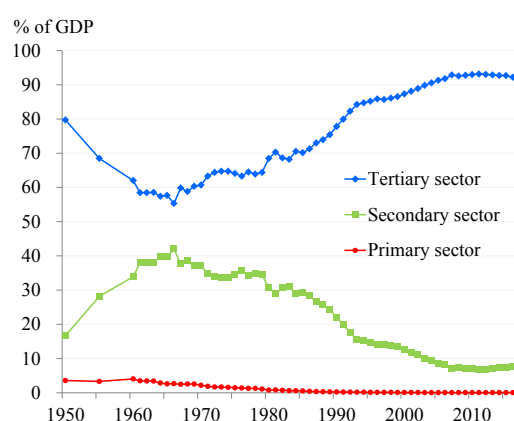
## 2. Hong Kong's economic transformation amid globalisation

As an economy becomes more deeply integrated into the global economy, a rapid transformation may ensue as the economy's comparative advantages evolve over time due to changes in the external environment. Hong Kong is no exception, and this section therefore attempts to broaden our understanding of globalisation through the lens of Hong Kong's economic transformation.

Hong Kong as an industrial economy (before the 1980s)

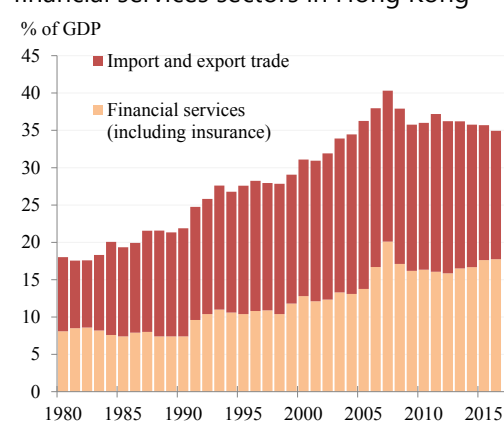
**In the late 1940s and 1950s, Hong Kong began to change from an entrepot to an industrial economy.** Massive flows of refugees and entrepreneurs fleeing the civil war in Mainland China brought cheap labour, massive capital and technological know-how into Hong Kong. These led Hong Kong to develop as an industrial economy in the 1950s and 1960s specialising in labour-intensive manufacturing industries including clothing, electronics, plastics and toys. Consequently, the share of the secondary sector in GDP increased from about 20% in the early 1950s to around 40% in the 1960s and 1970s (Graph 3). At that time, exports also increased significantly (often at double-digit rates) along with rising trade openness to 150–180% of GDP (Graph 1).

Graph 3: Hong Kong's economic transformation



Source: C&SD and World Bank

Graph 4: Import and export trade and financial services sectors in Hong Kong



Source: C&SD.

Hong Kong as a service-based economy and an international trade and financial centre since the 1980s

With the opening up of the Mainland economy in the late 1970s and rising local labour costs in Hong Kong, Hong Kong firms began to move their labour-intensive production activities to the southern part of Mainland China to take advantage of low labour costs there. The share of manufacturing in Hong Kong's GDP has declined visibly ever since (Graph 3). However, the relocation of production activities actually increased Hong Kong's trade openness, as the drop in domestic exports was more than offset by rising trade flows from re-exports and outward processing trades between Hong Kong, Mainland China and the rest of the world. The rising GDP contribution of the import and export trade sector (Graph 4) helped drive the transformation of Hong Kong into a service-based economy. Meanwhile, along with Hong Kong's growing investments in Mainland China and later massive foreign investment inflows into the Mainland via Hong Kong, Hong Kong also witnessed

rising financial openness as indicated by sharp rises in external financial assets and liabilities to over 1,000% of GDP (Graph 2).

**Hong Kong’s role as a link between Mainland China and the rest of the world and its status as an international financial centre were further consolidated after Hong Kong’s reversion to Mainland China in 1997.** Further trade liberalisation in Mainland China, especially its accession to the World Trade Organisation in 2001, increased Hong Kong’s total trade flows markedly. Meanwhile, Hong Kong became an international capital hub for Mainland corporates and international investors, which further boosted the domestic financial sector’s contribution to GDP. More recently, with Mainland China entering into a new growth phase and accumulating surplus capital, Hong Kong’s financial sector has played a role in diversifying investment channels for Mainland and international investors. Hong Kong has also facilitated financial liberalisation in Mainland China, serving as the launch pad for many new measures (eg the offshore renminbi business centre, as well as the Stock Connect and Bond Connect Schemes).

### 3. Macro and distributional effects of globalisation and policy implications

Globalisation has had a far-reaching effect on the Hong Kong economy, as summarised by the following four points.

#### Strong influence of external factors on Hong Kong’s business cycle fluctuations

Being a highly globalised economy, Hong Kong’s economic performance and its volatility are driven primarily by external factors. Our previous study (HKMA (2014)) shows that external shocks from the United States and Mainland China together could explain more than 70% of cyclical output fluctuations both before and after Hong Kong’s reversion to Mainland China (Table 1).

Table 1: Contribution to cyclical output fluctuations in Hong Kong

| (% share)     | Contribution from |       |      |
|---------------|-------------------|-------|------|
|               | US                | China | HK   |
| 1985Q1-1997Q2 | 57.1              | 13.7  | 29.2 |
| 2003Q4-2013Q2 | 47.6              | 28.7  | 23.7 |

Source: HKMA staff estimates.

Note: Variance decomposition over a 20-quarter horizon.

Graph 6: Volatility of key macroeconomic variables in Hong Kong

|               | Standard deviation of year-on-year growth |        |        |            |
|---------------|---|--------|--------|------------|
|               | Real GDP                                  | Export | Import | Inflation* |
| 1974Q4-1983Q3 | 5.8                                       | 10.7   | 13.0   | 5.1        |
| 1984Q1-2017Q3 | 4.4                                       | 9.1    | 9.6    | 4.2        |

\*The series of inflation starts from 1975Q2

Sources: C&SD, HKMA staff estimates.

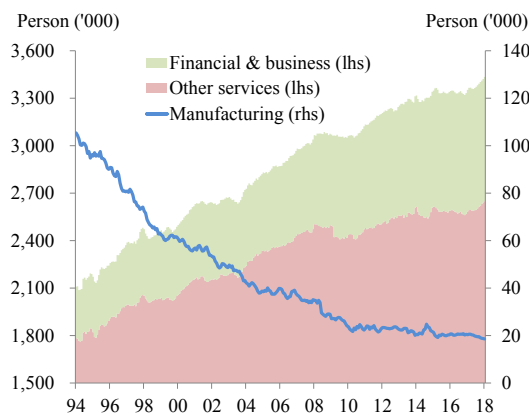
**Policies to dampen economic volatility therefore become crucial in macroeconomic management.** In this regard, monetary policy regimes play a particularly important role. Being a small and open economy with a high degree of cyclical synchronisation with the US economy, **Hong Kong adopted the Link**

**Exchange Rate System (LERS, ie pegging the Hong Kong dollar to the US dollar).** Empirical studies by Kwan and Liu (1999) and Crosby (2000) found that the LERS reduces the volatility of Hong Kong’s economic performance. Consistent with their findings, **the volatility of key macroeconomic variables in Hong Kong is found to have been lower after the implementation of the LERS** (Table 2).

### Rapid structural changes in the sectoral composition of labour market

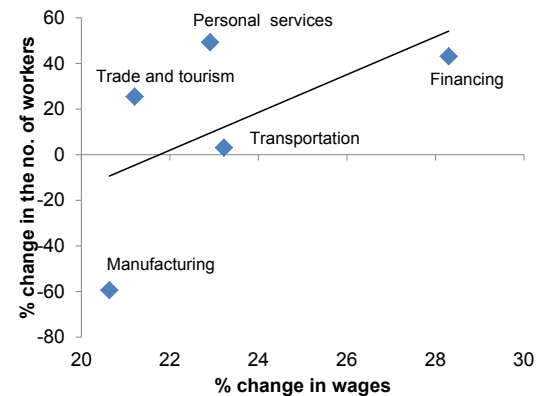
As shown in Section 2, **globalisation** accelerates or even induces economic transformation, **causing marked structural changes in the sectoral composition of the labour market.** In Hong Kong’s case, employment in the manufacturing sector declined significantly as Hong Kong changed into a service-based economy (Graph 5). **Nevertheless, this transformation did not create massive structural unemployment in Hong Kong.** Indeed, when the manufacturing sector shrank in Hong Kong, the rise of service sectors, including the trading and logistic sectors, helped to absorb most of the surplus of manufacturing workers. The overall unemployment rate even declined to around 2% in the early 1990s from about 4% in the early 1980s.

Graph 5: Employment by economic sector



Source: C&SD.

Graph 6: Change in wages and employment in five industries, 1994–2004



Source: C&SD.

**Hong Kong’s smooth economic transformation amid globalisation was largely underpinned by the flexibility of its labour market.** This is reflected in the high responsiveness of wages and employment adjustments among sectors subject to the economic transformation (Graph 6). In particular, when the manufacturing sector lost its competitiveness, its wages growth was below that of other service sectors. By contrast, wage growth in the financial industry outpaced that of other sectors as Hong Kong’s international financial centre expanded. These observations suggest that wage adjustments in Hong Kong faced no major rigidities during the economic transformation and that labour remained highly mobile across sectors.

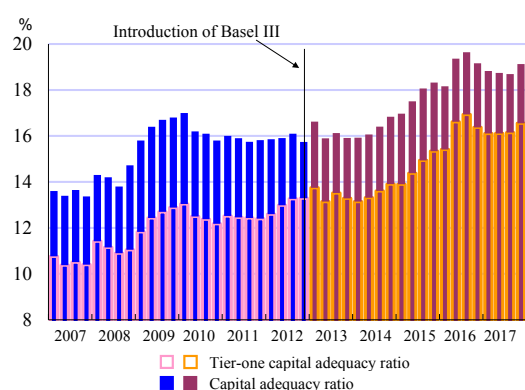
**Government measures also helped smooth economic transformation in Hong Kong.** These include increases in investment in education, the establishment of the Employees Retraining Board and the Continuing Education Fund. These measures not only enhanced labour mobility among sectors, but also helped upgrade labour force skills.

## Increased financial integration with higher international spillover of risks

**Globalisation has led to greater financial integration internationally.** Of the 195 banks operating in Hong Kong at end-2016, 186 were foreign-owned banks. Indeed, most global systemically important banks have an operation in Hong Kong. This, together with the large banking sector compared with the size of Hong Kong's economy (ie banking assets/annual GDP in Hong Kong was around 840% at September 2017), means that **the Hong Kong economy is potentially more vulnerable to external financial shocks.**

**Nevertheless, effective banking supervision and the sound fundamentals of banks in Hong Kong have helped to contain the risks associated with external financial shocks.** In fact, thanks to its strong capital and liquidity position (Graphs 7 and 8), the banking sector emerged from the Asian financial crisis and Great Financial Crisis (GFC) largely unscathed.

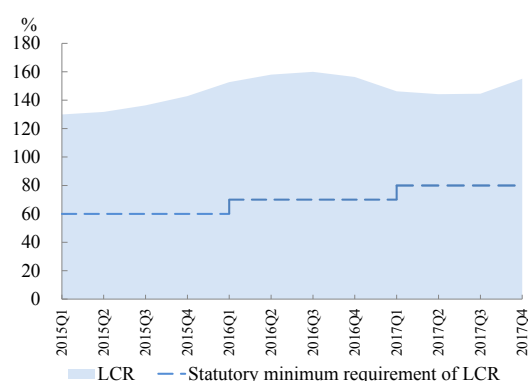
Graph 7: Capitalisation of locally incorporated banks



Note: Average consolidated ratio for all authorised institutions to carry on the business of taking deposit.

Source: HKMA.

Graph 8: Liquidity Coverage Ratio



Note: Average consolidated ratio for all banks in Hong Kong subject to the LCR requirements (i.e. Category 1 institutions in Hong Kong)

Source: HKMA.

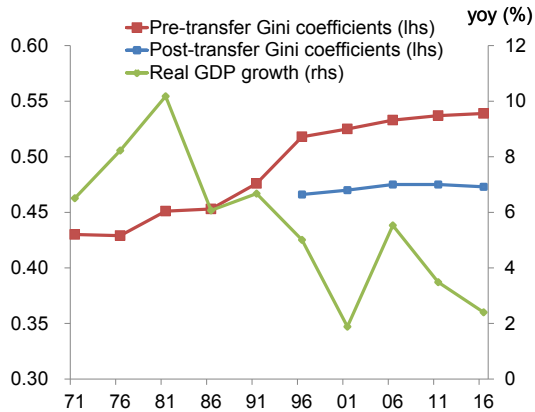
Nevertheless, **macroprudential measures have been deployed extensively by the Hong Kong Monetary Authority (HKMA) to reduce the risks of financial instability after the global financial crisis.** In particular, in view of rising property prices in Hong Kong amid strong capital inflows and the zero interest rate environment after the GFC, the HKMA has implemented eight rounds of prudential measures since late 2009 to help banks strengthen risk management in their mortgage loan businesses.

## Widening income and wealth inequalities

**Hong Kong saw widening income inequality amid globalisation.** Income inequality measured by the Gini coefficient rose quickly from 0.43 in 1971 to 0.53 in 2001 (Graph 9) mainly as a result of immigration and economic transformation, two often cited causes of rising income inequality amid globalisation. Specifically, massive inflows of immigrants from Mainland China before the 1980s increased the number of low-income households as their education and skill levels were relatively

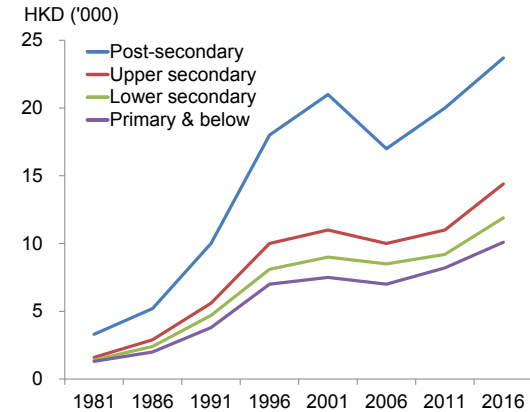
low. From the 1980s to the late 1990s, the shift towards a service- and knowledge-based economy acted as the main contributor to widening income inequality through rising disparities in wage growth both across sectors and among unskilled and skilled/better-educated workers (Graph 10).

Graph 9: Gini coefficients and real GDP growth



Source: C&SD.

Graph 10: Median monthly income from main employment by educational attainment



Source: C&SD.

**Despite widening income inequality, the social impact was possibly less notable at an early stage when globalisation was spurring income growth.** Although income inequality widened very rapidly from 1981 to 1996, fast economic growth reduced the potential discontent of low-income households as their real incomes also improved appreciably. Indeed, during this period, the median income of households in the bottom three income deciles gained cumulatively by 76% in real terms, as compared with a rise of 92% for the top three income deciles (Hong Kong government (2017)).

**Nevertheless, redistributive measures were needed particularly when the fast-growth era came to an end.** Although income inequality in Hong Kong became elevated during the economic transformation and remained at a high level, redistributive measures through taxation and social benefits, together with the implementation of Statutory Minimum Wage in 2011, have narrowed income inequality to some extent in recent decades (see blue line in Graph 9).

**Property price inflation in the past decades may transform income inequality into a serious wealth inequality issue.** As discussed earlier, during the economic transformation in Hong Kong, labour working in the financial sector and better-educated labour enjoyed much faster income growth, thus accumulating wealth much faster than others. Although data on wealth inequality in Hong Kong are scant, changes in wealth inequality can be assessed partially by looking at property price growth, as property investment is by far the major form of storing wealth by Hong Kong households.\* As a simple example, a household that purchased a private residential property in Hong Kong during the economic transformation between 1985 and 2015 has enjoyed an annualised price growth of 14%, which is much faster than the wage growth rate (7%).

\* According to the 2016 population census, 48.5% of Hong Kong households are owner-occupiers.

**Nevertheless, housing policies in Hong Kong have helped alleviate the widening wealth inequality to some extent.** The government has launched the home ownership scheme (HOS) in 1978 by which households who cannot afford private housing can purchase a government-subsidised apartment with a price much lower than market prices. Such HOS and other similar government programmes have so far helped a large number of households to get onto the housing ladder. The latest statistics show that there are nearly 400,000 government-subsidised housing units, which account for about 15% of the total housing stock in Hong Kong.

## 4. Conclusion

Three potential challenges face the Hong Kong economy amid globalisation. First, in view of the higher potential vulnerability to external financial shocks, central banks may need to play an even more active role in mitigating the associated risks, as the potential impacts of such shocks on the economy could be much larger than before.

Secondly, Hong Kong's case demonstrates that globalisation can cause rapid structural changes in the labour market. While Hong Kong's flexible labour market has so far helped to smooth the path of economic transformation, labour market adjustments will be more difficult when Hong Kong enters into the next stage of economic transformation in view of the higher degree of financial market expertise required and greater international competition in labour markets.

Finally, distributional effects remain a big challenge, particularly widening wealth inequality. Importantly, the unconventional post-crisis monetary policies adopted by major advanced economies may have a significant impact on wealth inequality through effects on asset price inflation, which could amplify the discontents of globalisation (See Chan (2017)).



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