

**Supplementary information further to the meeting of the
Legislative Council Panel on Financial Affairs
held on 3 May 2013**

(a) Net investment income of the Government Bond Programme since its establishment in 2009 after deducting payments of interests and other expenses for the Programme

According to the accounts of the Bond Fund audited by the Audit Commission, the net investment income of the Fund since its establishment in 2009 after deducting payments of interests for the bonds and other expenses are as follows-

HK\$'000	2009-10	2010-11	2011-12
Investment income	100,824	982,685	2,123,652
Interest payment for bonds	15,968	268,716	785,276
Other expenditures	1,031	975	32,429
Net investment income	83,825	712,994	1,305,947

The rise in interest payment for bonds since the establishment of the Government Bond Programme was due to a corresponding increase in the amount of bonds issued, including the first inflation-linked bond (iBond) issued in 2011-12. The increase in other expenditures in 2011-12 was mainly due to the issuance-related expenses arising from the first iBond, including placing fees and expenses for other external service providers.

(b) Deposits/funds held in bank accounts that were frozen due to investigation and enforcement actions taken in relation to suspected money laundering activities in the past three years

2. In Hong Kong's anti-money laundering regime, the only statutory basis for 'freezing' deposits or funds held in bank accounts due to investigation and enforcement action in relation to suspected money laundering is a restraint order. Sections 15 and 16 of the Organised and Serious Crime Ordinance Cap. 455¹ permit the Court of First Instance to make a restraint order on property (including deposits or funds held in a bank account) in order to preserve them to satisfy a future confiscation

¹ Similar provisions exist under both the Drug Trafficking (Recovery of Proceeds) Ordinance, Cap. 405 and the United Nations (Anti-Terrorism) Ordinance, Cap. 575

order. Restraint orders are usually applied for just after a defendant is charged and are often referred to as ‘freezing orders’.

3. The following statistics are for the past five years, up until 31 March 2013²:

	2009	2010	2011	2012	2013
Value of assets restrained ³	\$1,564,394,375	\$317,667,786	\$1,209,068,222	\$772,670,125	\$32,662,897
Amount recovered & paid to Gov't	\$74,146,486	\$150,360,670	\$1,597,778,774	\$23,602,352	\$17,299,381

4. It should be noted that yearly variations in assets restrained are often the result of a single or small number of cases involving significant assets.

5. In addition to restraint orders issued by the Court, where accounts are considered to present a high risk of money laundering as a result of some suspicion having been noted, banks are required by the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance, Cap 615 to apply special measures to mitigate that risk, including increased monitoring and enhanced customer due diligence.

(c) Regarding page 12 of the powerpoint, an analysis of the reasons for the faster growth in private consumption than the overall economy in the recent years, in particular, whether the phenomenon was mainly attributed to housing wealth effect or rise in consumer prices

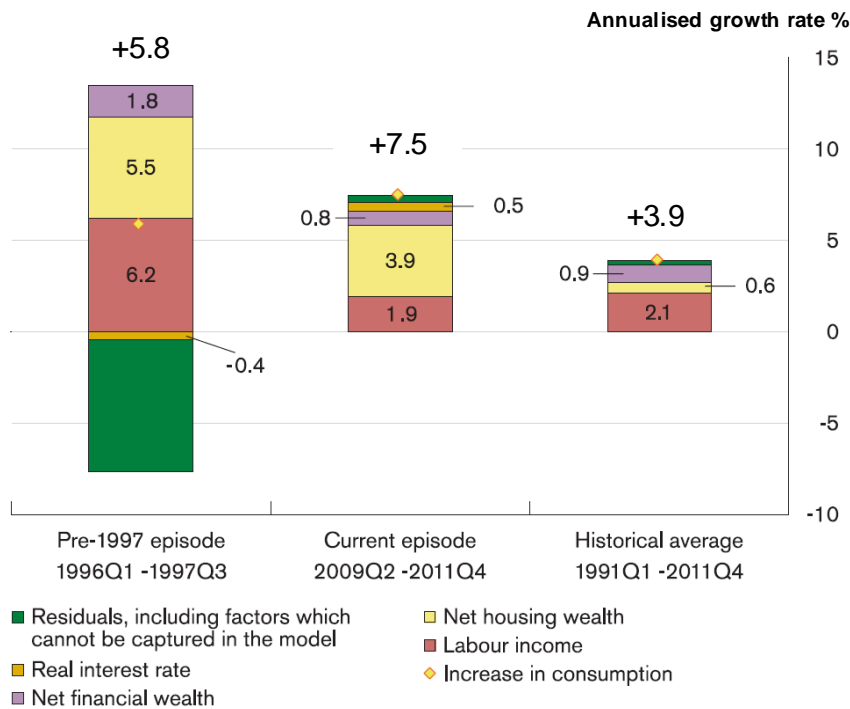
6. Page 12 of the powerpoint refers to the fast growth in private consumption relative to GDP in recent years, measured in real terms. In other words, the faster growth in consumption as presented was not due to inflation. Our empirical analysis further shows that the main driver of this growth was the housing wealth effect. Specifically, the HKMA’s estimate is that net housing wealth contributed about 3.9 percentage points, which was more than half of the annualised consumption growth of 7.5% during 2009-2011 (Chart 1). This growth contribution of about

² Source: The Joint Financial Intelligence Unit

³ No breakdown is maintained on where these assets are restrained but the majority are held in bank accounts

52% was much higher than the historical average during 1991-2011, which was only some 16% of the consumption growth over this period of time. Similarly, net housing wealth also made an outsized contribution during the pre-1997 episode. Details of our methodology and findings are set out in the note at Annex, which is an extract from the March 2013 issue of the HKMA Half-Yearly Monetary and Financial Stability Report.

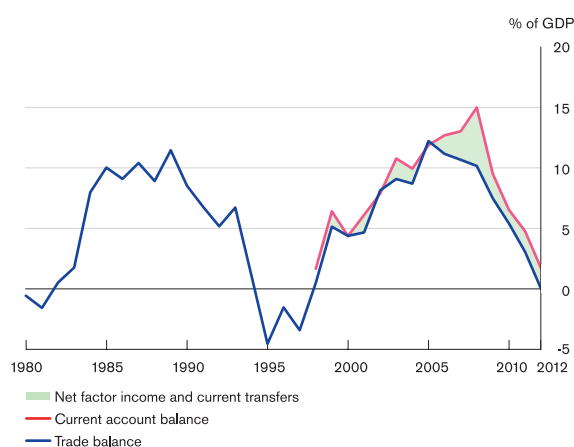
Chart 1: Drivers of consumption growth in the current episode, the pre-1997 episode and the period from 1991 to 2011



Box 2 Recent movements of the current account balance in Hong Kong

Hong Kong's current account balance has declined in recent years, from recording a surplus equivalent to 15% of GDP in 2008 down to 6% of GDP in 2011 and about 2% of GDP in 2012 (Chart B2.1). This article explains the recent decline in Hong Kong's current account balance, based on the trade-balance approach and the savings-investment approach. We find that it was much stronger domestic consumption (hence a decline in domestic savings) that has contributed to such developments. This leads us to examine in further detail the domestic consumption behaviour. Our empirical study shows that rising net housing wealth as a result of the booming property market could have explained more than half of the consumption growth since 2009.

Chart B2.1
Hong Kong's current account balance under the trade balance approach



The concept of current account balance and two analytical approaches

The current account balance reflects the gap between income and spending in an economy, by measuring the net earnings from “here and now” transactions (i.e. those transactions that do not give rise to future claims) with foreigners during a specific period of time. It is usually viewed from the perspective of external balance of an economy as mainly the difference between exports and imports, also known as the trade balance approach. Essentially, the current account balance is the sum of the trade balance, net factor income and net current transfers:

$$\begin{aligned} \text{Current account balance} \\ &= \text{Trade balance} \\ &\quad + \text{Net factor income} + \text{Net current transfers} \end{aligned}$$

For most economies including Hong Kong, trade balance itself is the main thrust of the current account balance. A current account surplus therefore usually reflects exports in excess of imports, and vice versa in the case of a current account deficit.

Another way to look at the current account balance is the savings-investment (or internal balance) approach. By the national income accounting identity, the current account balance can be viewed as the gap between national savings and domestic investment:

$$\begin{aligned} \text{Gross national product (GNP)}^{12} \\ &= \text{Consumption} + \text{Investment} \\ &\quad + \text{Current account balance} \end{aligned}$$

¹² In our discussion, the term GNP refers to the gross national disposable income as defined in the sixth edition of the IMF's *Balance of Payments and International Investment Position Manual*.

Current account balance

$$= \text{GNP} - (\text{Consumption} + \text{Investment})$$

$$= (\text{GNP} - \text{Consumption}) - \text{Investment}$$

$$= \text{National savings} - \text{Investment}$$

Unlike the trade balance approach, the savings-investment approach stresses how macroeconomic factors, through domestic consumption and investment decisions, can ultimately determine the current account balance. When an economy runs a current account surplus, gross national savings must, by definition, exceed domestic investment. Alternately, when an economy has a current account deficit, national savings must be less than domestic investment.

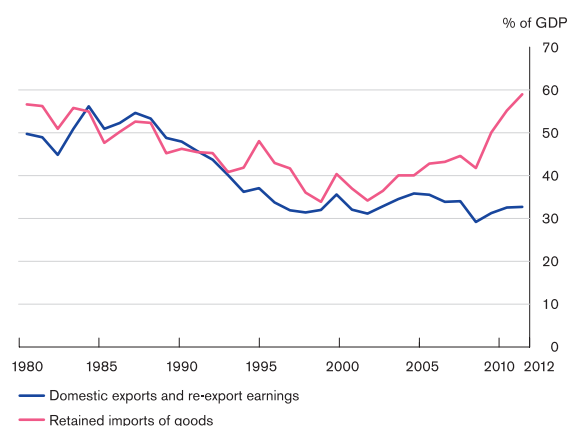
What causes the recent decline in Hong Kong's current account balance?

(A) The trade balance approach

Along with the current account deterioration in recent years, Hong Kong's trade balance also worsened, from a surplus equivalent to 10% of GDP in 2008 to 3% of GDP in 2011 and nil in 2012 (see Chart B2.1 above). A further look at the trade dynamics suggests that much stronger imports, rather than lower exports, have contributed to such developments.

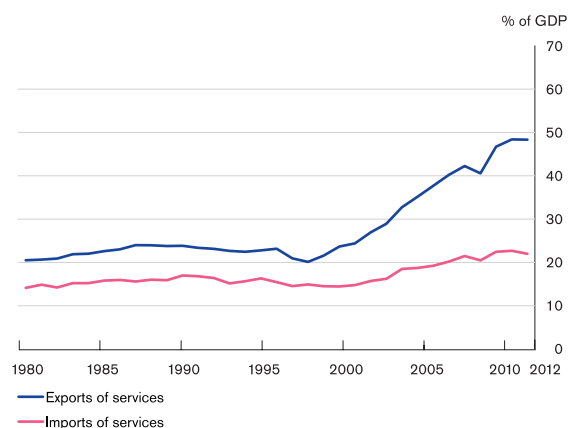
Chart B2.2 shows that there has not been a significant drop in exports of goods (i.e. measured as domestic exports and re-export earnings) in GDP terms since 2009. Market diversification has allowed Hong Kong traders to benefit from the two-speed world, with weaker demand from the advanced economies being offset by stronger demand from the developing economies including Mainland China and other emerging economies in Asia, Latin America and the Middle East. Services exports also held up well. Offshore trade, as part of services exports, continued to expand. More importantly, inbound tourism has provided considerable support to services exports, leading to their dramatic increase in recent years (Chart B2.3).

Chart B2.2
Hong Kong's trade in goods



Source: C&SD.

Chart B2.3
Hong Kong's trade in services



Source: C&SD.

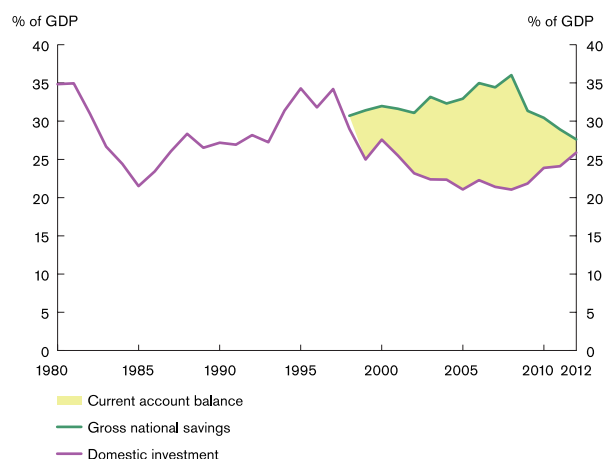
On the other hand, over the past five years, retained imports of goods have increased noticeably to 59% of GDP from 45% of GDP. This reflected stronger domestic demand, as well as surging inbound tourist spending, which also contributed to the rise in services exports in recent years. However, it is difficult to know to what extent it is domestic demand or tourist demand that has contributed to the rise in retained imports.¹³ Meanwhile, services imports have grown steadily. If excluding those related to trade and logistics, there would be even stronger increases in services imports due to robust demand for financial and insurance services and outbound travel.

(B) The savings-investment approach

The savings-investment approach provides another perspective of the recent decline in Hong Kong's current account balance. Chart B2.4 shows that it was mainly driven by a decrease in the savings rate to 28% of GDP in 2012 from 36% of GDP in 2008. That also means domestic consumption, as the mirror image of savings, has grown rapidly and much faster than income.¹⁴ On the other hand, there are no signs

of excessive investment. The investment rate (i.e. the investment-to-GDP ratio), while increasing gradually amid a robust pipeline of government infrastructure projects, remained below the historical average level.

Chart B2.4
Hong Kong's current account balance under the savings-investment approach



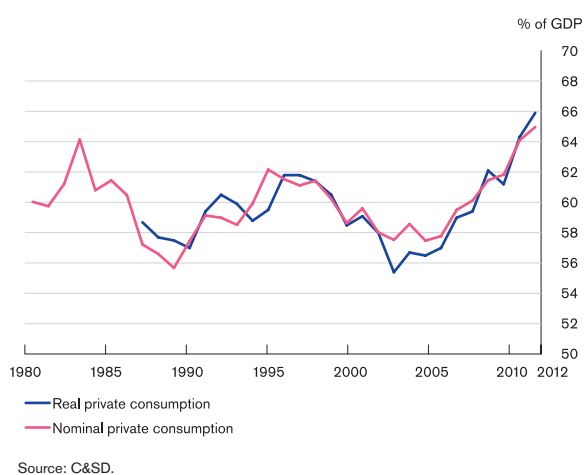
Source: C&SD.

¹³ Shuttle trade from Hong Kong to Mainland China can potentially understate exports and hence the trade balance and current account balance. While it is difficult to estimate the exact size of shuttle trade due to lack of reliable data, it seems not likely that shuttle trade alone could have explained the decline in Hong Kong's current account balance, which amounted to 13 percentage points of GDP over the past five years. Moreover, given that shuttle trade has existed since well before 2008, the extent of any misestimation on the current account balance would be relatively steady over time, and therefore would not have a significant impact on its changes over time.

¹⁴ We also use household expenditure surveys to cross check the savings rate. Household expenditure surveys, however, are conducted every five years, the latest two rounds in 2005 and 2010 respectively. As such, the comparison period does not exactly correspond to the period (from 2008 to present) over which we observed a sharper deterioration in Hong Kong's current account position. With this caveat and limitation, we find that the trend of the household savings rate so derived collates with that using the macro numbers we deployed in this article. The average household savings rate declined by 3.3 percentage points to 11.5% of income between 2005 and 2010. This is consistent with the decrease in the aggregate savings rate (by 2.5 percentage points of GDP) over this same period using the macro numbers.

Indeed, private consumption has increased at an average annualised rate of 6.3% since the second quarter of 2009. Moreover, private consumption growth was high in both nominal and real terms, suggesting that inflation or the price effect was not the main underpinning force of increased spending. The synchronised increase in both the nominal and real private consumption-to-GDP ratios also indicates that increased spending was not simply a nominal but also a real phenomenon (Chart B2.5).

Chart B2.5
Private consumption-to-GDP ratio



What could have driven the recent strong consumption growth in Hong Kong?

We have identified stronger domestic consumption (hence a decline in domestic savings) as the main cause of the recent decline in the current account balance. But what could have driven the strong consumption growth? Standard macroeconomic theories suggest consumption depends on such factors as labour income, wealth, and the real interest rate. They respectively account for the income effect, wealth effect and inter-temporal substitution effect. Higher income induces more consumption, while rising asset prices

make consumers wealthier or feel wealthier, so they spend more. Rising asset prices also allow households to have more collaterals against which to borrow and spend. Regarding the inter-temporal substitution effect, a lower real interest rate will induce consumers to spend more today because current consumption becomes less costly than future consumption.

Besides these factors, long-term structural factors such as population ageing and financial deepening may also affect consumption. Moreover, households may save more and consume less out of precautionary motive if they face more income uncertainty, which may be measured by unemployment volatility.

To determine the underlying factors behind the strong consumption growth in recent years, we estimate a consumption function for Hong Kong following Lai and Lam (2002)¹⁵, Cutler (2004)¹⁶ and Liu, Pauwels and Tsang (2007a).¹⁷ Determinants considered in the analysis include a) cyclical factors such as labour income, net housing wealth, net financial wealth and real interest rate; b) long-term structural factors such as ageing population and financial deepening and unemployment volatility.

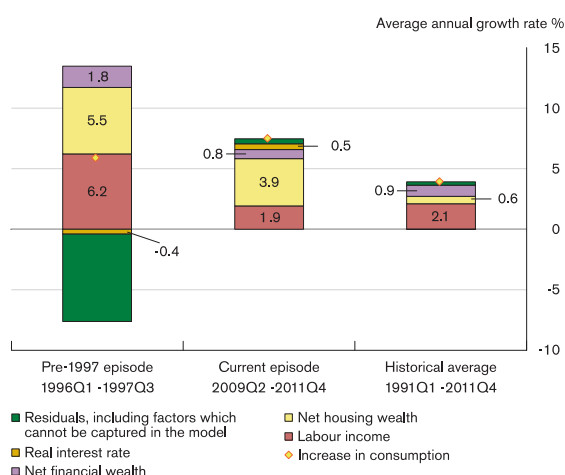
¹⁵ Lai, Kitty and Raphael Lam (2002), "The nexus of consumer credit, household debt service and consumption," HKMA Quarterly Bulletin, November 2002, 35-48.

¹⁶ Cutler, Joanne (2004), "The relationship between consumption, income and wealth in Hong Kong," Hong Kong Institute for Monetary Research Working Paper No.01/2004.

¹⁷ Liu, Li-gang, Laurent L. Pauwels and Andrew Tsang (2007), "Hong Kong's consumption function revisited," HKMA Working Paper No.16/2007.

We find that net housing wealth was the main driver of the strong consumption growth in recent years (Chart B2.6). It contributed more than half of the consumption growth during 2009-2011, by adding, in annualised terms, about 3.9 percentage points to the 7.5% growth rate. This growth contribution was much higher than the historical average during 1991-2011, which was just some 16% of the consumption growth over this period of time. Similarly, net housing wealth also made an outsized contribution during the pre-1997 episode.

Chart B2.6
Drivers of consumption growth in the current episode, the pre-1997 episode and the period from 1991 to 2011



Source: HKMA staff estimates.

The contribution from labour income was still visible in recent years but not as large as that in the pre-1997 episode or over the long term. The historical norm shows that consumption growth has been largely driven by income growth over the past two decades. It is worth pointing out that negative real interest rates, through the inter-temporal substitution effect, also played a role in fuelling consumption growth in recent years. In contrast, in the pre-1997 episode and over the long term, real interest rates only provided negative and nil contributions

respectively. The contribution from net financial wealth was relatively small in recent years when compared with previous episodes.¹⁸ Moreover, none of the long-term structural factors are found to be statistically significant.

Conclusion

Our analysis shows that the decline in the current account balance since 2009 was mainly due to stronger domestic consumption (hence a decline in domestic savings). We also find that much of the consumption growth could be accounted for by the housing wealth effect and to a lesser extent by rising labour income. However, housing wealth in Hong Kong can be volatile. Indeed, the strong consumption growth in the pre-1997 episode was also to a large extent driven by housing wealth, but the burst of the property bubble eventually led to a sharp decline in consumption and plunged the economy into recession. This reminds us that property market cycles can pose risks not only to banking and financial stability but also to macroeconomic stability.

¹⁸ This could be due to a faster rise in consumer credit in recent years, which would act as a drag on net financial wealth. Nevertheless, consumer credit may have helped support consumption growth in recent years, as credit card advances and other personal loans have increased by about 15% each year since 2010.