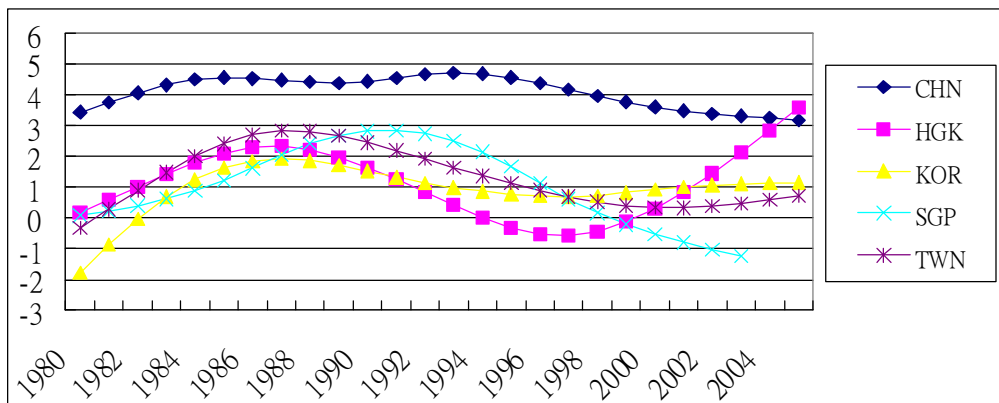


Executive Summary

Our assessment of the competitiveness of the Hong Kong economy from various perspectives indicates that the overall competitiveness of Hong Kong economy has been improving during the past several years. However, from a longer term historical perspective, there are still a number of areas in which Hong Kong's competitiveness has been eroded relative to her main competitors in East Asia, especially in export sector.

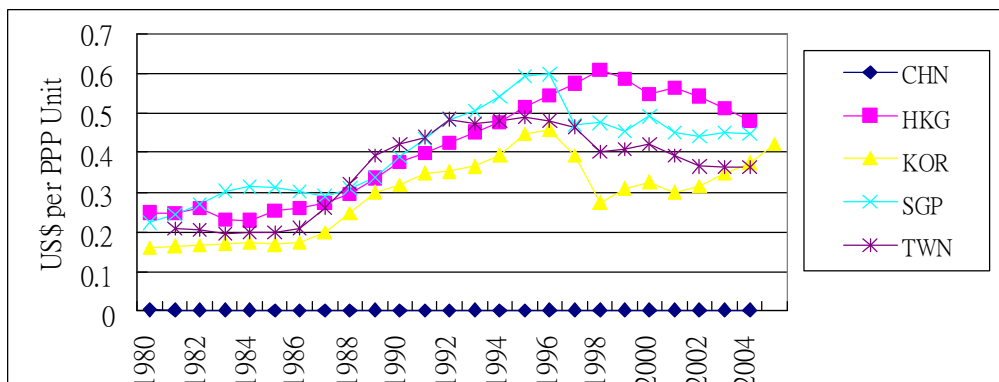
On the positive side, Hong Kong's productivity growth successfully turned around after hitting the lowest point during the Asian Financial Crises, suggesting that Hong Kong has been adjusting well to adverse shocks.

Figure 1. Comparison of Productivity Growth Rates (smoothed series)



Also, Hong Kong's unit labour costs started to improve since 2000 comparing to her Asian competitors.

Figure 2. Comparison of Unit Labour Cost



Furthermore, in terms of export competitiveness, Hong Kong performs relatively well in SITC 76 (telecommunication and sound equipments) and trade-related services.

On the negative side, the recent decline in Hong Kong's unit labour cost is less steep than her major trade partners, eroding her competitiveness.

More importantly, Hong Kong's export competitiveness has been seriously eroded in several goods categories (SITC 75, office equipments, and SITC 776, transistors), as well as in service exports (transportation services and travel services). What is alarming is that the erosion in competitiveness occurs in all her export markets, including the China market.

In our view, further integration measures with the Mainland should be fostered. Given the minimal size of the manufacturing sector in Hong Kong, the only way to maintain a healthy TFP growth is to promote innovation in the service sector. Besides innovations in financial sector and logistic industry, Hong Kong should promote innovations in sports, travel, culture, and entertainment industry as well. Labour market flexibility remains important for maintaining Hong Kong's competitiveness. Policies that target export growth in high-tech industry (SITC 776 for instance) may be considered. Partnership with Guangdong (Shenzhen in particular) to develop high-tech manufacturing is the right way forward as it utilizes both sides' comparative advantages. It would enable Hong Kong to maintain some manufacturing activities, especially those up-stream ones, such as research and development, and hence could help Hong Kong maintain high economic growth.