
Contents

	<i>Paragraph</i>
<i>A. Introduction</i>	1–3
<i>B. Concerted Efforts to Meet the Challenges</i>	
Facing up to Adversity	4
Diagnosis	5–9
<i>C. The Road to Economic Recovery</i>	
I. The Elements for Recovery	10
Our Advantages	11
New Opportunities	12
A Clear Direction	13
II. Promoting Economic Restructuring	
A Market-led Approach	14
The Role of the Government	15
Improving the Business Environment	16
Enhancing Core Industries	17
Encouraging Diversified Development	18
Opening up New Horizons	19
Human Resources Development	20–24
Stabilising the Property Market	25–26
Asia’s World City	27–29

D. Closer Economic Co-operation with the Mainland

I. Seizing New Opportunities	30
II. Forging Closer Co-operation	31
Closer Partnership in Trade	32
Speeding up and Improving Boundary Crossings	33
Individual Travellers from Guangdong Province	34
III. Expediting Economic Integration with the PRD	
Direction and Goals	35
New Areas of Co-operation	36
A Bridge Linking Hong Kong to the Western PRD	37
New Business Model	38
Summing Up	39

E. Sharing Responsibility to Tackle the Deficit

I. Aggravating the Deficit	41
II. Possible Consequences	
Worsening of the Investment Environment	42
Impact on the Financial Markets	43–44
III. Decisive Action to Eliminate the Fiscal Deficit	45
Causes and Solutions	46–47
Optimising the Use of Public Resources	48
Joining Hands with the Community	49–51

	<i>Paragraph</i>
Overall Impact	52
Standing by the Community	53
<i>F. Legislating on Article 23 of the Basic Law</i>	54–55
<i>G. Conclusion</i>	56–62

Madam President,

A. Introduction

1. This is the first Policy Address of my second term as Chief Executive of the Hong Kong Special Administrative Region. Over the past five years, we have successfully implemented “One Country, Two Systems” and weathered the Asian financial crisis. At the same time, we have set the broad direction for our future development and for steering Hong Kong out of its economic difficulties. It is clear to me that the success of “One Country, Two Systems” involves maintaining our socio-economic systems and way of life and ensuring Hong Kong’s economic growth and social progress. The common goal of our community is to achieve long-term prosperity and stability. The most important task of the Administration is to lead Hong Kong out of the present economic difficulties and restore people’s confidence in their future. This is our greatest challenge.

2. Published with my Address today is the “Policy Agenda” – our road map for the way forward in specific policy areas. This was drawn up after extensive consultation and thorough deliberation over the past few months. It is a pragmatic and proactive response from my new team to the expectations and aspirations of the people of Hong Kong. It embraces the views and suggestions of our community. This Policy Agenda also reflects the gradual formation of mainstream thinking in the community about our future development as well as our common values. It forms the basis on which we will organise our work and sets the direction in which the Government and the whole community will strive together.

3. Directors of Bureaux will present the details of the Policy Agenda later. My Policy Address today will focus on the major issues of public concern. These include the background and causes of our present economic difficulties, our plans to expedite economic recovery, decisive resolution of the fiscal deficit, as well as current legislative work on Article 23 of the Basic Law. My theme today is

revitalisation of the economy – only sustained economic growth can lay the foundation for improving people's livelihood and help in taking our society forward.

B. Concerted Efforts to Meet the Challenges

Facing up to Adversity

4. The economic situation we are facing is severe and unprecedented in decades. First, despite the recent signs of economic recovery, deflation over the past 50 months has accumulated to 13%, and there is no indication that it will disappear in the short term. Confidence in local investment and consumption has suffered. For some, incomes have continued to drop. Second, people's wealth has shrunk with declining asset values, with some facing the hardship of negative equity. These distressing consequences have become more obvious in recent years. Third, economic contraction and restructuring have led to changes in the employment structure and resulted in increasing unemployment, a prime concern of the community. Despite a slight improvement in recent months, unemployment remains far too high. Lastly, the substantial reduction in Government revenue and rising public expenditure have resulted in increasing fiscal deficits in the past few years. As a result, our fiscal reserves have been sharply reduced. This is beginning to affect our credit ratings. If not dealt with properly, the stability of our financial system could be jeopardised.

Diagnosis

5. For many years, Hong Kong's fast economic growth, high levels of income, near-full employment, stable financial market, general affluence and abundant opportunities have been the envy of others. These strengths, however, seem to be disappearing. Why? What could have caused such profound changes in our economy? How did the internal and external forces interact to produce these results? If we wish to improve our situation, what strategies and measures will enable us to succeed in the new economic contest?

6. The rapid growth of our economy in the past two decades has been due mainly to our seizing the opportunities provided by the opening up of the

Mainland. The relocation of Hong Kong's manufacturing sector across the boundary enabled our successful transformation into a service-oriented economy. At the same time, a bubble economy emerged, characterised by soaring asset prices. It was at this time that a significant change in the world economy occurred, marked by globalisation and the rise of the knowledge-based economy. These have led to a re-definition of productivity and changed the rules of economic competition. Whoever possesses an optimised economic structure and a workforce superior in technological know-how would be more able to seize the initiative in the New Economy.

7. For various reasons, a bubble economy emerged in Hong Kong at that time and gave rise to superficial prosperity – a phenomenon not based entirely on increased productivity, but mainly driven by the combined effects of surging asset values, wages and prices. This in turn led to inflated costs, which seriously affected people's livelihood and weakened Hong Kong's competitiveness. Many of our citizens speculated on stocks and property and this “quick money” mentality undermined their entrepreneurial spirit. No place on earth, however well endowed, could sustain a growing bubble over a long period of time. The question was no longer whether a crisis would strike, but when, how serious and for how long. The Asian financial crisis in 1997 punctured the bubble, precipitating our economic reversal.

8. As a small open economy, Hong Kong owed its past economic miracles to a number of inherent institutional factors and a hardworking, persevering and enterprising population. But we cannot discount special circumstances and other external factors. From the 1950's to the 1970's, Hong Kong was able to achieve industrialisation early and establish itself as the bridge for regional economic and trade co-operation through its geographical location. One of the main reasons for our success was China's closed-door policy and, excepting Japan, the less advanced state of development in the Asia-Pacific economies in general. Even in the 1980's, we were able to deploy our strengths gainfully, when the Mainland was at its initial stage of reform. Our past successes were therefore attributable largely to our neighbouring economies, particularly the Mainland, not fully exploiting their inherent competitiveness. Now, the task of restructuring our economy has been complicated by the emerging economies around us.

9. In short, the advent of globalisation, the move towards a knowledge-based economy and the rapid rise in the competitiveness of our neighbours have posed obvious challenges to our traditional advantages and position. Other latent weaknesses, such as a weak technological base and a mismatch in human resources, have begun to surface and create an impact. With the bursting of the bubble economy, cyclical fluctuations in the world economy, price differentials between Hong Kong and its neighbours and persistent deflation, Hong Kong now finds itself in a prolonged economic downturn. The community is suffering from the pains of economic adjustment, with rising unemployment and falling wages for many.

C. The Road to Economic Recovery

I. The Elements for Recovery

10. Our economy is facing difficulties unprecedented since World War II. Experience around the world tells us that economic restructuring usually takes a long time, but that does not mean we should be pessimistic. Our traditional advantages and newly opened up opportunities already provide the basic elements we need to overcome our problems and revitalise our economy.

Our Advantages

11. Despite the significant changes in our external environment, we have not lost our fundamental strengths. Leaders of the Central Government consider the role of Hong Kong irreplaceable for the future development of our country. Visiting politicians and foreign investors are very positive about our future. Let us not forget that Hong Kong is the most important international financial centre in the Asia-Pacific region. We are a hub for trade, shipping, information and services. We still have the hardware and software required of a world-class city, including our keen business acumen, a well-developed infrastructure, a versatile financial system, robust legal institutions, policies conducive to a free and open society, a clean and efficient civil service, simple and low taxation, a large pool of talent and a cosmopolitan community. As long as we move with the times, give full play to our strengths, keep on exploring and innovating, I believe the strategic position and unique role of Hong Kong will never be replaced.

New Opportunities

12. The Mainland is widely recognised as one of the world's most dynamic economies with immense potential. Its adopted strategy for the next 20 years is to quadruple its Gross Domestic Product (GDP) by the end of this period. Judging from the present international trends, I am confident that this is attainable. China now ranks sixth in the world in terms of the size of its economy; according to a World Bank forecast, it will rank even higher by 2020. The Mainland's rapid economic development and continuing opening up will

provide a historic opportunity for Hong Kong to lift itself out of the existing difficulties and revitalise its economy. We must value and make full use of this. The gradually recovering Asia-Pacific economies will further broaden the scope for the economic development of Hong Kong.

A Clear Direction

13. Our direction and position are very clear. Backed by the Mainland and engaged globally, we are building Hong Kong as Asia's World City, consolidating and developing our position as an international financial centre, a producer services centre, a hub for information services and logistics and a premier tourist destination. We will strive to foster further economic growth by applying new knowledge, new technologies and through providing high value-added services. To be more specific, strengthened economic ties with the Mainland, greater emphasis on investment in human resources and a reinvigorated services sector will form the main thrusts of our economic revival.

II. Promoting Economic Restructuring

A Market-led Approach

14. Hong Kong is a free market economy, and the prime mover of economic restructuring rests mainly with the private sector. While the Government has an active role in promoting the development of hard and soft infrastructure, the wider community must itself move to meet the new challenges posed by the knowledge-based economy. We need to apply new knowledge, technologies and innovative thinking, and to improve our services and management, so as to continually enhance our competitiveness.

The Role of the Government

15. The economic restructuring that is sweeping through the world has highlighted the unique role of the government. Whether it is persuading trading partners to open their markets as part of the globalisation process, or promoting technological education to facilitate the development of the knowledge-based

economy, governments in various countries have assumed a key role of driving the transformation process. As a highly open economy, the use of monetary and fiscal policies in Hong Kong to revitalise economic growth is unlikely to be effective. We have to focus instead on enhancing the competitiveness of our economy. Over the past five years, I have repeatedly stressed that the Government has to embark on important initiatives on a macro-level. These include investing heavily in education, upgrading economic infrastructure, promoting innovation and technology, improving the business environment, helping the business sector to develop new markets, actively protecting our ecology and environment and improving our quality of life. Concurrently, we will reinforce our strengths in our four main economic pillars – finance, logistics, tourism and producer services sectors. We should also capitalise on the rapid development of our Motherland to hasten our economic restructuring. These are important tasks, necessary not only for economic needs, but also for discharging our responsibilities and making good our pledges to the community. We will focus on the following areas:

Improving the Business Environment

16. One of our urgent tasks is to further improve our business environment. To overcome our economic difficulties, we must strive to attract foreign investment, retain domestic investment and boost local economic activities, with a view to broadening our production capacity, creating employment, and expanding our tax base. Following the principle of “big market, small government”, we have to reduce business costs by cutting red tape, embarking on de-regulation, streamlining procedures and enhancing administrative efficiency. We believe we can do better. I therefore plan to set up a high-level task force to examine these issues and put forward policy recommendations.

Enhancing Core Industries

17. Financial services, logistics, tourism and producer services are the main pillars of our economy. They need to be reinforced and enhanced.

- ◆ We should strengthen Hong Kong’s role as a major international financial centre in Asia and the premier capital formation centre of

China. Our leading position will not be surpassed easily by other cities in the region. However, we must be alert to the rapid developments around us. Building on our legal system that upholds the rule of law, we will further improve our market structure and corporate governance to meet international standards. We will promote the development of the bond market and fund management businesses, and facilitate the development of new financial products, especially derivatives. We will not only consolidate our status as an international financial centre, but also strive to be a major financial centre of China.

- ◆ We must maintain Hong Kong's position as a centre of trading. As the biggest among our pillar industries, external trade and related services currently account for one-third of our GDP, and the share is increasing. Over the past two decades, trade patterns have changed rapidly from domestic exports to re-exports. Offshore trade is on the rise, and is destined to become more pronounced in the future. Apart from further promoting our re-exports, we will develop Hong Kong as a multi-modal trade management and operations centre.
- ◆ The rapid growth in trade denotes the importance of modern logistics services to Hong Kong. The logistics industry can bring our existing advantages into full play and create many jobs. We will foster its growth. To strengthen our position as Asia's premier transportation and logistics hub, we will facilitate the development of Hong Kong International Airport's logistics centre and express cargo terminal, and build a modern Logistics Park on North Lantau Island. We will also enhance Hong Kong's information connectivity, upgrade the necessary infrastructure, ensure a smooth flow of cargo between Guangdong and Hong Kong and strive to reduce operating costs. In addition, we will promote closer co-operation with other cities in the Pearl River Delta (PRD) to develop appropriate standards and division of labour, and to expand business opportunities. Hong Kong's container throughput has ranked number one in the world for years. This leading position will be strengthened when Container Terminal 9 comes on stream later this year. Feasibility studies on Container Terminal 10 will begin shortly.

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- ◆ We should capitalise on greater economic integration with the PRD to strengthen our role as a regional centre for business operations. We will continue to attract multinational corporations to set up regional headquarters or offices, and Mainland enterprises to set up branch offices in Hong Kong. In addition, we will enhance our convention and exhibition facilities to further reinforce our function as a regional business operations centre.
 - ◆ Tourism is one of the few sectors that has registered growth during the present economic downturn, and the industry continues to show great potential for further development. The World Tourism Organisation has forecast that China will lead the world in tourism by 2020, and Hong Kong will take fifth place, partly because of our Mainland connections. Our established policy is to promote the travel industry. A series of new projects, including the Disneyland theme park, are well underway to further increase our appeal to tourists. Other efforts include enhancing cultural, recreational, sports and arts activities as well as preserving and promoting our heritage and cultural relics. These will consolidate Hong Kong's position as a premier tourist destination. The hotel industry is actively preparing to cope with the anticipated rapid growth in demand. More than 20 new hotels are coming on stream in the next three years. These will create nearly 10 000 jobs.

Encouraging Diversified Development

18. The vitality of our economy owes much to the numerous small and medium enterprises which employ many workers. The Special Administrative Region Government (SARG) will give them strong support. Traditional industries and the local community economy play a unique role in the restructuring of our economy, by offering a wider variety of jobs. We will actively complement their development.

Opening up New Horizons

19. Creative industries are important elements of a knowledge-based economy. The knowledge and wisdom of Hong Kong people, their innovative entrepreneurial spirit and agility combine to form a sound foundation. In addition to strengthening our pillar industries, we will seek to inject a new dimension and vigour into our economy by actively promoting creative industries. They are the synergy of artistic creativity and product development, involving specialities such as the performing arts, film and television, publishing, art and antique markets, music, architecture, advertising, digital entertainment, computer software development, animation production, fashion and product design. These individual industries and professions are already well-established and have considerable potential for growth. The Secretary for Home Affairs, the Secretary for Commerce, Industry and Technology, and relevant bureaux and departments will work together to devise a concrete plan and create the necessary favourable environment to promote and facilitate the development of these creative industries.

Human Resources Development

20. Our people are our most valuable resource and the key to the development of a knowledge-based economy. One crucial means of promoting economic restructuring is by investing in education. Only by developing our own local human resources and providing opportunities for continuing education for people of all walks of life can we prepare ourselves for the changes in the marketplace. This is of utmost importance to the well-being of our people and the long-term development of Hong Kong. Let me reiterate, we will continue with the education reforms that are now starting to bear fruit. We will optimise the use of educational resources, improve the quality of education, encourage life-long learning and enhance manpower training. I can assure you that investment in education will remain our priority, notwithstanding the need to address our budgetary problems.

21. Apart from nurturing local talent, we will continue to attract talented people from around the world. We must not lag behind in the intense global competition for highly skilled people. We will formulate policies to proactively

attract them to live and work in Hong Kong. Our existing policy is to attract talent from overseas. We will make reference to this policy to facilitate Mainland talent and professionals to work and live in Hong Kong. In addition, we intend to attract entrepreneurs from the Mainland to come to invest in Hong Kong. We hope that this flow of people and capital will encourage Mainland/Hong Kong co-operation in the development of high value-added and high technology activities. It will also promote cross-boundary professional services, thereby accelerating Hong Kong's transition to a knowledge-based economy and create more employment.

22. We have decided to encourage more overseas investors to settle in Hong Kong and will formulate relevant immigration policies as soon as possible. I believe that such a policy will benefit our economy, in particular our financial and real estate sectors. Domestic consumption, among other things, will also receive a welcome boost.

23. In the long run, we need to upgrade the quality of our people. This is essential if we are to meet the challenges of the knowledge-based economy and we will implement policies to this end. The Chief Secretary for Administration has submitted to me the report on population policy, which covers many policy areas. The report will be published after consideration by the Executive Council.

24. Our young people are our hope for the future. The Government has all along attached great importance to their education and holistic development. In a recent draft report, the Chairman of the Commission on Youth put forward recommendations on providing diversified training and enhancement of the employability of our young people. The final report will be released as soon as possible.

Stabilising the Property Market

25. Real estate plays an indispensable role in the economic development of any place, not least in Hong Kong. 40 000 new households are formed each year. Also, living conditions and living space-per-person still have much room for improvement. The potential demand for first-time purchases and trade-ups remains considerable. There are still extensive opportunities for the development of the real estate sector.

26. A stable property market is one of the important elements in revitalising Hong Kong's economy. At this stage, to restore interest in investment and consumption requires the restoration of confidence in property ownership. The decline in property prices in recent years and prolonged deflation have inhibited local investment and consumption, contributing to a vicious cycle. Not long ago, the Government re-defined its role in the property market and launched a package of measures to stabilise it. These measures will be effective in the long term.

Asia's World City

27. Hong Kong is Asia's World City. This identity embodies the spirit and characteristics of Hong Kong and reflects our competitive edge. We will continue to consolidate and build on this position. We have a fair and independent judicial system. Both the Government and the community uphold and cherish the rule of law. We are determined to preserve a level playing field for business. We will adhere to our "big market, small government" policy and maintain a simple and low tax regime. We are adamant in maintaining an efficient government and favourable business environment. We will continue to safeguard the free flow of information and capital, and protect the freedoms and rights we now enjoy.

28. Hong Kong is one of the safest cities in the world, but we will be vigilant in maintaining good law and order. We will continue to clean up our environment and beautify our surroundings – pre-requisites for a world-class city. We will encourage and enable more citizens to acquire biliterate and trilingual proficiency. We will actively promote the development of sports. As the place where East meets West, we believe that the interplay of different cultures will stimulate diversity and inspire creativity, and we will spare no effort to promote development in this area.

29. In short, we are creating a unique and attractive environment in which both local and overseas people like to live, do business, work, or visit, regardless of their nationality, race, sex, age or religion. I hope that our friends from overseas who stay or stop over in Hong Kong will find that this city makes them feel at home.

D. Closer Economic Co-operation with the Mainland

I. Seizing New Opportunities

30. Staunch support from the Mainland and our global outlook have been crucial to our economic success. We in turn have been playing a unique role in China's modernisation process. Accession to the World Trade Organisation (WTO) has ushered in a new stage of opening up the Mainland. Notwithstanding some difficulties in our own economic development, we have not reduced our investments in China and remain its biggest outside investor. Two decades of substantial investment has provided us with a solid foundation on which we can further contribute to the Mainland's economic development, post-WTO. Despite the rapid economic development of Chinese cities, Hong Kong, as a more developed economy, has not lost any of its advantages. This will enable us to continue to give strong support to our country as it opens up further to the world.

II. Forging Closer Co-operation

31. Over the past year, the positive effects of China's accession to the WTO have begun to emerge. Total trade registered strong growth, reaching US\$620 billion and ranked fifth in the world. Foreign direct investment amounted to US\$50 billion, the highest in the world. Four years from now, we expect the Mainland to have become more fully aligned with the rest of the world in trade and economic matters. We must seize these opportunities to elevate Hong Kong from its traditional role as an intermediary to a major hub connecting the Mainland and the international markets. We can do this by supporting the Mainland's economic development and opening up of its economy. At the same time, we will enhance our position as the financial and commercial centre of China. Measures to promote economic co-operation with the Mainland will include:

Closer Partnership in Trade

32. The Central Government has agreed to speed up discussions on Hong Kong entering into a Closer Economic Partnership Arrangement with the Mainland, with a view to reaching an arrangement on the main parts by June 2003. I believe this arrangement will benefit our services sectors in their expansion into the Mainland market, and open new opportunities for businesses. It will also help to promote Hong Kong's traditional industries and emerging industries, facilitate our economic restructuring and create jobs.

Speeding up and Improving Boundary Crossings

33. One priority is to improve conditions at our boundary crossings to facilitate the flow of passengers, vehicles and goods between Hong Kong and the Mainland. With the support and facilitation of the Central Government and Mainland authorities, we will implement 24-hour passenger clearance at Lok Ma Chau/Huanggang with effect from 27 January this year. We are also taking steps to improve conditions at other crossings such as Lo Wu and Sha Tau Kok. We will continue to effect improvements with the target of completing normal clearance procedures on both sides of the boundary within 30 minutes for passengers, and 60 minutes for goods vehicles. To address fundamentally the challenge of moving people, goods and vehicles between Hong Kong and the Mainland smoothly and expeditiously, we will accelerate the construction of the Shenzhen Western Corridor for completion in the latter half of 2005. We will endeavour to complete the Sheung Shui to Lok Ma Chau Spur Line as soon as possible to link up with the Huanggang Underground Railway.

Individual Travellers from Guangdong Province

34. In response to a proposal by the SARG, the Central Government agreed to study further relaxation of current restrictions to facilitate Mainland residents visiting Hong Kong, including allowing residents within Guangdong Province to visit in their personal capacity. These measures will not only provide a welcome stimulus to tourism and consolidate our position as a preferred tourist destination, but will also help to further strengthen our ties with Guangdong Province and expand the scope for mutual co-operation.

III. Expediting Economic Integration with the PRD

Direction and Goals

35. Given our geographical location and cultural ties, we have a special relationship with Guangdong Province, particularly the PRD. After some 20 years, the area is now a highly developed and closely knit region. Today, much of the global competition is a contest of integrated strengths among different economic regions. A city is simply not strong enough to compete on its own. To advance its competitive edge, Hong Kong must pool its strengths with other cities in the region. Hong Kong has the advantage of being a world-class international centre of finance, business and logistics. On the other hand, the PRD is the fastest-growing processing base in the world. It will further develop its modern manufacturing and high technology industries. We should make the PRD the economic hinterland supporting development in the rest of the country. In turn, the PRD can use Hong Kong's strengths to elevate its status and competitiveness to become a global player.

New Areas of Co-operation

36. Leaders of the Central Government and Guangdong Province as well as the Chief Executive of Macau fully support the development of the PRD, including Macau, into a major modernised economic region through enhancing co-operation with Hong Kong. The region will be a production and manufacturing base, a centre of modern services such as logistics, professional and financial services, tourism and entertainment, communication as well as consumer and personal services. The leader of the Guangdong Provincial Government and I agreed that we should build on our achievements and venture into new areas of co-operation. In addition to maintaining the tried and tested joint ventures in infrastructure, manufacturing industry and environmental protection, new areas of common interest will be explored. These will include raising and speeding up the level of co-operation to realise our common goal of achieving a major modernised economic region, enhancing our co-ordination in regional infrastructure projects, strengthening our world-class logistics services, developing

the western part of the PRD, and fully expanding our services industries. There is scope to explore new areas of co-operation in the financial sector, in improving market regulation and in education. The prospects for economic co-operation with Guangdong are excellent.

A Bridge Linking Hong Kong to the Western PRD

37. The region to the west of the Pearl River estuary will be important to Hong Kong's future economic development. A bridge linking Hong Kong to Macau and the western part of the PRD will be of strategic importance to the development of the whole region. There is now a consensus in the community that such a bridge should be built. However, building the proposed bridge requires the consensus of Guangdong Province and the Macau SAR. The cost effectiveness of the project and its effects on the ecology and environment require strict, scientific evaluation. The Central Government has already instructed the State Development Planning Commission to carry out a detailed feasibility study and we will do our best to facilitate it. Subject to its finding that the project is feasible from the environmental, transportation and economic perspectives, I believe the bridge will be built as soon as possible through the joint efforts of Guangdong, Hong Kong and Macau.

New Business Model

38. Guangdong and Hong Kong share a common goal to engage the world. We will step up efforts to promote the economic potential of Hong Kong and the PRD. We will actively open up new markets, bringing in more foreign capital, attracting foreign talent, and encouraging more multinational corporations to set up their regional headquarters in Hong Kong. In particular, we will seize the opportunity of deepening economic integration between Guangdong and Hong Kong. We will help tens of thousands of small and medium enterprises from the United States, Europe and Japan to use Hong Kong as a base to operate businesses in the PRD – with regional offices in Hong Kong, investment, procurement and production in the PRD. They will be able to improve their operational efficiency and reinforce their competitiveness back home. We will also help PRD enterprises to establish outlets in Hong Kong so that they can sell directly to foreign companies, and develop ties with trading partners. This new business model will

bring mutual benefits, providing more businesses for the PRD and enhancing Hong Kong's position as an international trade and business centre.

Summing Up

39. The way forward for our economic development is to capitalise on our advantages and enhance our four pillar industries. We will also foster the development of creative industries, promote innovation and technological progress, and support the development of small and medium enterprises into new business areas. We will speed up economic integration with the PRD to facilitate economic restructuring and create jobs. After feeling our way over the past few years, I now believe we have embarked on the right track. The way forward is realistic and practicable. Together with my colleagues and the entire civil service, we are determined and confident that we will work untiringly to accomplish our historic mission.

E. Sharing Responsibility to Tackle the Deficit

40. The fiscal deficit is the result of a combination of economic problems. It has reached a critical stage. If not tackled immediately, it will become an insurmountable obstacle to our efforts to ride out the current economic difficulties. Therefore, solving the deficit problem is Government's top priority.

I. Aggravating the Deficit

41. The imbalance in the public accounts has worsened drastically in recent years. A consolidated deficit of more than \$60 billion was recorded in 2001-2002, which was much higher than the previous year. Although our overall real economic performance improved slightly in 2002, our GDP in current dollar terms registered negative growth after taking into account the effects of continued deflation. The causes of our fiscal imbalance remain. They include increases in welfare spending because of the economic downturn, the drop in revenue from land sales and related sources, the decline in tax revenues and the postponement of the second offering of Mass Transit Railway Corporation shares. As a result, the fiscal deficit for the first eight months of 2002-2003 amounted to \$70.8 billion. We estimate that when the current financial year closes at the end of March, the deficit will hit a record high of over \$70 billion, representing more than 5% of GDP.

II. Possible Consequences

Worsening of the Investment Environment

42. As I said earlier, we must ensure our economy returns to growth by adopting proactive steps to attract foreign investment and retain domestic investment. These investors pay close attention to our credit ratings, which take into account the Government's fiscal position. In making their assessments, international rating agencies mainly focus on the outlook for revenue and expenditure, especially in the recurrent account. Recently, Standard & Poor's

announced that it would downgrade its outlook for Hong Kong's long-term local currency credit rating from stable to negative. This, in effect, is a warning that this rating will be downgraded if the fiscal deficit does not improve in the future. A downgraded rating will inevitably have an adverse effect on both the public and private sectors, resulting in higher financing costs. This would lead to a worsening investment environment and a general erosion of the attractiveness of Hong Kong to foreign investors. We cannot overlook the importance of maintaining a favourable investment environment which is crucial to our economic recovery and restructuring.

Impact on the Financial Markets

43. Our fiscal deficit has already attracted attention in international markets and the local financial market is becoming increasingly concerned. To maintain financial stability, we need to put in place sound and comprehensive fiscal policies, make continuous efforts to improve the regulation of our market mechanisms and have the backing of strong fiscal reserves. The Asian financial crisis amply demonstrated the need for these safeguards. The current deficit is serious and is threatening to undermine our financial strength and market confidence. If the problem is not solved as soon as possible, Hong Kong risks being exposed to heightened speculation, which may trigger outflows of capital, rising interest rates, turmoil in the financial markets leading ultimately to possible attacks on our linked exchange rate system.

44. Our investment environment and the financial markets are the cornerstones of our economic development. They are the foundations upon which we can build successful economic restructuring. Any failure to address the worsening fiscal deficit will definitely hinder Hong Kong's economic recovery. To address our problems we must, as a priority, resolve the fiscal deficit. I believe all sectors of the community have come to realise the gravity of the situation and many have put forward constructive suggestions. There have been many calls for the Government to join forces with the community to seek an early and thorough solution. I have the responsibility, confidence and determination to take all necessary steps to progressively achieve fiscal balance within five years. We will proceed on the basis of a community consensus on responsibility sharing, fairness and reasonableness.

III. Decisive Action to Eliminate the Fiscal Deficit

45. The Financial Secretary will propose specific measures to solve the fiscal deficit when he presents his 2003-2004 Budget Speech to the Legislative Council in March. Today, I will only set out our basic thinking and guiding principles.

Causes and Solutions

46. The major cause of our fiscal deficit lay in the rise in public expenditure during the period of the bubble economy. In the six years between 1991-1992 and 1996-1997, public expenditure grew on average by 14% annually. From 1997-1998 to 2001-2002, we took steps to cut spending. This was done cautiously, taking into account the acceptability of those cost-cutting measures to the community during difficult times of economic restructuring. But public expenditure still continued to grow at an average annual rate of 5%. Having public spending consistently exceeding the rate of economic growth is a departure from the principle of small government we have always promoted. If expenditure continues to grow unchecked, we will have no alternative but to keep on raising taxes and increasing fees, thus channelling more and more resources to the Government. Such a move will only result in less efficient use of community resources and a deteriorating business environment. None of us would like to see this happen.

47. To eliminate the fiscal deficit, we must adopt a three-pronged approach – boost economic growth, cut public expenditure, and raise revenue. Public revenue hinges essentially on economic performance. In the final analysis, the solution to the deficit problem lies in economic growth. The measures I mentioned earlier to promote economic restructuring and restore growth will, in the long run, tackle the problem at source. We accept that we need time to achieve economic restructuring, but solving the fiscal deficit problem is an immediate imperative. We therefore consider it necessary to raise revenue and cut public expenditure at this critical juncture. Coupled with our efforts to promote economic growth, we should be able to solve basically the deficit problem within

a few years. Our target is to reduce, through various means, Government's projected spending of \$220 billion in the operating accounts in 2006-2007 by \$20 billion. We also intend to introduce appropriate tax increases and adjust government fees and charges upwards to help eliminate the fiscal deficit. Detailed arrangements will be announced by the Financial Secretary in his Budget Speech.

Optimising the Use of Public Resources

48. I am pleased to note that many people in the community have made clear their willingness to accept measures to raise revenue, including reasonable tax and fee increases. But they have also asked Government to cut its spending significantly. We will make full use of this opportunity to reduce the size of government, re-defining its responsibilities, reducing unnecessary intervention, streamlining and re-organising work procedures and departmental structures. We will also carefully review our social welfare policies, re-prioritise the provision of public services and give full play to market forces. In short, our moves to tackle the deficit problem will expedite the return to a small, lean government, which is more energetic, more sharply focused on its priorities, more efficient and better able to make optimum use of resources.

Joining Hands with the Community

49. I would like to stress that civil servants are not the cause of our fiscal deficit. Over the past few years they have made solid contributions to cutting Government expenditure. Under the Enhanced Productivity Programme, they have already been doing more with less, while assuring the quality of public services. With the serious fiscal deficit problem, civil servants have again responded positively and indicated their readiness to participate in achieving the expenditure cut of \$20 billion. They are prepared to ride out the present difficulties with the rest of the community and accept a pay cut, if circumstances so require.

50. To achieve the goal of reducing expenditure, we plan to set an overall target of cutting the civil service establishment by 10% by 2006-2007 through natural wastage and normal retirement. That means the number of civil servants will drop to about 160 000. From 1 April this year, we will freeze civil service recruitment across the board. Only under exceptional circumstances and after

careful scrutiny will approval be given for any external recruitment. Also, we will launch the second phase of the Voluntary Retirement Scheme. The details are being finalised and will be released as soon as possible.

51. We are keenly aware that the fiscal deficit problem is pressing and calls for quick resolution. The Government and civil service colleagues have already commenced consultations with the expectation of producing early results.

Overall Impact

52. We will examine carefully the potential impact of the various measures to resolve the fiscal deficit. In particular, we will ensure they will not add significantly to deflation nor, despite increased taxes, fees and charges, fundamentally change the primary principle of maintaining a simple and low tax regime. In achieving our goal to eliminate the fiscal deficit, we are proceeding cautiously to strike the right balance between maintaining financial discipline on the one hand and the need to revitalise the economy on the other. We will economise, enhance efficiency, dispense with redundant services and re-deploy our resources, taking practical measures to prevent any erosion in the quality of public services and ensuring the continuation of the necessary ones.

Standing by the Community

53. To demonstrate our determination to share the hard times with the community, the 14 Principal Officials, the Director of the Chief Executive's Office, the Head of the Central Policy Unit and myself will cut our pay by 10% with effect from 1 April 2003. I am convinced that by joining hands with the community, the Government can reduce its expenditure and contribute effectively to solving the fiscal deficit problem.

F. Legislating on Article 23 of the Basic Law

54. Over the past few years I have been saying, “When Hong Kong succeeds, China will benefit. When China succeeds, Hong Kong will prosper”. Our economic and social progress require not only a secure Hong Kong, but more importantly, a stable situation in the Mainland. Following our return to the Motherland, ensuring national security has become the natural and basic civic responsibility for each one of us to observe and practise. The SARG has stressed all along that the enactment of legislation under BL23 is meant to protect national security. It does not undermine in any way the preservation of the characteristics of Hong Kong as an open, pluralistic and cosmopolitan city. It will not affect the basic rights and freedoms we now enjoy. Nor will it undermine the SARG’s compliance with internationally accepted norms of behaviour. This is the fundamental principle behind the whole legislative proposal.

55. During the consultation exercise conducted over the past three months, the community held animated and extensive discussions on the legislative proposal. I consider this kind of dialogue to be proper and normal. The SARG has noted that the community at large generally realises the need to legislate under BL23, while some citizens have expressed their doubts and worries about certain aspects of the legislative proposal. We value citizens’ views and suggestions very highly, and will study these issues in depth. We will exchange further views with the citizens concerned over the next few weeks. I firmly believe that, when the SARG presents the Bill, all will be able to see that many of their views will have been accepted. Finally, I reiterate that the SARG will take this matter forward in a thoroughly open-minded and enlightened manner, and be completely transparent in the legislative process.

G. Conclusion

56. Madam President, over the past few years, the Government has vigorously promoted economic restructuring through a broad range of policies and measures. Despite some pain in putting them in place, they are now taking effect. We see a significant drop in business costs, increasing market competition, growing acceptance of innovations and technologies, and a public sector delivering better services with higher efficiency. Increasing numbers of multinational corporations are setting up their regional headquarters here. Foreign companies are actively seeking listing in Hong Kong. Our financial services, logistics, tourism and producer services continue to do well. Closer economic integration with the PRD keeps on creating new jobs. Last November, 3.27 million people were employed, setting a record high. All this is compelling evidence that our economy is proceeding vigorously under the new role envisaged for Hong Kong. Economic restructuring is a difficult journey, but I am pleased to say that we continue to make good and steady progress.

57. We must understand that the move towards a knowledge-based economy will confront us with many significant changes. I believe we are mentally prepared for that. As industrial production relocates northwards, and corporations slim down to achieve greater cost effectiveness, the unemployment rate will unfortunately remain high for long periods. The income of some people will drop and the income gap will grow. People will inevitably find it difficult to cope with these structural changes and many will feel insecure. These changes may also cause friction in society. We can understand the situation and appreciate the feeling of those who have been hurt by economic restructuring. However, we also know that we have to move on and not indulge in nostalgia. Nor should we seek to turn the clock back. We will do our utmost to assist those in need of support. Through training and retraining programmes, the Government is providing opportunities for life-long learning to help citizens adjust to the demands of economic restructuring. Our efforts to promote tourism, develop logistics, promote the local community economy and our determination to tackle the problem of illegal workers will increase employment opportunities.

58. From another perspective, globalisation, the advent of the knowledge-based economy and the rapid economic development of our Motherland also

provide tremendous scope for development. There are great opportunities never seen before for those members of the community who possess the knowledge, creativity and enterprising spirit. They can fully deploy their expertise and talents in new ventures to create wealth. Their success in turn will further the growth and progress of our society.

59. Economic restructuring will create plenty of opportunities for our business and industrial sectors, and much room for further exploitation by our professionals. There will also be many jobs and career development opportunities for different sectors of our community. Ultimately, everyone will benefit.

60. Today, we find ourselves at a critical moment. We must be masters of our own destiny. In the past 50 years, Hong Kong has faced and overcome many challenges, turning crises into opportunities. All involved, whether they were entrepreneurs or employees, have embraced the opportunities and created success stories by virtue of their diligence, agility and willingness to keep learning. These events give us confidence that we will succeed in the new round of economic restructuring.

61. For ourselves and our next generation, I sincerely hope we can all put the community's common interests first when we proceed along this path of development. We are all in the same boat and should, therefore, support and care for one another. We should, in particular, show our sympathy and do our best to take care of the disadvantaged in the community.

62. We do not underestimate the challenges in pushing for restructuring and revitalising our economy. But we need to look beyond the immediate problems to see the bright future that lies ahead. The SARG and I are confident, determined and certain that we can lead Hong Kong out of its current difficulties and accomplish the mission of revitalising our economy. We will create a more prosperous Hong Kong under "One Country, Two Systems".