

APPENDIX A

MEDIUM RANGE FORECAST

2006-07 TO 2011-12

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SECTION I – FORECASTING ASSUMPTIONS AND BUDGETARY CRITERIA

1 A number of computer-based models are used to derive the Medium Range Forecast (MRF). These models reflect a wide range of assumptions about the factors determining each of the components of Government's revenue and expenditure. Some are economic in nature (the general economic assumptions) while others deal with specific areas of Government's activities (the detailed assumptions). These are supported by studies of historical and anticipated trends.

General Economic Assumptions

Real Gross Domestic Product (real GDP)

2 GDP is forecast to increase by 4.5% to 5.5% in real terms in 2007. For planning purposes, over the ensuing four-year period 2008 to 2011, the trend growth rate of the economy in real terms is assumed at 4.5% per annum. We have made reference to the mid-point of the range forecast of GDP growth rate for 2007 in deriving the MRF.

Price change

3 The GDP deflator, measuring overall price change in the economy, is forecast to decrease by 0.5% in 2007. For the four-year period 2008 to 2011, the GDP deflator is assumed to increase at a trend rate of 1.5% per annum. The Composite Consumer Price Index, measuring inflation in the consumer domain, is forecast to increase by 1.5% in 2007. The trend rate of increase for the ensuing period 2008 to 2011 is assumed to be 3.5% per annum.

Nominal Gross Domestic Product (nominal GDP)

4 Taking the assumptions on the rates of change in the real GDP and the GDP deflator together, the growth rate of GDP in nominal terms is forecast at 4% to 5% in 2007, and the trend growth rate in nominal terms for the period 2008 to 2011 is assumed at 6% per annum.

Detailed Assumptions

5 The MRF incorporates a wide range of detailed assumptions on expenditure and revenue patterns over the forecast period, taking the following, amongst other factors, into account –

- estimated cash flow of capital projects,
- forecast completion dates of these capital projects and their related recurrent consequences in terms of staffing and running costs,
- estimated cash flow arising from new commitments and policy initiatives,
- the expected pattern of demand for individual services,
- the trend in yield from individual revenue sources, and
- new revenue/expenditure measures in the 2007-08 Budget.

Budgetary Criteria

6 In addition to the above forecasting assumptions, there are a number of criteria against which the results of forecasts are tested for overall acceptability in terms of budgetary policy.

7 The following covers the more important budgetary criteria –

Budget surplus/deficit

The Government aims to sustain balance in the consolidated and operating accounts. The Government needs, over time, to achieve an operating surplus to partially finance capital expenditure.

Expenditure policy

The general principle is that, over time, expenditure growth should not exceed the growth of the economy. The Government aims to keep public expenditure at or below 20% of GDP. Capital expenditure, by its nature, will fluctuate from year to year.

Revenue policy

Account is taken of the need to maintain, over time, the real yield from revenue.

Fiscal reserves

The Government aims to maintain adequate reserves in the long run.

SECTION II – THE MRF FOR 2006–07 TO 2011–12

8 The current MRF (*Note a*) is summarised in the following table which indicates the forecast financial position of the Government –

Table 1

(\$ million)	Original Estimate	Revised Estimate	Estimate	Forecast			
	2006–07	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12
Operating Account							
Operating revenue (<i>Note b</i>)	195,264	211,610	201,524	217,895	228,543	243,642	258,451
Operating expenditure (<i>Note c</i>)	209,000	195,748	214,200	221,700	229,500	237,500	245,800
Surplus/(deficit) before investment income	(13,736)	15,862	(12,676)	(3,805)	(957)	6,142	12,651
Investment income (<i>Note b</i>)	14,361	22,695	19,882	26,811	29,653	26,967	28,720
Operating surplus after investment income	625	38,557	7,206	23,006	28,696	33,109	41,371
Capital Financing Statement							
Capital revenue (<i>Note d</i>)	39,500	46,856	46,048	49,609	50,830	51,719	53,878
Asset sales (<i>Note d</i>)	4,348	107	299	6,721	6,728	6,629	8,228
Capital spending (<i>Note e</i>)	43,848	46,963	46,347	56,330	57,558	58,348	62,106
Surplus before investment income/interest expenses	39,369	33,867	33,438	35,640	46,285	50,911	49,659
Investment income (<i>Note d</i>)	4,479	13,096	12,909	20,690	11,273	7,437	12,447
Interest expenses (<i>Note e & f</i>)	3,852	6,807	6,092	6,664	6,444	5,467	5,415
Surplus after investment income/interest expenses	826	826	799	754	642	576	577
Repayment of bonds and notes (<i>Note e & f</i>)	7,505	19,077	18,202	26,600	17,075	12,328	17,285
Capital financing surplus after bond repayment	4,955	16,527	18,202	23,900	13,575	12,328	17,285
Consolidated Account							
Fiscal reserves at 1 April	300,756	310,663	365,747	391,155	438,061	480,332	525,769
Operating surplus	625	38,557	7,206	23,006	28,696	33,109	41,371
Capital financing surplus before bond repayment	7,505	19,077	18,202	26,600	17,075	12,328	17,285
Consolidated surplus	8,130	57,634	25,408	49,606	45,771	45,437	58,656
Repayment of bonds and notes	2,550	2,550	-	2,700	3,500	-	-
Consolidated surplus after bond repayment	5,580	55,084	25,408	46,906	42,271	45,437	58,656
Fiscal reserves at 31 March	306,336	365,747	391,155	438,061	480,332	525,769	584,425
As a number of months of government expenditure	15	19	19	20	21	22	24
As a percentage of GDP	21.1%	24.8%	25.4%	26.9%	27.8%	28.7%	30.1%
Outstanding debts at 31 March							
Toll Revenue Bond	4,098	4,200	2,820	2,320	1,020	790	-
Other government bonds and notes	17,450	17,450	17,450	14,750	11,250	11,250	11,250

Notes –

(a) *Accounting policies*

- (i) The MRF is prepared on a cash basis and reflects forecast receipts and payments, whether or not they relate to operating or capital transactions.
- (ii) The MRF includes the General Revenue Account and the Funds (Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Land Fund, Loan Fund and Lotteries Fund).

(b) *Operating revenue*

- (i) The operating revenue has taken into account the revenue-concession measures proposed in the 2007-08 Budget, and is made up of –

	2006–07 Revised Estimate	2007–08 Estimate	2008–09 Forecast	2009–10 Forecast	2010–11 Forecast	2011–12 Forecast
(\$ million)						
Operating revenue before investment income	211,610	201,524	217,895	228,543	243,642	258,451
Investment income	22,695	19,882	26,811	29,653	26,967	28,720
Total	234,305	221,406	244,706	258,196	270,609	287,171

- (ii) For the purpose of the MRF, investment income under the Operating Account includes the investment income of the General Revenue Account which are credited to revenue head Properties and Investments and the investment income of the Land Fund. The rate of investment return for 2007-08 is 7% and for 2008-09 to 2011-12 is assumed to be in the range of 6.4% to 8.3% a year.

(c) *Operating expenditure*

This represents the expenditure charged to the Operating Account of the General Revenue Account. The levels of operating expenditure in 2007-08 to 2011-12 represent the expenditure guidelines for these years.

(d) *Capital revenue*

- (i) The breakdown of capital revenue is –

	2006–07 Revised Estimate	2007–08 Estimate	2008–09 Forecast	2009–10 Forecast	2010–11 Forecast	2011–12 Forecast
(\$ million)						
General Revenue Account	4,818	2,336	4,200	3,276	1,213	548
Capital Works Reserve Fund	36,925	38,652	40,771	43,227	45,832	48,593
Capital Investment Fund	2,267	1,976	1,358	728	793	731
Innovation and Technology Fund	10	-	-	-	-	-
Loan Fund	1,866	2,084	2,246	2,530	2,776	2,864
Lotteries Fund	970	1,000	1,034	1,069	1,105	1,142
Capital revenue before asset sales and investment income	46,856	46,048	49,609	50,830	51,719	53,878
Asset sales	107	299	6,721	6,728	6,629	8,228
Investment income	6,807	6,092	6,664	6,444	5,467	5,415
Total	53,770	52,439	62,994	64,002	63,815	67,521

- (ii) For the purpose of the MRF, the annual land premium included under the Capital Works Reserve Fund is assumed at 2.5% of GDP throughout the MRF period.
- (iii) For the purpose of the MRF, investment income under the Capital Financing Statement includes investment income of the Funds except Land Fund (i.e. Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Loan Fund and Lotteries Fund).

(e) *Capital spending*

The breakdown of capital spending is –

	2006–07 Revised Estimate	2007–08 Estimate	2008–09 Forecast	2009–10 Forecast	2010–11 Forecast	2011–12 Forecast
(\$ million)						
General Revenue Account	1,512	2,471	3,970	3,970	3,970	3,970
Capital Works Reserve Fund	24,507	24,978	25,760	37,582	42,497	41,242
Capital Investment Fund	3,124	-	552	358	250	250
Disaster Relief Fund	19	-	-	-	-	-
Innovation and Technology Fund	508	901	938	917	911	874
Loan Fund	3,230	4,132	3,703	3,046	2,974	3,029
Lotteries Fund	967	956	717	412	309	294
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Capital spending before interest on and repayment of government bonds and notes	33,867	33,438	35,640	46,285	50,911	49,659
Interest expenses	826	799	754	642	576	577
Repayment of bonds and notes	2,550	-	2,700	3,500	-	-
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Total	37,243	34,237	39,094	50,427	51,487	50,236

(f) *Government bonds and notes*

Interest expenses and repayment of bonds and notes are only in respect of the global bond issue and not the Toll Revenue Bond. The interest expenses and repayment of the Toll Revenue Bond are charged directly against the net toll revenue of concerned tunnels and bridges. The toll revenue thus foregone has been taken into account in forecasting Government's operating revenue.

SECTION III – RELATIONSHIP BETWEEN GOVERNMENT EXPENDITURE/PUBLIC EXPENDITURE AND GDP IN THE MRF

9 For monitoring purposes, the Government's own expenditure is consolidated with the expenditure of the Trading Funds and the Housing Authority (collectively referred to as "other public bodies") in order to compare total public expenditure with GDP.

Government Expenditure and Public Expenditure in the Context of the Economy *Table 2*

(\$ million)	Original Estimate	Revised Estimate	Estimate	Forecast			
	2006–07	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12
Operating expenditure	209,000	195,748	214,200	221,700	229,500	237,500	245,800
Capital expenditure	36,634	31,569	34,237	35,842	46,569	51,237	49,986
Total government expenditure	245,634	227,317	248,437	257,542	276,069	288,737	295,786
Other public bodies expenditure	19,255	18,246	19,408	18,943	19,488	20,093	20,219
Total public expenditure (Note a)	264,889	245,563	267,845	276,485	295,557	308,830	316,005
Gross Domestic Product (calendar year)	1,451,624	1,472,291	1,538,176	1,630,851	1,729,109	1,833,287	1,943,742
Growth in GDP (Note b)							
Nominal terms		6.5%	4.5%	6.0%	6.0%	6.0%	6.0%
Real terms		6.8%	5.0%	4.5%	4.5%	4.5%	4.5%
Growth in government expenditure (Note c)							
Nominal terms		0.4%	9.3%	3.7%	7.2%	4.6%	2.4%
Real terms		-0.1%	9.2%	1.8%	5.0%	2.4%	0.3%
Growth in public expenditure (Note c)							
Nominal terms		0.2%	9.1%	3.2%	6.9%	4.5%	2.3%
Real terms		-0.3%	8.9%	1.4%	4.8%	2.4%	0.2%
Public expenditure as a percentage of GDP	18.2%	16.7%	17.4%	17.0%	17.1%	16.8%	16.3%

Notes –

- (a) Public expenditure comprises government expenditure (i.e. all expenditure charged to the General Revenue Account and financed by the Government's statutory funds excluding Capital Investment Fund), and expenditure by the Trading Funds and the Housing Authority. But *not* included is expenditure by those organisations, including statutory organisations, in which the Government has only an equity position, such as the Airport Authority, the MTR Corporation Limited and the Kowloon-Canton Railway Corporation. Similarly, advances and equity investments from the Capital Investment Fund as well as repayment of government bonds and notes are excluded as they do not reflect the actual consumption of resources by the Government.
- (b) For 2007-08, the GDP growth in nominal terms of 4.5% represents the mid-point of the range forecast of nominal GDP growth at 4% to 5% for the calendar year 2007. Similarly, the growth in real terms of 5% represents the mid-point of the range forecast of real GDP growth at 4.5% to 5.5% for 2007.
- (c) The growth rates refer to year-on-year change. For example, the rates for 2006–07 refer to the change between revised estimate for 2006–07 and actual expenditure in 2005–06. The rates for 2007–08 refer to the change between the 2007–08 forecast and the 2006–07 revised estimate, and so forth.

10 Table 3 shows the relationship amongst the sum to be appropriated in the 2007-08 Budget, government expenditure and public expenditure. It also shows the effect of the Budget revenue measures on the overall surplus position for 2007-08.

**Relationship between Government Expenditure
and Public Expenditure in 2007-08**

(\$ million)

Table 3

Components of expenditure and revenue	Appropriation	Government expenditure and revenue			Public expenditure
		Operating	Capital	Total	
Expenditure					
General Revenue Account					
Operating					
Recurrent	205,601	205,601	-	205,601	205,601
Non-recurrent	8,599	8,599	-	8,599	8,599
Capital					
Plant, equipment and works	1,119	-	1,119	1,119	1,119
Subventions	1,352	-	1,352	1,352	1,352
	216,671	214,200	2,471	216,671	216,671
Transfer to Funds	1,617	-	-	-	-
Capital Works Reserve Fund	-	-	25,777	25,777	25,777
Innovation and Technology Fund	-	-	901	901	901
Loan Fund	-	-	4,132	4,132	4,132
Lotteries Fund	-	-	956	956	956
Trading Funds	-	-	-	-	3,731
Housing Authority	-	-	-	-	15,677
	218,288	214,200	34,237	248,437	267,845
Revenue (before Budget revenue measures)					
General Revenue Account					
Taxation		195,320	200	195,520	
Other revenue		33,509	2,136	35,645	
Land Fund		228,829	2,336	231,165	
		9,841	-	9,841	
Capital Works Reserve Fund		238,670	2,336	241,006	
Capital Investment Fund		-	42,677	42,677	
Civil Service Pension Reserve Fund		-	2,158	2,158	
Disaster Relief Fund		-	1,210	1,210	
Innovation and Technology Fund		-	3	3	
Loan Fund		-	285	285	
Lotteries Fund		-	2,390	2,390	
		-	1,380	1,380	
		238,670	52,439	291,109	
Surplus before Budget revenue measures		24,470	18,202	42,672	
<i>Less: Effect of Budget revenue measures</i>		17,264	-	17,264	
Consolidated surplus		7,206	18,202	25,408	

SECTION IV – ESTIMATES OF CONTINGENT LIABILITIES

11 The Government's contingent liabilities as at 31 March 2006, and estimates of these should they remain unsettled as at 31 March 2007 or 31 March 2008, are provided below as supplementary information to the MRF –

(at 31 March)	2006 \$m	2007 \$m	2008 \$m
Guarantee to the Hong Kong Export Credit Insurance Corporation for liabilities under contracts of insurance	10,988	11,702	12,229
Litigation	290	309	323
Possible capital subscriptions to the Asian Development Bank	2,003	2,003	2,003
Guarantees provided under loan guarantee schemes for small and medium enterprises	5,287	5,440	5,131
Total	<u>18,568</u>	<u>19,454</u>	<u>19,686</u>