

APPENDIX A

MEDIUM RANGE FORECAST

2005–06 TO 2010–11

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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% to 5% in real terms in 2006. For planning purposes, over the ensuing four-year period 2007 to 2010, the trend growth rate of the economy in real terms is assumed at 4% per annum. We have made reference to the mid-point of the range forecast of GDP growth rate for 2006 in deriving the MRF.

Price change

3 The GDP deflator, measuring overall price change in the economy, is forecast to increase by 0.5% in 2006. For the four-year period 2007 to 2010, the GDP deflator is assumed to increase at a trend rate of 2% per annum. The Composite Consumer Price Index, measuring inflation in the consumer domain, is forecast to increase by 2.3% in 2006. The trend rate of increase for the ensuing period 2007 to 2010 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 4.5% to 5.5% in 2006, and the trend growth rate in nominal terms for the period 2007 to 2010 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 resulting from 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 2006 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. In the longer term, the Government needs 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 in the long run aims to maintain the level of reserves at around 12 months of total government expenditure.

SECTION II – THE MRF FOR 2005–06 TO 2010–11

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	Forecast				
	2005–06	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11
Operating Account							
Operating revenue (<i>Note b</i>)	181,388	192,481	195,264	203,335	213,668	224,622	236,988
Operating expenditure (<i>Note c</i>)	208,000	194,749	209,000	214,200	219,600	225,100	230,700
Surplus/(deficit) before investment income	(26,612)	(2,268)	(13,736)	(10,865)	(5,932)	(478)	6,288
Investment income (<i>Note b</i>)	11,161	8,057	14,361	12,489	13,666	15,093	16,579
Operating surplus/(deficit) after investment income	(15,451)	5,789	625	1,624	7,734	14,615	22,867
Capital Financing Statement							
Capital revenue (<i>Note d</i>)	42,159	38,413	39,500	38,946	40,730	41,358	43,136
Asset sales (<i>Note d</i>)	5,401	436	4,348	10,837	18,848	8,351	10,351
	47,560	38,849	43,848	49,783	59,578	49,709	53,487
Capital spending (<i>Note e</i>)	44,741	42,008	39,369	43,404	43,387	43,430	45,346
Surplus/(deficit) before investment income/interest expenses	2,819	(3,159)	4,479	6,379	16,191	6,279	8,141
Investment income (<i>Note d</i>)	2,940	2,279	3,852	3,085	2,746	2,377	2,185
Interest expenses (<i>Note e & f</i>)	853	852	826	799	754	642	576
Surplus/(deficit) after investment income/interest expenses	4,906	(1,732)	7,505	8,665	18,183	8,014	9,750
Repayment of bonds and notes (<i>Note e & f</i>)	-	-	2,550	-	2,700	3,500	-
Capital financing surplus/(deficit) after bond repayment	4,906	(1,732)	4,955	8,665	15,483	4,514	9,750
Consolidated Account							
Fiscal reserves at 1 April	287,296	295,981	300,756	306,336	316,625	339,842	358,971
Operating surplus/(deficit)	(15,451)	5,789	625	1,624	7,734	14,615	22,867
Capital financing surplus/(deficit) before bond repayment	4,906	(1,732)	7,505	8,665	18,183	8,014	9,750
Consolidated surplus/(deficit)	(10,545)	4,057	8,130	10,289	25,917	22,629	32,617
Repayment of bonds and notes	-	-	2,550	-	2,700	3,500	-
Consolidated surplus/(deficit) after bond repayment	(10,545)	4,057	5,580	10,289	23,217	19,129	32,617
Write-back of provision for loss in investments with the Exchange Fund		718					
Fiscal reserves at 31 March	276,751	300,756	306,336	316,625	339,842	358,971	391,588
As number of months of government expenditure	13	16	15	15	15	16	17
Outstanding debts at 31 March							
– Toll Revenue Bond	4,877	4,638	4,098	2,678	2,138	790	790
– Other government bonds and notes	20,000	20,000	17,450	17,450	14,750	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 2006 Budget, and is made up of –

(\$ million)	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11
Operating revenue before investment income	192,481	195,264	203,335	213,668	224,622	236,988
Investment income	8,057	14,361	12,489	13,666	15,093	16,579
Total	<u>200,538</u>	<u>209,625</u>	<u>215,824</u>	<u>227,334</u>	<u>239,715</u>	<u>253,567</u>

- (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 is assumed at 6% in 2006-07 and 5% per annum in 2007-08 to 2010-11.

(c) Operating expenditure

This represents the expenditure charged to the Operating Account of the General Revenue Account. The levels of operating expenditure in 2006-07 to 2010-11 represent the expenditure guidelines for these years.

(d) Capital revenue

- (i) The breakdown of capital revenue is –

(\$ million)	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11
General Revenue Account	4,233	4,010	2,227	2,347	1,162	754
Capital Works Reserve Fund	28,835	30,647	32,324	34,276	36,346	38,541
Capital Investment Fund	2,639	1,984	1,803	1,407	896	738
Innovation and Technology Fund	19	-	-	-	-	-
Loan Fund	1,614	1,761	1,455	1,524	1,736	1,842
Lotteries Fund	1,073	1,098	1,137	1,176	1,218	1,261
Capital revenue before asset sales and investment income	<u>38,413</u>	<u>39,500</u>	<u>38,946</u>	<u>40,730</u>	<u>41,358</u>	<u>43,136</u>
Asset sales	436	4,348	10,837	18,848	8,351	10,351
Investment income	2,279	3,852	3,085	2,746	2,377	2,185
Total	<u>41,128</u>	<u>47,700</u>	<u>52,868</u>	<u>62,324</u>	<u>52,086</u>	<u>55,672</u>

- (ii) For the purpose of the MRF, the annual land premia included under the Capital Works Reserve Fund are assumed at 2.1% 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 –

(\$ million)	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11
General Revenue Account	1,552	1,829	3,970	3,970	3,970	3,970
Capital Works Reserve Fund	29,067	27,139	34,061	35,415	36,507	38,826
Capital Investment Fund	6,521	3,561	643	320	250	250
Disaster Relief Fund	15	-	-	-	-	-
Innovation and Technology Fund	528	794	918	890	839	552
Loan Fund	3,298	4,886	2,672	1,989	1,432	1,423
Lotteries Fund	1,027	1,160	1,140	803	432	325
Capital spending before interest on and repayment of government bonds and notes	42,008	39,369	43,404	43,387	43,430	45,346
Interest expenses	852	826	799	754	642	576
Repayment of bonds and notes	-	2,550	-	2,700	3,500	-
Total	42,860	42,745	44,203	46,841	47,572	45,922

(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 Housing Authority and the Trading Funds (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	Forecast				
	2005-06	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Operating expenditure	208,000	194,749	209,000	214,200	219,600	225,100	230,700
Capital expenditure	39,792	36,339	36,634	43,560	43,821	43,822	45,672
Total government expenditure	247,792	231,088	245,634	257,760	263,421	268,922	276,372
Other public bodies	20,798	19,167	19,255	19,309	18,562	18,510	18,637
Total public expenditure (Note a)	268,590	250,255	264,889	277,069	281,983	287,432	295,009
Gross Domestic Product (calendar year)	1,332,877	1,382,203	1,451,624	1,539,281	1,632,232	1,730,795	1,835,310
Growth in GDP (Note b)							
Nominal terms		7.0%	5.0%	6.0%	6.0%	6.0%	6.0%
Real terms		7.3%	4.5%	4.0%	4.0%	4.0%	4.0%
Growth in government expenditure (Note c)							
Nominal terms		-2.2%	6.3%	4.9%	2.2%	2.1%	2.8%
Real terms		-1.4%	6.0%	3.4%	0.6%	0.5%	1.2%
Growth in public expenditure (Note c)							
Nominal terms		-2.7%	5.8%	4.6%	1.8%	1.9%	2.6%
Real terms		-2.0%	5.5%	3.1%	0.2%	0.4%	1.1%
Public expenditure as a percentage of GDP	20.2%	18.1%	18.2%	18.0%	17.3%	16.6%	16.1%

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 2006-07, the GDP growth in nominal terms of 5% represents the mid-point of the range forecast of nominal GDP growth at 4.5% to 5.5% for the calendar year 2006. Similarly, the growth in real terms of 4.5% represents the mid-point of the range forecast of real GDP growth at 4% to 5% for 2006.
- (c) The growth rates refer to year-on-year change. For example, the rates for 2005-06 refer to the change between revised estimate for 2005-06 and actual expenditure in 2004-05. The rates for 2006-07 refer to the change between the 2006-07 forecast and the 2005-06 revised estimate, and so forth.

10 Table 3 shows the relationship amongst the sum to be appropriated in the 2006 Budget, government expenditure and public expenditure. It also shows the effect of the Budget revenue measures on the overall surplus position for 2006–07.

**Relationship between Government Expenditure
and Public Expenditure in 2006–07**

(\$ million)

Table 3

Components of expenditure and revenue	Appropriation	Government expenditure and revenue			Public expenditure
		Operating	Capital	Total	
Expenditure					
General Revenue Account					
Operating					
Recurrent	199,931	199,931	-	199,931	199,931
Non-recurrent	9,069	9,069	-	9,069	9,069
Capital					
Plant, equipment and works	892	-	892	892	892
Subventions	937	-	937	937	937
	210,829	209,000	1,829	210,829	210,829
Transfer to Funds	3,516	-	-	-	-
Capital Works Reserve Fund	-	-	27,965	27,965	27,965
Innovation and Technology Fund	-	-	794	794	794
Loan Fund	-	-	4,886	4,886	4,886
Lotteries Fund	-	-	1,160	1,160	1,160
Trading Funds	-	-	-	-	3,595
Housing Authority	-	-	-	-	15,660
	214,345	209,000	36,634	245,634	264,889
Revenue (before Budget revenue measures)					
General Revenue Account					
Taxation		169,714	170	169,884	
Other revenue		34,239	3,840	38,079	
		203,953	4,010	207,963	
Land Fund		7,952	-	7,952	
		211,905	4,010	215,915	
Capital Works Reserve Fund		-	32,836	32,836	
Capital Investment Fund		-	2,055	2,055	
Civil Service Pension Reserve Fund		-	979	979	
Disaster Relief Fund		-	2	2	
Innovation and Technology Fund		-	239	239	
Loan Fund		-	1,844	1,844	
Lotteries Fund		-	1,387	1,387	
Asset sales		-	4,348	4,348	
		211,905	47,700	259,605	
Surplus before Budget revenue measures		2,905	11,066	13,971	
<i>Less:</i> Effect of Budget revenue measures		2,280	-	2,280	
Surplus after Budget revenue measures		625	11,066	11,691	
<i>Less:</i> Advances and equity investments from the Capital Investment Fund		-	3,561	3,561	
Repayment of bonds and notes		-	2,550	2,550	
Consolidated surplus		625	4,955	5,580	

SECTION IV - ESTIMATES OF CONTINGENT LIABILITIES

11 The Government's contingent liabilities as at 31 March 2005, and estimates of these should they remain unsettled as at 31 March 2006 or 31 March 2007, are provided below as supplementary information to the MRF –

(at 31 March)	2005 \$m	2006 \$m	2007 \$m
Guarantee to the Hong Kong Export Credit Insurance Corporation for liabilities under contracts of insurance	10,207	10,921	11,467
Litigation	392	419	440
Possible capital subscriptions to the Asian Development Bank	2,112	2,112	2,112
Guarantees provided under loan guarantee schemes for small and medium enterprises, the Film Guarantee Fund and the Loan Guarantee Scheme for Severe Acute Respiratory Syndrome Impacted Industries	5,134	5,168	5,446
Total	<u>17,845</u>	<u>18,620</u>	<u>19,465</u>