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January 13, 1993

To: Members of the Executive Board

From: The Secretary

Subject: United Kingdom - Hong Kong - Staff Report for the 1992
Article IV Consultation Discussions

Attached for consideration by the Executive Directors is the staff report for the 1992 Article IV consultation discussions with respect to Hong Kong, which is tentatively scheduled for discussion on Wednesday, February 3, 1993.

Mr. Citrin (ext. 38982) or Mr. Miranda (ext. 36522) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM - HONG KONG

Staff Report for the 1992 Article IV Consultation Discussions

Prepared by the Staff Representatives for the
1992 Consultation Discussions with Respect to Hong Kong

Approved by Bijan B. Aghevli and Joaquin Ferran

January 12, 1993

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I. Introduction ^{1/}

The 1992 Article IV consultation discussions with respect to Hong Kong were held during November 4-14. The staff team met with the Financial Secretary and other senior government officials. ^{2/} Mr. Peretz, Executive Director for the United Kingdom, was present during the discussions. ^{3/}

In concluding last year's consultation discussions, Directors had noted that economic recovery was well under way and commented extensively on the role of policies in dealing with inflation. While most Directors supported the authorities' commitment to maintaining a fixed exchange rate link with the U.S. dollar, a few Directors saw merit in a more flexible monetary and exchange rate strategy to reduce price pressures. Directors observed that fiscal policy had been expansionary in recent years, and that the planned construction of a new Hong Kong airport would impart a large stimulus to aggregate demand in the period ahead. They stressed that a more restrictive fiscal policy was needed if inflation was to be brought down.

II. Recent Developments

Hong Kong's enviable record of economic success over recent decades has been underpinned by the Government's approach of providing a favorable business environment by maintaining a free international trade and finance regime, limited domestic regulation, a low rate of taxation, and fiscal discipline. Since the mid-1980s, the strengthening of economic linkages with southern China has enhanced Hong Kong's role as the provider of essential financial and trade-related services to China and has also been associated with a transfer of labor-intensive manufacturing activities to China. Accordingly, Hong Kong's economy has become increasingly sensitive to developments in China; these sensitivities have been heightened by the prospective return of sovereignty over Hong Kong to China in 1997. In 1991, the economic recovery in China and the Sino-British agreement on a new airport boosted confidence and revitalized growth in Hong Kong. More

^{1/} It should be noted that the term "country" used in this report does not in all cases refer to a territorial entity that is a state as understood by international law and practice. The term also covers some territorial entities . . . at are not states but for which statistical data are maintained and provided internationally on a separate and independent basis.

^{2/} The staff team consisted of Messrs. Aghevli, Citrin, Lin, Mihaljek, and Miranda, and Mrs. Goodger (Administrative Assistant, all CTA).

^{3/} While Article IV consultations can be conducted only with members, the Fund can hold Article IV consultation discussions with sub-parts of a member at a member's request. These discussions formally are part of the 1992 Article IV consultation with the United Kingdom. The staff report (SM/92/4) for the 1991 Article IV consultation discussions with respect to Hong Kong was discussed at the Executive Board on January 24, 1992 (EBM/92/7 and EBM/92/8).

recently, however, some uncertainties have arisen owing to a political dispute with China and to renewed disagreement over the financing of the new airport project.

Since last year's consultation discussions, economic growth in Hong Kong has gained further momentum, underpinned by strong private demand and accommodative financial conditions. Real GDP grew by 4 1/4 percent in 1991, led by investment in machinery and equipment and private consumption (Table 1). Exports also accelerated, reflecting strong demand from China as well as a further expansion in re-exports of goods produced in China. Nevertheless, with robust domestic demand leading to rapid import growth, net external demand made a substantial negative contribution to growth. The buoyancy in both domestic expenditures and export performance was sustained into 1992: real GDP increased by 4 3/4 percent in the first half of the year (year on year), and it is estimated to have increased by 5 percent for the year as a whole.

Despite the pickup in growth, price pressures have moderated somewhat. Consumer price inflation fell from 12 percent in 1991 to an average of 9 1/2 percent (year on year) in the first eleven months of 1992 (Chart 1). This decline was partly due to special factors, including the reversal of indirect tax increases and a slowdown in price increases of fuel and fresh foodstuffs, but also reflected some easing in resource constraints. The unemployment rate rose from 1 1/4 percent in 1990 to 2 percent by the first half of 1992, owing to an increase in labor force growth that reflected both a reduction in net outward migration and the inflow of foreign workers under two new Government schemes. Average wage increases declined from 13 percent (annual rate) in 1989-90 to 9 1/2 percent (year on year) in March 1992. ^{1/}

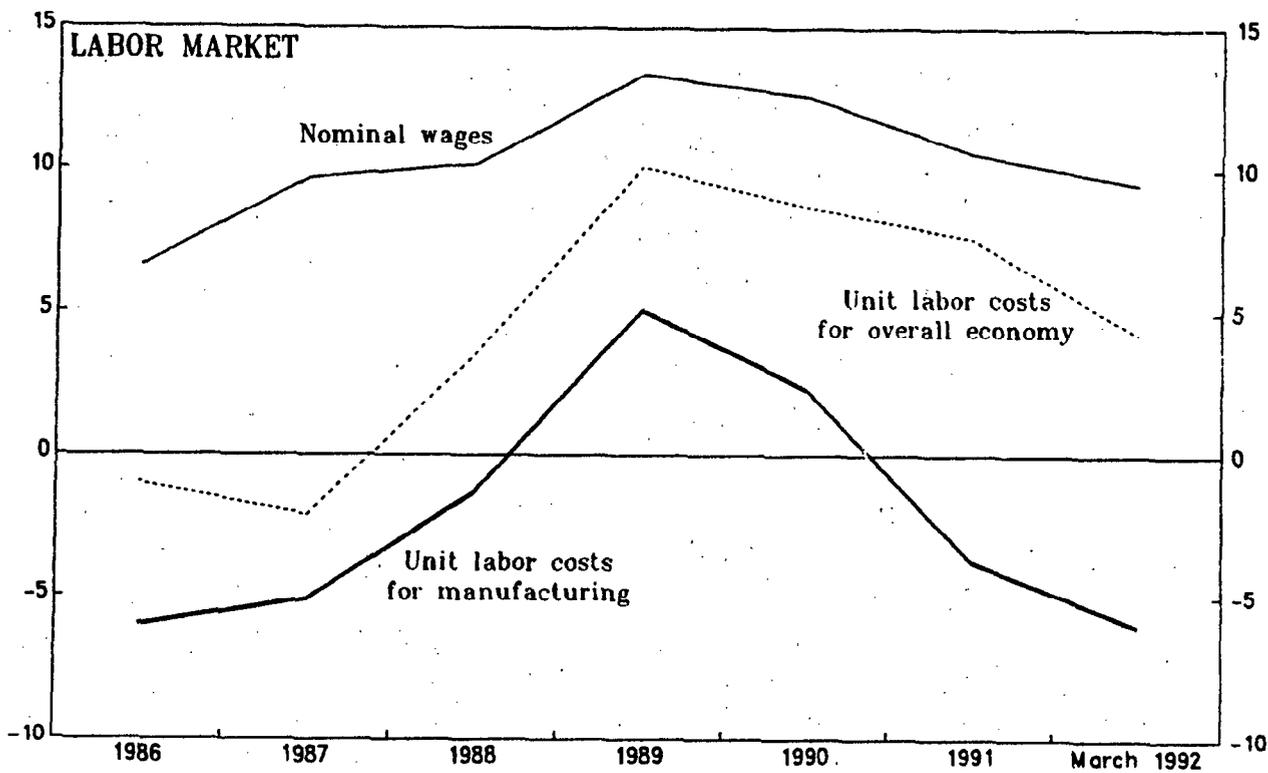
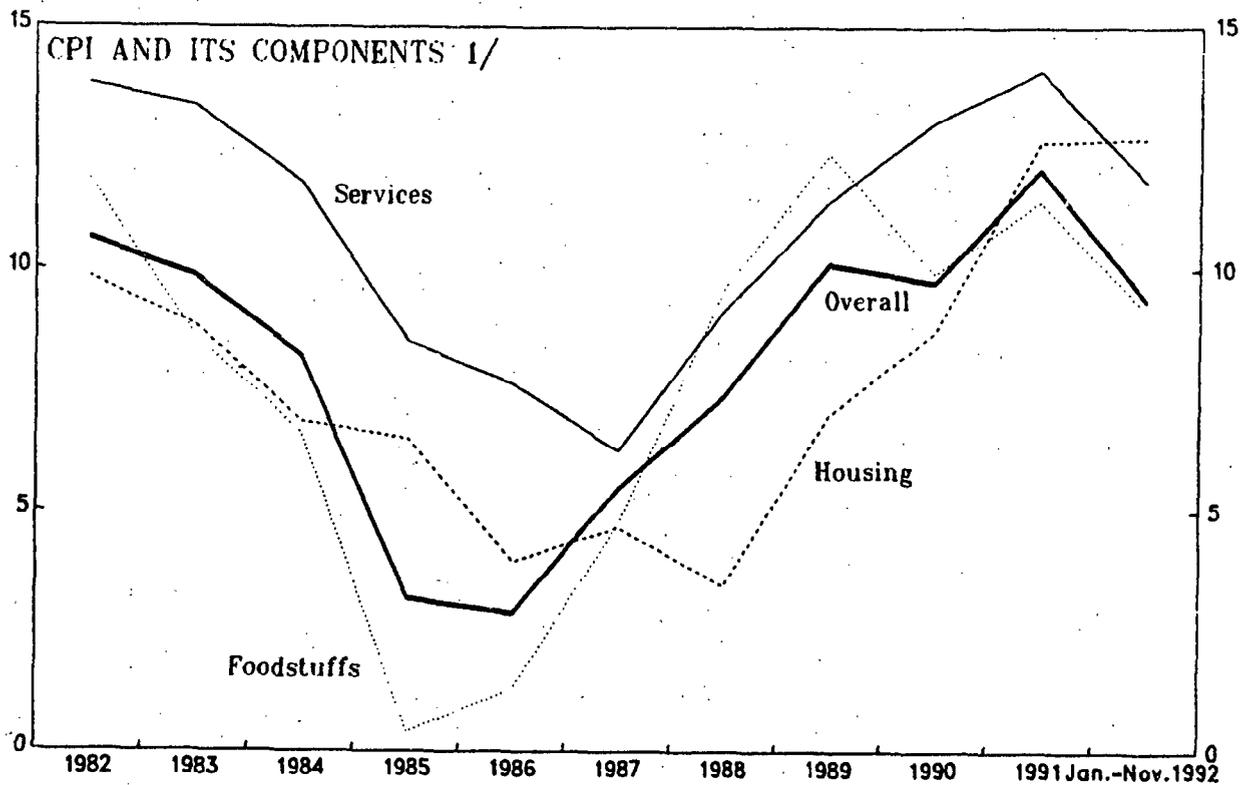
Nevertheless, strong inflationary pressures persist. Indeed, as the impact of special factors has dissipated, inflation has picked up in recent months: in November, core consumer price inflation (excluding food for home use) registered a year-on-year increase of 10 1/2 percent. Furthermore, continued rapid growth has led to a renewed tightening in the labor market, with the unemployment rate falling to 1 3/4 percent by August.

The acceleration in economic activity has been accompanied by substantial gains in asset prices. In the property market, price increases have been particularly marked in the residential and commercial sectors: by the first half of 1992, prices of residential and commercial property were 1 1/2 to 2 times their average levels in 1990. Equity prices also rose dramatically through mid-November 1992, when the Hang Seng Index of stock

^{1/} The GDP deflator has not shown signs of deceleration, rising by 10 3/4 percent (year on year) in the second quarter of 1992, compared with 10 1/2 percent in 1991. This may reflect the possibility that lower increases in import prices were not immediately reflected in domestic output prices.

CHART 1

HONG KONG
SELECTED INDICATORS OF PRICES AND COSTS, 1982-92
(Percentage change)



Source: Census and Statistics Department, Hong Kong Monthly Digest of Statistics.
1/ Based on CPI(A).

Table 1. Hong Kong--Summary Data, 1988-92

	1988	1989	1990	1991	1992 Staff Est.
	(Percentage change)				
Growth, prices, and unemployment					
Real GDP	8.3	2.8	3.2	4.2	5.0
Real domestic demand	8.7	1.2	7.0	7.9	7.6
Private consumption	8.7	4.0	6.2	7.7	7.5
Gross fixed capital formation	7.4	2.9	8.0	9.2	7.2
Foreign balance <u>1/</u>	0.1	1.7	-3.3	-3.4	-2.6
Consumer prices	7.4	10.1	9.7	12.0	9.4 <u>2/</u>
Unemployment rate (in percent)	1.4	1.1	1.3	1.8	1.7 <u>3/</u>
Money and credit (end-year)					
Narrow money (M1)	8.5	6.8	13.3	19.5	20.9 <u>4/</u>
Broad money (M3)	20.2	18.7	21.5	11.6	10.7 <u>4/</u>
Trade					
Exports	30.4	15.7	12.2	19.7	21.9 <u>5/</u>
Domestic exports	11.5	3.0	0.8	2.3	2.0 <u>5/</u>
Re-exports	50.7	25.8	19.5	29.2	30.7 <u>5/</u>
Imports	32.0	12.8	14.2	21.2	22.8 <u>5/</u>
	(In percent of GDP)				
Trade balance	-1.3	1.5	-0.5	-2.0	-2.0
Exports	113.7	114.3	114.3	119.0	122.1
Imports	115.0	112.7	114.8	121.0	124.0
Net exports of goods and nonfactor services	5.1	8.0	5.1	3.3	3.2
Consolidated budget balance <u>6/</u>					
Revenue	16.8	16.5	16.0	17.6	17.2
Expenditures	12.4	14.3	15.3	14.3	16.5
Interest rates (end-period in percent)					
Best lending rate	10.0	10.0	10.0	8.5	6.5 <u>7/</u>
Time deposits (three-month)	6.5	6.5	6.8	4.8	2.8 <u>7/</u>
Exchange rates					
Linked rate (fixed)				HK\$7.80/US\$1	
Present market rate				HK\$7.74/US\$1 (December 31, 1992)	
Real effective exchange rate (period average; 1980-100)	84.3	89.8	94.9	101.7	104.6 <u>8/</u>

Sources: Data provided by the Hong Kong authorities; and staff estimates.

1/ Contribution to change in real GDP.

2/ January-November compared with corresponding year earlier period.

3/ Rate for three-month period ending in August 1992.

4/ Year-on-year growth rate for November.

5/ January-September compared with corresponding year earlier period.

6/ Fiscal year beginning April 1. Official projections for 1992.

7/ As of December 1992.

8/ Period average, January-September.

prices reached double its 1990 average. A key factor underlying these increases in asset prices was increased optimism regarding long-term growth prospects for Hong Kong and the southern China region. However, with the escalation of political tensions with China in mid-November, investor confidence waned and equity prices declined by nearly 20 percent by end-1992, although they still remained about 20 percent above their end-1991 level.

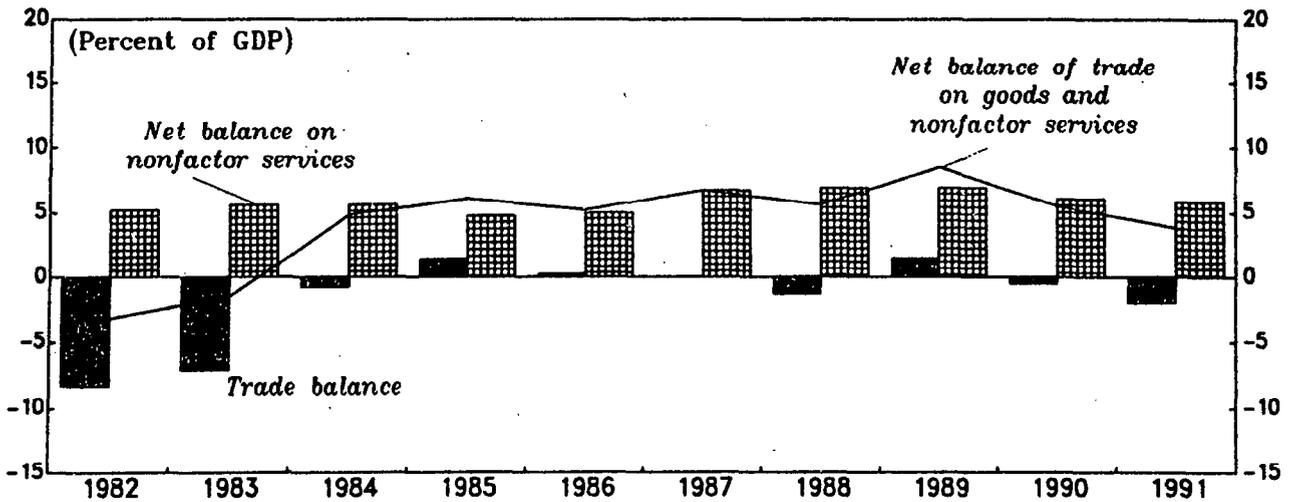
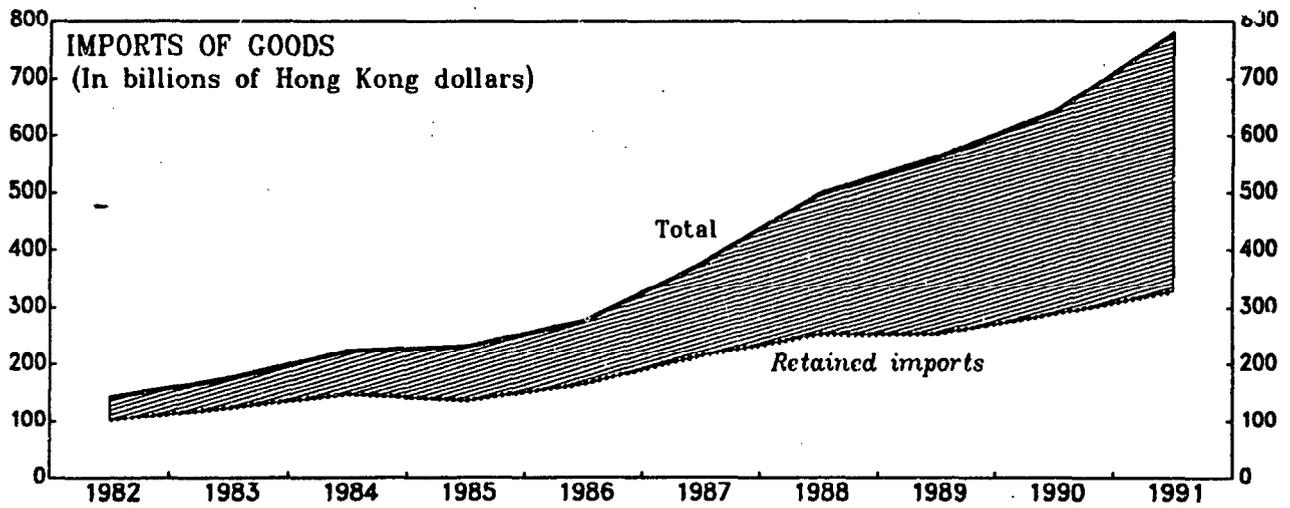
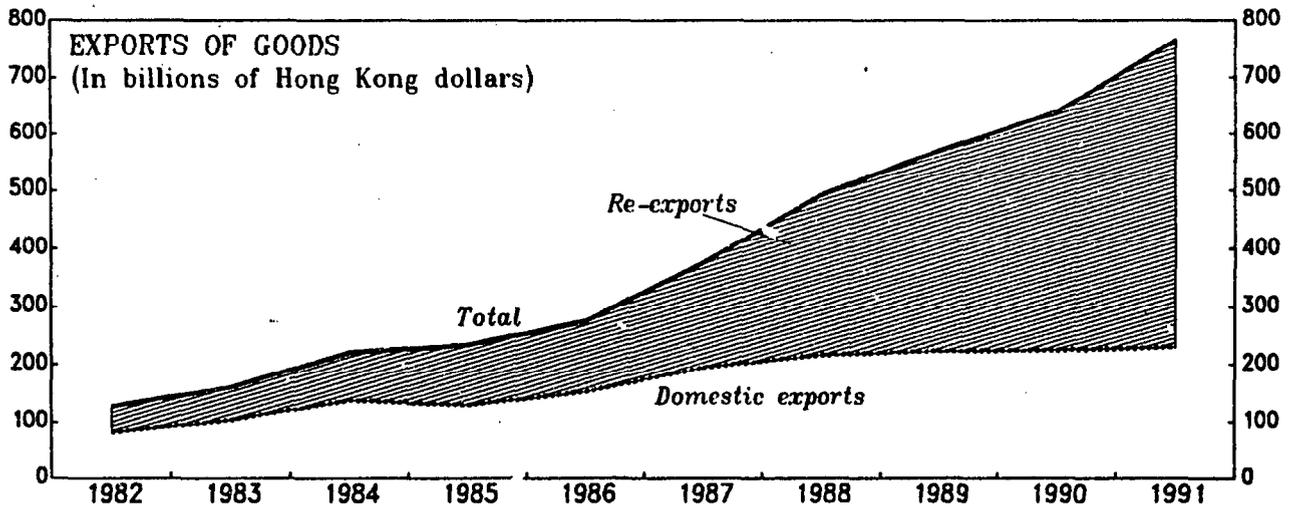
The merchandise trade deficit widened from 1/2 percent of GDP in 1990 to 2 percent of GDP in 1991 (Chart 2), as growth in both exports and imports accelerated to about 20 percent. The widening in the trade deficit was accompanied by a small narrowing in the surplus on nonfactor services transactions, and the merchandise trade and nonfactor services balance registered a surplus of 3 1/4 percent of GDP in 1991. In the first half of 1992, the merchandise trade deficit widened somewhat, while the nonfactor services surplus rose further. For the year as a whole, the balance on merchandise trade and nonfactor services transactions is projected by the staff to remain broadly unchanged in relation to GDP.

III. Economic Prospects and Policy Issues

Looking to 1993 and beyond, Hong Kong's economic prospects will depend importantly on the following factors. On the one hand, Hong Kong will benefit from the expected gradual economic recovery in the industrial economies and from continued rapid growth in China. In addition, trade tensions between the United States and China have abated with the recent resolution of negotiations under Section 301 of the U.S. Trade Act. On the other hand, the latest political disagreement between the United Kingdom and China and the dispute over the new Hong Kong airport, which have both intensified in the weeks following the consultation discussions in Hong Kong, adversely affect the economic outlook. Protracted political uncertainty could weaken confidence and lead to a deterioration in the investment climate.

Notwithstanding the renewal of political tensions and the associated uncertainties, Hong Kong's economic fundamentals remain strong. In particular, Hong Kong's role as the provider of essential financial and trade-related services in the region would be enhanced by continued economic reform in China and the further expansion of productive capacity in southern China. A resolution of the political problems and the construction of the new Hong Kong airport would serve the long-term economic interest of Hong Kong. On the assumption that the current disputes are soon resolved, and that bilateral trade tensions between China and the United States do not re-intensify, output growth should remain in the range of 5 to 5 1/2 percent over the medium term. In such circumstances, the risk of an acceleration in inflation will remain a key issue in the period ahead.

HONG KONG
EXTERNAL SECTOR DEVELOPMENTS, 1982-91



Source: Census and Statistics Department, National Income Branch and Trade Analysis Section.

1. The inflation problem

Hong Kong's current inflation stems from a combination of excess demand pressures and structural changes that have been taking place in Hong Kong. A rapid economic expansion and a sharp drop in labor force growth during the late 1980s brought the economy to an extremely high degree of resource use. ^{1/} Factor markets subsequently have stayed tight as the cyclical recovery that began in the latter half of 1990 has maintained output at close to capacity. At the same time, structural shifts in the economy associated with the increased outprocessing of manufacturing activities in southern China, as well as Hong Kong's strategic advantages in providing services to support China's external trading relationships, have contributed to the persistence of domestic cost and price pressures. Traditionally, these pressures have been kept in check by the need for manufacturers to maintain international competitiveness. Since the latter half of the 1980s, however, cost savings associated with the increased outprocessing of manufacturing and some services to China, as well as the expansion of financial and trade-related services in support of growing trading relationships with China, have accommodated relatively high wage increases without undermining external competitiveness. At the same time, in the nontradable services sectors, such wage increases have led to sizable price increases and a rise in the overall rate of consumer price inflation to well above that in the United States and other trading partner countries.

Meanwhile, interest rates have fallen substantially at the time of a cyclical upswing in the economy, further fueling the growth of private consumption and investment. In the discussions, the authorities acknowledged that low interest rates were playing a role in the inflationary process. In their view, however, the inflation problem stemmed primarily from the continuing structural transformation of Hong Kong's economy associated with the expansion of linkages with China. While the structural changes were likely to continue for some time, once the pace of transformation slowed down, the high degree of openness of Hong Kong's economy would work to lower domestic inflation to a level that would be in line with those of Hong Kong's main competitors. Furthermore, the traditional flexibility of labor markets in Hong Kong would make the reduction of inflation a relatively rapid and costless process.

While agreeing that inflation should moderate as the process of structural transformation slowed, the staff expressed concern that strong private demand sustained by continued low interest rates, combined with substantial infrastructural investments for the new airport by both the public and private sectors, would further intensify excess demand pressures. In the absence of corrective measures, such pressures could lead to an acceleration in inflation. In such circumstances, an increasing

^{1/} The decline in labor force growth reflected a fall in the birth rate, a more restrictive policy regarding immigration from China, and sizable emigration, especially after the events in China in June 1989.

entrenchment of inflationary expectations would be likely, which would inevitably reduce the flexibility of Hong Kong's economy and increase the cost of re-establishing appropriate real wage levels.

2. Monetary and exchange rate policies

Since the introduction of the linked exchange rate system in October 1983, the overriding objective of monetary policy in Hong Kong has been to maintain the market exchange rate at close to the linked rate of HK\$7.8 per US\$1 set for the note issue (Chart 3). In such circumstances, interest rates in Hong Kong have moved broadly in line with those in the United States. Accordingly, with the easing in monetary conditions in the United States, interest rates in Hong Kong have fallen since early 1989 (Chart 4). During 1992, domestic interest rates continued to decline substantially: as of end-December, the three-month Hong Kong dollar interbank offered rate stood at 4 1/4 percent, and the Best Lending Rate stood at 6 1/2 percent.

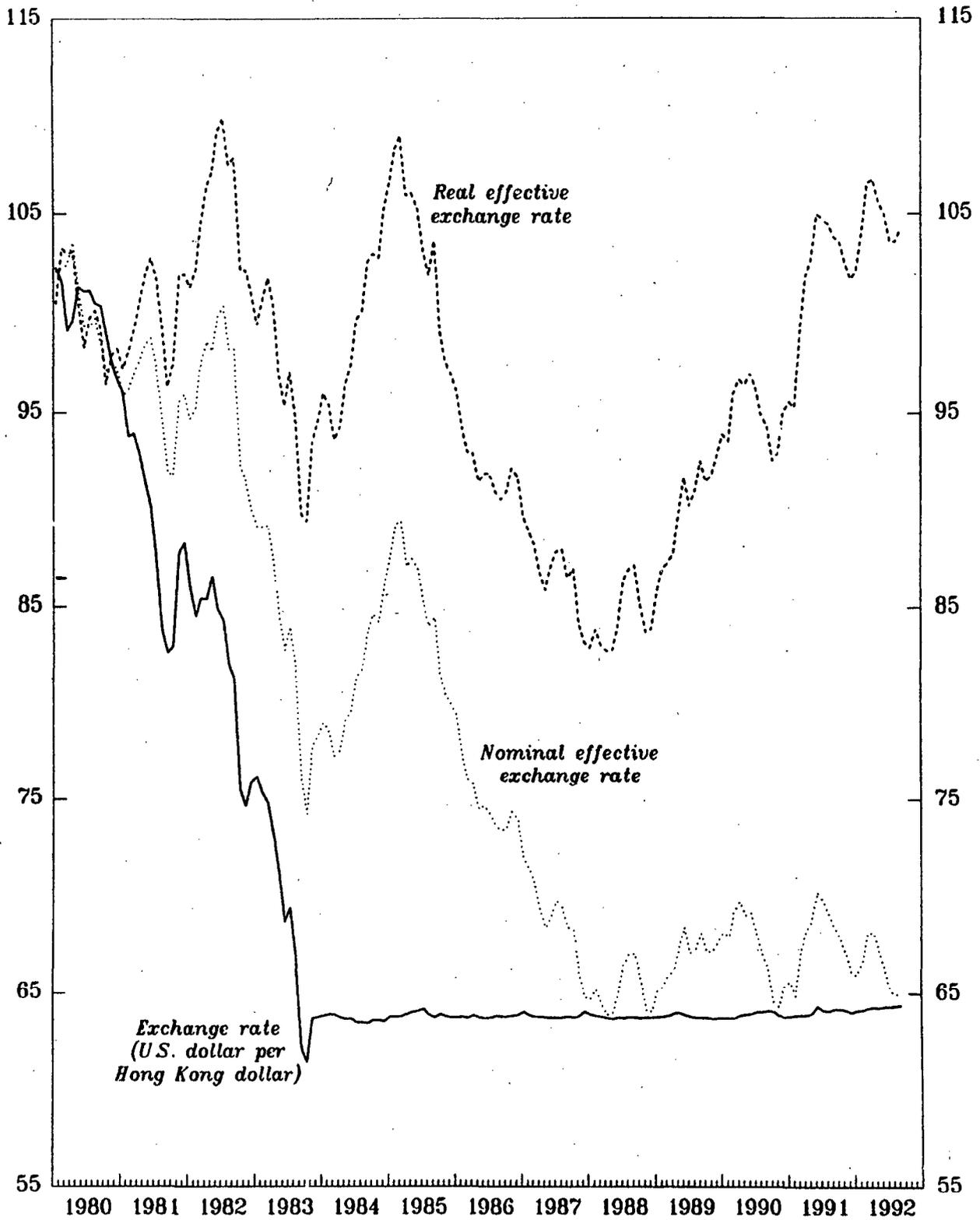
The low levels of interest rates, indeed now substantially negative in real terms, have exacerbated excess demand pressures and accommodated rapid rates of monetary and credit expansion (Chart 5). In the September-November 1992 period, the increase in total liquidity (Hong Kong dollar M3) and in domestic credit averaged about 20 percent (year on year). The rapid rates of liquidity and credit growth have also reflected substantial fund-raising activities in the local stock market. Indeed, bank lending to finance a large new share issue in October led to a sharp jump in the growth of M3--to 37 percent (year on year)--although the substantial oversubscription of the share issue led to a deceleration of liquidity and credit growth in November as the loans unwound.

The authorities recognize that the pegged exchange rate regime severely limits the effectiveness of monetary policy in containing inflation. They noted that their recent attempts to tighten domestic liquidity and raise domestic interest rates had to be abandoned because of resulting upward pressures on the exchange rate. The authorities remain firmly convinced, however, that the exchange rate link, which was introduced following a severe financial crisis in September 1983, serves as the cornerstone for financial stability and confidence in Hong Kong. In their view, a revaluation of the Hong Kong dollar aimed at reducing inflation would inevitably lead the public to expect that the exchange rate would be allowed to depreciate under different circumstances. Such an expectation would be detrimental to financial stability, given Hong Kong's vulnerability to any reversals in confidence in the period leading up to 1997. Especially in light of their view that the current inflationary pressures stem mainly from structural factors, the authorities believe that the temporary cost to the economy of moderate inflation is less than the potential damage caused by a loss in confidence and financial uncertainty. To the extent that structural shifts have led to a rise in the real equilibrium exchange rate, they prefer that the adjustment process take the form of temporarily higher domestic inflation, rather than an appreciation in the nominal exchange rate.

CHART 3

HONG KONG

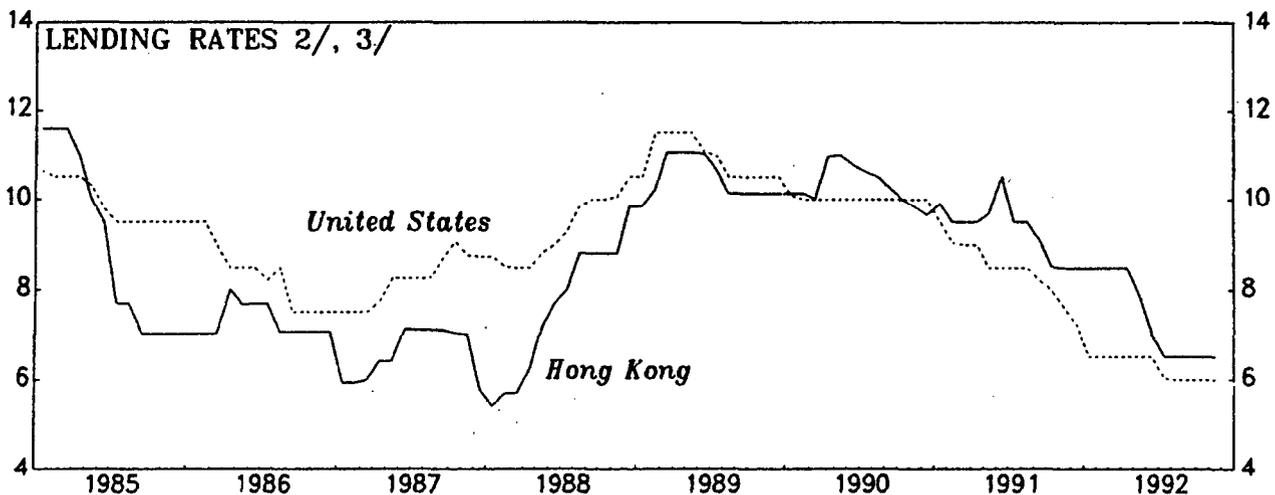
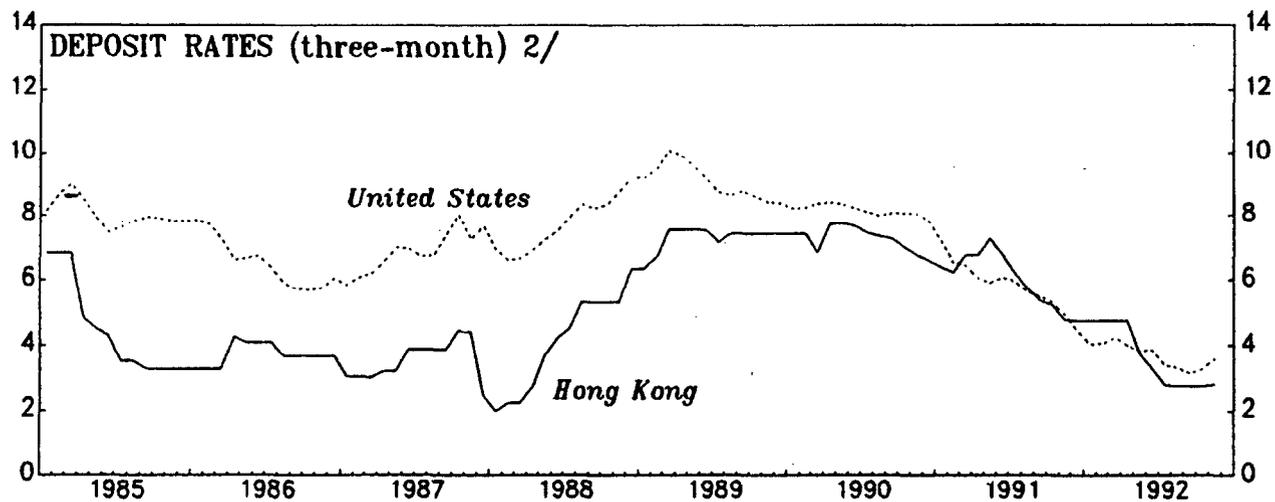
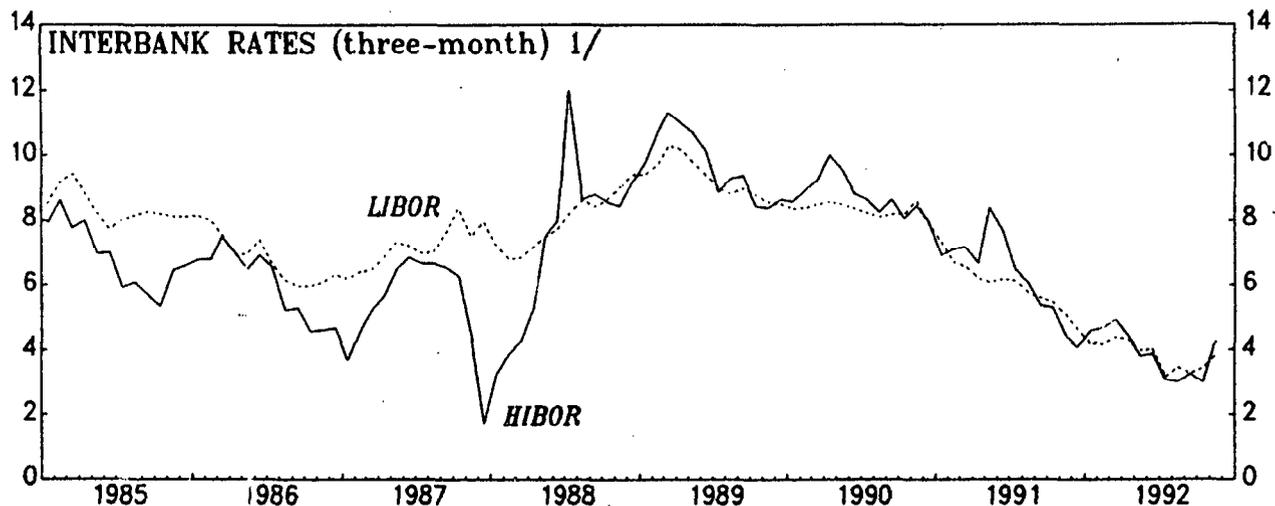
EXCHANGE RATE DEVELOPMENTS, 1980-92 1/
(1980=100)



Source: IMF, Information Notice System.
1/ Increase indicates appreciation.

CHART 4

HONG KONG
INTEREST RATES, 1985-92
(Percent per annum)



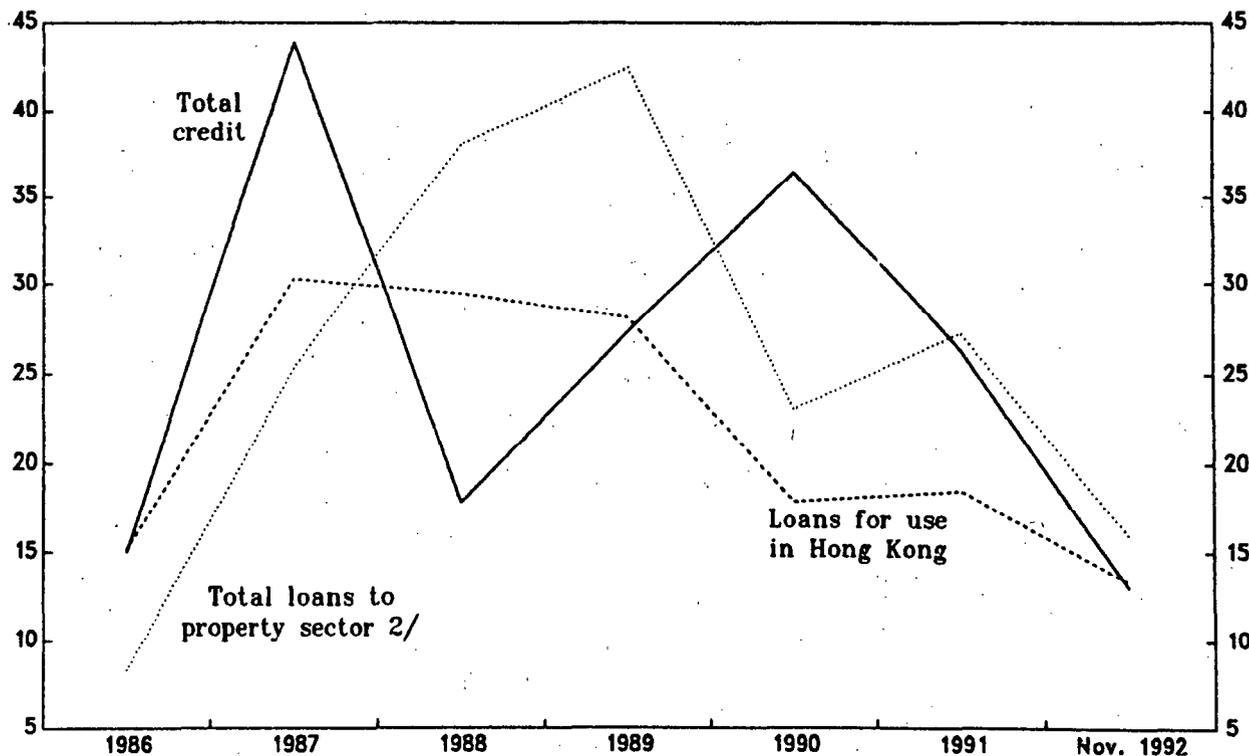
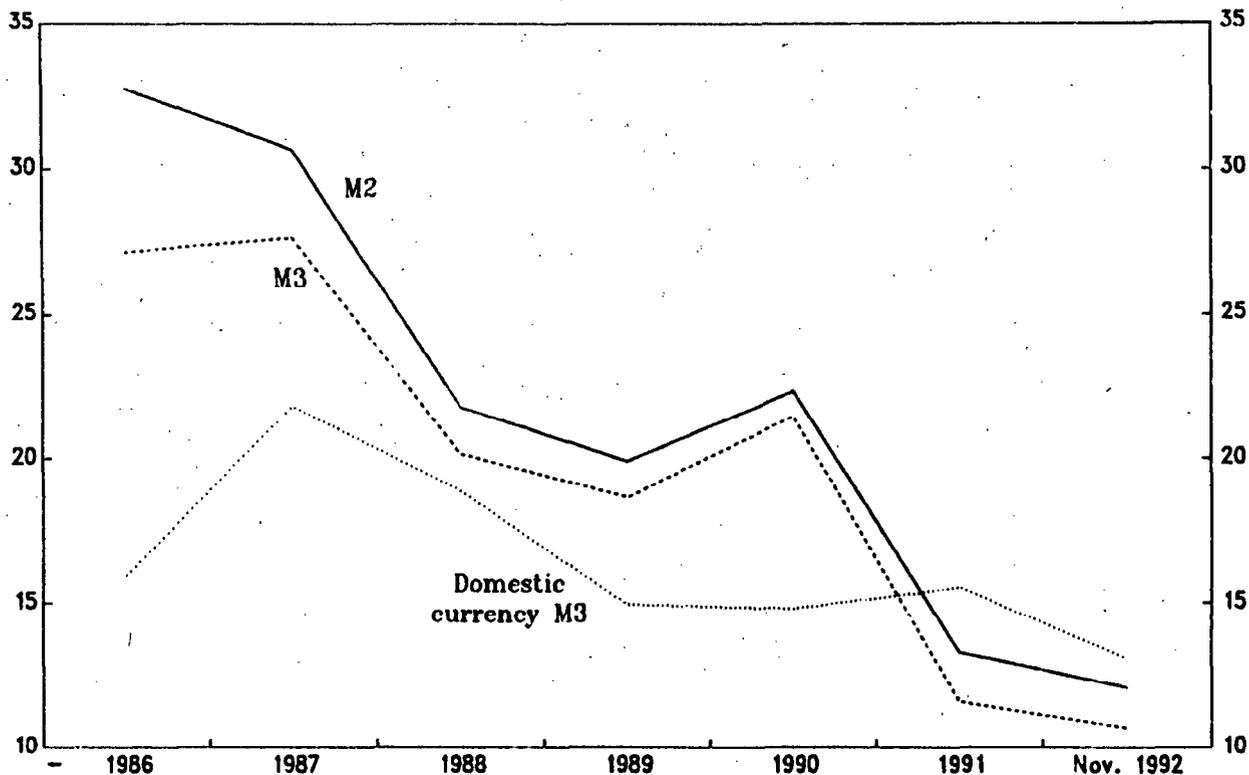
Sources: Census and Statistics Department, Hong Kong Monthly Digest of Statistics; and IMF, International Financial Statistics.

1/ End-of-period London interbank offered rate and Hong Kong interbank offered rate.

2/ Monthly period averages.

3/ U.S. prime lending rate and the Hong Kong and Shanghai Banking Corporation's quoted best lending rate.

HONG KONG
MONEY SUPPLY, 1986-92 1/
(Percent per annum)



Source: Census and Statistics Department, Hong Kong Monthly Digest of Statistics.
1/ End-of-period percentage changes.
2/ For 1992, year-on-year growth rate for September.

In view of Hong Kong's generally successful economic performance and the high degree of uncertainty leading up to the transfer of sovereignty to China in 1997, the staff supported the authorities' continued commitment to the exchange rate anchor. The introduction of the link served to restore financial stability in 1983, and its merits have been evident in recent periods of instability. While a sustained deterioration in underlying economic fundamentals and a reversal in confidence could entail the risk of downward pressure on the exchange rate, the recent intensification of the political disputes with China and the sharp drop in the Hong Kong stock market so far has not been accompanied by significant downward pressure on the exchange rate or upward pressure on interbank interest rates.

At the same time, with the decline in interest rates in the United States during the past year, monetary conditions in Hong Kong have loosened further than is justified by cyclical considerations. While the emerging economic recovery in the United States would put upward pressure on interest rates, they are likely to remain low in real terms in Hong Kong. In this environment, eschewing the use of monetary and exchange rate policy imposes a greater burden on other instruments, particularly fiscal policy, in containing demand pressures.

3. Fiscal policy

Fiscal policy has traditionally been aimed at maintaining a low tax burden while providing an adequate level of social infrastructure and public services. Under this basic strategy, the Government has sought to keep expenditure growth below trend growth in GDP, while taking necessary measures to maintain the real revenue yield from direct and indirect taxes. This prudent approach resulted in growing fiscal surpluses in the mid-1980s and the accumulation of a large stock of net financial assets. In 1989/90 and 1990/91, however, the budget surplus declined markedly, owing largely to increases in public sector salaries and expenditures for public infrastructure and social services (Table 2). 1/

In 1991/92, the fiscal position unexpectedly registered a sharp improvement. The consolidated budget recorded a surplus of 3 1/4 percent of GDP, compared with an original budget estimate of near balance. This unexpected outturn reflected, almost equally, lower capital expenditures on the Airport Core Program (ACP), and higher revenues from stamp duties and land sales.

In 1992/93, however, the fiscal surplus is expected to narrow substantially. The budget, presented in March, envisaged a surplus of 3/4 percent of GDP, down some 2 3/4 percentage points of GDP from the final 1991/92 outturn. 2/ Capital expenditures were set to rise by some

1/ Fiscal years run from April to March.

2/ At the time of the budget presentation, the 1991/92 surplus was estimated at 2 1/4 percent of GDP, somewhat lower than the final outturn.

Table 2. Hong Kong: Consolidated Government Account, 1988/89-1992/93

	1988/89	1989/90	1990/91	1991/92		1992/93	
				Budget	Actual	Initial	Proj.
(In millions of Hong Kong dollars)							
General revenue account							
Revenue	65,781	74,365	82,674	96,775	101,456	113,560	115,323
Expenditure	42,643	51,962	62,627	73,560	72,851	84,595	86,966
Current expenditure	41,260	49,077	60,378	71,230	70,773	81,935	81,457
Capital expenditure	1,383	2,885	2,249	2,330	2,078	2,660	5,509
Surplus before transfers	23,138	22,403	20,047	23,215	28,605	28,965	28,357
Transfers to funds	6,310	17,700	20,210	26,760	20,550	18,790	18,790
Surplus after transfers	16,828	4,703	-163	-3,545	8,055	10,175	9,567
Consolidated account funds ^{1/}							
Revenue ^{2/}	6,877	8,064	6,849	8,100	12,144	12,760	13,086
Capital expenditure	11,153	19,404	22,929	31,210	19,340	36,580	36,370
Deficit before transfers	-4,276	-11,340	-16,080	-23,110	-7,196	-23,820	-23,284
Transfers from general revenue account	6,310	17,700	20,210	26,760	20,550	18,790	18,790
Surplus after transfers	2,034	6,360	4,130	3,650	13,354	-5,030	-4,494
Total consolidated account							
Revenue	72,658	82,429	89,523	104,875	113,600	126,320	128,409
Expenditure	53,796	71,366	85,556	104,770	92,191	121,175	123,336
Current	41,260	49,077	60,378	71,230	70,773	81,935	81,457
Capital	12,536	22,289	25,178	33,540	21,418	39,240	41,879
Surplus/deficit (-)	18,862	11,063	3,967	105	21,409	5,145	5,073
(In percent of GDP)							
Total consolidated account ^{3/}							
Revenue	16.8	16.5	16.0	16.9	17.6	17.5	17.2
Expenditure	12.4	14.3	15.3	16.9	14.3	16.8	16.5
Current	9.5	9.8	10.8	11.5	11.0	11.4	10.9
Capital	2.9	4.5	4.5	5.4	3.3	5.4	5.6
Surplus	4.3	2.2	0.7	--	3.3	0.7	0.7
(Percentage change)							
Total consolidated account							
Revenue	19.4	13.4	8.6	17.1	26.9	11.2	13.0
Expenditure	11.2	32.7	19.9	22.5	7.8	31.4	33.8
Current	15.5	18.9	23.0	18.0	17.2	15.8	15.1
Capital	-0.9	77.8	13.0	33.2	-14.9	83.2	95.5
(In millions of Hong Kong dollars)							
Memorandum item:							
Borrowing ^{4/}	1,200	1,098	2,400	2,400

Source: Data provided by the Finance Branch of the Government Secretariat.

^{1/} Consists of the Capital Works Reserve Fund, Development Loan Fund, Mass Transit Fund, and Student Loan Fund prior to 1990/91; Capital Works Reserve Fund, Capital Investment Fund, and Loan Fund beginning 1990/91.

^{2/} Excluding borrowing (Government definition includes revenue from the sale of bonds in Consolidated Account Funds).

^{3/} Projections for FY 1992/93 based on staff's estimate of GDP.

^{4/} The Government Bond Program was launched in November 1991 in an effort to develop a market in fixed income securities and facilitate the funding of long-term government infrastructural projects. The bonds are issued before the Government actually requires the funds. The size of the Program is limited to HK\$5 billion of gross debt outstanding as of June 30, 1997.

83 percent, owing to a sharp acceleration in capital spending on the new airport as well as on other public works projects. On the revenue side, measures announced in the budget entailed a net yield of 1/4 percent of GDP, with measures to raise revenue (mainly a hike in the corporate tax rate and an increase in property rates) largely offset by various tax concessions (in particular, the raising of personal income tax allowances). Subsequent to the budget presentation, it became apparent that unexpected buoyancy in revenues, as well as some underspending on public works, was continuing into this fiscal year. In response, the authorities rolled back the planned increase in property rates and also announced several new spending initiatives. Accordingly, the latest official projections for 1992/93 indicate a consolidated budget balance unchanged from that envisaged in the original budget.

A further deterioration in the fiscal position is projected over the medium term. Total cumulative expenditures (excluding some financing costs) on the ACP, which are expected to be spread over five years, are estimated at 16 percent of GDP. Of this amount, roughly half would be either directly spent or financed by the consolidated budget, with the remainder being undertaken by other public agencies and private entities. Thus, official medium-term projections presented in the March 1992 Budget envisage that, in the absence of further measures, the budget balance would record a deficit of over 1 percent of GDP in 1993/94, before improving slightly to a deficit of 1/2 percent of GDP by 1996/97. In addition, airport-related spending by public agencies, set to commence in 1994/95, would average 1 percent of GDP in 1994/95-1996/97; this spending would be financed by government equity injections and borrowing.

During the discussions, the staff expressed concern over the inflationary impact of the current and prospective fiscal developments. The authorities maintained that the high level of accumulated financial assets could easily accommodate the swing in the fiscal position over the medium term without damaging the long-run sustainability of fiscal policy, and that the relatively small size of Government and the openness of the economy limited the role that fiscal policy could play in helping to reduce inflation in Hong Kong. While the staff agreed that the projected deterioration in the fiscal position would not damage Hong Kong's long-term fiscal sustainability, it emphasized that, regardless of the size of Government, large reductions in the net savings-investment balance of the public sector would translate into increased claims on the overall availability of resources in the economy. In the context of full employment, part of the increased demand for resources would be met by higher imports, but part of it would also be reflected in an intensification of price pressures. Indeed, the sizable decline in the consolidated budget surplus from 1988/89 to 1990/91 coincided with the emergence of excess demand pressures, while the improvement in the fiscal position in 1991/92 was accompanied by some easing in price pressures.

On the basis of fiscal policies currently in place, budgetary operations would add a significant positive impulse to aggregate demand both in

the current fiscal year and in the period beyond. The staff acknowledged that the deterioration in the budget balance overstated the fiscal stimulus, as part of the deterioration represented a decline in revenues from land sales and an increase in equity investments by the Government ahead of actual capital expenditures. Even excluding these elements, however, the reduction in the fiscal surplus would be large, and would entail positive impulses to demand equivalent to roughly 1 1/2 percent of GDP in both the current and next fiscal year. Furthermore, large expansionary impulses are envisaged for the period beyond the next fiscal year, particularly when account is also taken of the planned commencement of large-scale spending by the Airport Authority and the Mass Transit Railway Corporation (MTRC) on the ACP. Including the planned expenditures of these agencies, and assuming no offsetting measures, the staff estimates additional positive fiscal impulses to demand averaging 1 1/2 percent of GDP for the period 1994/95-1996/97, with a particularly large demand stimulus in 1994/95.

Table 3 summarizes a quantitative medium-term assessment of the macroeconomic impact of a fiscal expansion as outlined above. The simulation exercise incorporates the impact of airport-related spending by the Airport Authority and the MTRC, as well as that of the envisaged decline in the consolidated budget balance. ^{1/} The precise results of the simulation are sensitive to underlying assumptions and should be interpreted with caution. Nevertheless, they illustrate the important macroeconomic effects that may arise from such a fiscal expansion. The results indicate that, in the absence of offsetting measures, budgetary operations would substantially raise the annual growth rate of total domestic demand. The resulting increase in excess demand pressures would in part be relieved through more rapid growth of imports. At the same time, however, there would be a significant acceleration in the inflation rate: for the GDP deflator, from about 10 1/2 percent at present to 14 1/2 percent by 1996/97.

The budgetary estimates in the last two fiscal years have been on the conservative side, and the deterioration in the budget position may again turn out to be smaller than currently envisaged. At the same time, however, there is a risk of added pressure on the budget given that rising affluence in Hong Kong is, understandably, leading to increased demand for social services and public infrastructure. Thus, given the present full employment situation, and assuming continued rapid growth in private demand, a more restrictive fiscal policy would be needed to help contain inflationary pressures. This requirement would be particularly valid if monetary policy is to remain targeted at maintaining the exchange rate link. In the staff's view, the minimum aim of fiscal policy should be to avoid a significant

^{1/} The simulation exercise assumes that potential output growth would remain at 5 percent over the medium term, equal to its current estimated rate. While the construction of the new airport will enhance the long-term growth potential of Hong Kong's economy, this would only occur after the airport is completed.

Table 3. Hong Kong: Medium-Term Effects of Fiscal Expansion, FY 1992-96

(Deviations from baseline in percent)

Fiscal Years	1992	1993	1994	1995	1996
Real GDP (level) <u>1/</u>	0.9	1.5	2.9	3.1	3.0
Total domestic demand (level)	2.0	3.6	6.8	8.2	8.8
Imports of goods and nonfactor services (level)	0.5	0.9	1.6	1.8	1.9
GDP deflator (rate of increase)	0.2	1.2	2.1	3.4	3.9
Consumer prices (rate of increase)	0.2	1.0	1.8	3.0	3.4
Memorandum items:					
Fiscal impulse (in percent of GDP):					
Central government <u>2/</u>	1.5	1.3	0.8	0.4	0.5
Public sector <u>2/,3/</u>	1.5	1.3	2.7	1.3	0.8

Source: Staff estimates.

1/ Deviation from trend level of GDP; assuming potential growth of 5 percent per annum.

2/ Excludes projected changes in revenues from land sales and equity injections related to the Airport Core Program.

3/ Includes capital spending on the airport by the Airport Authority and the MTRC.

narrowing of the budgetary surplus that would exacerbate price pressures so long as the economy continues to operate at full capacity.

The achievement of such a neutral fiscal policy requires measures to yield additional net resources of about 1 1/4 percent of GDP in 1993/94. The staff would emphasize continued efforts to economize on operational expenditures and to smooth and possibly stretch out capital expenditures. Action on the revenue side should also be considered. Possible measures in that regard would include raising the salaries tax rate to bring it in line with the corporate income tax rate and introducing indirect taxes or user fees on the consumption of publicly provided services (such as electricity, gas, and water).

4. Labor market and land management policies

In addition to action to contain pressures on the demand side, supply side measures may also contribute to alleviating pressures on the availability of resources. During the last two years, the authorities have adopted increased flexibility in Hong Kong's labor import policies to provide the economy with a greater scope for growth. In January 1992, the Government announced that the ceiling on the number of foreign workers that could be imported under the general scheme for labor imports would be doubled--to 25,000 workers. The increase in foreign workers since this scheme was introduced in 1990 has amounted to almost 1 percent of the total labor force and contributed to an easing in labor market conditions. During the discussions, the authorities noted that continued flexibility in this area would enhance prospects for noninflationary growth; they also envisage allowing additional labor imports under a scheme for the importation of construction workers in connection with the new airport project.

In the area of land management policies, the authorities took several steps in 1991 to discourage speculative property activities. A number of tax and regulatory measures--including advancing the timing of payment of stamp duty on property transactions--were implemented to make property speculation more costly and difficult. Also, the authorities successfully persuaded banks to lower loan-to-value ratios and take other steps to tighten their real estate lending policies. In addition, the sale of public lands was increased, particularly for residential purposes. These measures have contributed to a cooling of activity in the residential property market. Growth in bank lending (in domestic currency) to purchase residential property moderated from 26 percent (year on year) in the second quarter of 1991 to 16 percent by the third quarter of 1992, and the rate of increase in residential property prices has slowed in 1992.

5. Other issues

In 1992, the authorities took several measures to further improve the framework for financial and monetary management. Legislation was introduced and passed concerning the creation of the Hong Kong Monetary Authority (HKMA), which is expected to become fully operational during the early part

of 1993. Under the reform, the Office of the Exchange Fund and the Office of the Commissioner of Banking would be merged into a single monetary authority, which would be accountable to the Government through the Financial Secretary. The authorities explained that the decision to establish the HKMA was motivated almost exclusively by the need to recruit and retain staff of the highest possible caliber. The establishment of the HKMA would not entail the assumption of further central banking functions, such as the issue of currency or check clearing functions. Furthermore, it would not involve a change to the linked exchange rate framework. In the area of monetary operations, in June 1992, the authorities introduced the Liquidity Adjustment Facility (LAF) as a discount window that would assist banks in making late adjustments to their liquidity positions. The authorities observed that the LAF had improved their ability to influence conditions in the interbank market, with the volatility of interbank interest rates having diminished significantly.

In the area of trade policies, the authorities emphasized the importance to the world economy of a successful conclusion to the Uruguay Round. While the Government is not directly involved in the agricultural negotiations, it is actively working to help resolve outstanding issues in other areas. A key issue for Hong Kong in the multilateral negotiations continues to be the need for increased discipline with regard to anti-dumping measures. In this regard, the authorities expressed strong concern over the increasing incidence of what they considered to be unfair dumping accusations leveled against Hong Kong firms.

With respect to bilateral trade policy issues, the authorities stated that, notwithstanding the successful resolution of U.S.-China trade negotiations in October, the annual recurrent nature of the renewal of Most-Favored-Nation (MFN) status for China by the United States would keep U.S.-China trade frictions a source of uncertainty. The authorities stressed that given the increased linkages between Hong Kong and China, the imposition of trade restrictions against China would inevitably have a serious impact on Hong Kong. They estimate that if China were to lose its MFN status, the direct effects of a reduction in trade flowing through Hong Kong would curtail annual GDP growth in Hong Kong by 2 1/2 percent. In addition, there would be a deterioration in the investment climate that would further undermine Hong Kong's growth prospects.

Since the last consultation discussions, the authorities have taken steps toward increasing the availability of comprehensive balance of payments statistics. In July 1992, the authorities released information on official foreign reserves, which amounted to HK\$225 billion (US\$29 billion) as of end-1991. While data on factor services, transfers, and capital account transactions are not collected, the Government has initiated preparatory work toward the collection of data on external investment income flows. The staff encouraged the authorities to continue their efforts toward compiling a full set of external payments statistics, in order to allow a complete analysis of Hong Kong's external transactions.

IV. Staff Appraisal

Hong Kong's economy has performed strongly during the past year. Output growth reached 5 percent in 1992, and there was some relief on the inflation front. Nevertheless, inflationary pressures persist. Indeed, the latest data indicate some pickup in core inflation and continued tightness in the labor market. With the economy operating at around full capacity, the risk of a renewed acceleration in wage and price increases is ever-present.

Looking ahead, the expected gradual recovery in the industrial countries, the abatement of trade frictions between China and the United States, and the reaffirmation of China's commitment to continued economic reform bode well for growth prospects in Hong Kong. On the other hand, the intensification of political disagreements with China and the dispute over the new Hong Kong airport do present a significant risk to the economic outlook. The resolution of these problems would enhance economic prospects for Hong Kong. On the assumption that they are indeed resolved, the staff expects growth in 1993 to be at least as rapid as in 1992. In that event, the containment of inflation pressures would remain the key policy concern.

Hong Kong's relatively high inflation is to an important extent attributable to structural factors. There is a concern, however, that continued rapid growth in private spending together with the substantial demand for resources associated with the construction of the new airport would push aggregate demand beyond the economy's supply capacity and lead to an acceleration of inflation in the period ahead. The persistence of high inflation would work to reduce the flexibility of labor markets in Hong Kong and increase the subsequent cost of restoring an appropriate wage-price structure.

In the face of considerable uncertainty, the linked exchange rate system has underpinned financial confidence and stability since 1983, and the staff supports a continued commitment to the exchange rate anchor. At the same time, the exchange rate link rules out the effective use of monetary policy in containing inflation. Indeed, at the time of a cyclical upswing in the economy, interest rates have declined substantially along with those in the United States, fueling to the buoyancy of private spending and inflationary pressures. Thus, while the objective of maintaining financial stability continues to justify the authorities' commitment to the exchange rate anchor, such an approach necessarily shifts the burden of controlling inflation onto other policy instruments.

Given the constraint on monetary policy, the staff continues to believe that fiscal policy should play a key role in containing domestic demand. While an unexpected rise in the fiscal surplus was registered last year, there is a risk that fiscal policy will turn significantly expansionary in the current fiscal year and the period beyond. The construction of the airport core projects is desirable from the viewpoint of Hong Kong's long-term growth potential, but will call heavily on economic resources over its

period of implementation. In view of the authorities' conservative approach to preparing budget projections, it is possible that the actual budgetary outcome may turn out to be more favorable than that indicated by the latest official projections. However, in the absence of offsetting measures, present projections point to the emergence of sizable fiscal deficits and a significant positive fiscal stimulus to aggregate demand once large-scale spending on the airport is initiated. Notwithstanding the relatively small size of Government in Hong Kong and the openness of the economy, such a sharp decline in net public savings would lead to a significant intensification of price pressures.

In the staff's view, the minimum aim of fiscal policy should be to avoid imparting additional stimulus to aggregate demand so long as the economy remains at full employment and inflationary pressures are strong. To this end, the staff would stress the need to continue to restrain operational expenditures and to smooth and stretch out capital expenditures. Consideration could also be given to raising additional revenues.

In addition to fiscal action, measures on the supply side of the economy can also help moderate inflation. During the last two years, the increased flexibility adopted by the Government in its labor import policies contributed to an easing in labor market tightness. This positive result argues for allowing a further expansion in labor imports. In the area of land management policies, the measures taken by the authorities and the banks appear to have contributed to a cooling of activity in the residential property market. The expanded sale of public lands in the last two years also has been useful, and further increases would be beneficial.

The authorities have continued to take steps to enhance monetary management and financial stability in Hong Kong. The recent decision to establish a central monetary authority will allow a strengthening of technical expertise and analytical capabilities and is thus an important further step in this direction.

Hong Kong's remarkable achievements owe much to the authorities' commitment to maintaining an environment free of restrictions for all trade and business activities. Indeed, Hong Kong's economic performance stands out for its dynamism in the face of a difficult global environment. However, the recent developments in the financial markets highlight the central importance of political events in shaping investors' attitudes toward Hong Kong. A resolution of political tensions should bolster confidence and help realize the economy's robust growth potential.

It is recommended that the next consultation discussions with respect to Hong Kong be held on the standard 12-month cycle.

Fund Relations with Hong Kong

The Fund's contacts with Hong Kong until 1989 were limited.

1. Since 1979, the staff has been making estimates for the main macroeconomic indicators of Hong Kong for the purposes of the world economic outlook exercise, based primarily on indirect sources.
2. Over the last several years, staff have visited Hong Kong to gather information and views in the preparation of the international capital markets reports.
3. A mission from the (former) Bureau of Statistics visited Hong Kong during July 13-24, 1987 with a view to compiling a balance of payments statement from available statistics and to discuss issues arising out of the recommendations of the Working Party on the statistical discrepancy in world current account balances. An internal report for limited circulation was prepared as a result of the visit.
4. The Managing Director visited Hong Kong in December 1989 and held discussions with senior officials.
5. A staff team visited Hong Kong during May-June 1990 to gather basic data and prepare the groundwork for the first Article IV consultation discussions, which were subsequently conducted in October 1990. The second Article IV consultation discussions with Hong Kong were conducted in October 1991.
6. As part of the efforts to explore ways of compiling a more complete set of balance of payments statistics, two Hong Kong officials have attended IMF Institute courses.