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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/8

3:00 p.m., January 24, 1992

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	S. Gurumurthi, Temporary
	Wei B.
	G. C. Noonan
	J. M. Abbott, Temporary
J. de Groote	
	G. H. Spencer
	E. Quattrociocche, Temporary
	T. S. Allouba, Temproary
	A. Gronn, Temporary
	N. Tabata
	S. von Stenglin, Temporary
	T. Sirivedhin
	J. R. N. Almeida, Temproary
	P. Bonzom, Temporary
	M. A. Hammoudi, Temporary
	J. M. Jones, Temporary
D. Peretz	
G. A. Posthumus	
	N. Toé, Temporary
A. Torres	
A. Végh	

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant

Also Present

Central Asia Department: U. Baumgartner, D. A. Citrin, K. Miranda. Exchange and Trade Relations Department: J. Ferrán, Deputy Director. Legal Department: J. L. Hagan. Secretary's Department: A. Jbili, A. Leipold. Southeast Asia and Pacific Department: A. Adarkar, R. P. Kronenberg, B. J. Smith, Wang J. Advisors to Executive Directors: M. A. Ahmed, M. Galán, B. R. Fuleihan. Assistants to Executive Directors: Chen M., Deng H., Duan J., N. A. Espenilla, Jr., M. E. Hansen, R. Meron, F. Moss, L. F. Ochoa, R. K. W. Powell.

1. UNITED KINGDOM - HONG KONG - 1991 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/92/7, 1/24/92) their consideration of the staff report for the 1991 Article IV consultation with respect to Hong Kong (SM/92/4, 1/6/92).

Mr. Abbott made the following statement:

This second Article IV consultation makes clear that the rapid transformation of the Hong Kong economy is leading to macroeconomic dislocations that require close policy attention. Ten percent inflation is the most immediate problem, but in the medium term it is clear the fiscal system will need to be brought into better alignment with the requirements of a wealthier and more mature economy.

The increasing economic integration of Hong Kong and South China and neighboring Asian economies comes through vividly in the trade, employment, and productivity statistics of Hong Kong. Trade flows have mushroomed. Domestic exports and retained imports are up more than 100 percent since 1983. The expansion of re-export business, however, has been even more dramatic, with the increase since 1983 being more than 200 percent. The re-export trade reflects not simply transshipment through Hong Kong but, increasingly, a finer division of labor between Hong Kong and its trading partners. More and more products formerly manufactured in Hong Kong are now subcontracted or partially produced in neighboring areas, particularly South China.

The burgeoning trade flows through Hong Kong have continued to support rapid real economic growth there, but the value added in Hong Kong has shifted more and more to service activities rather than direct manufacturing of complete export goods. Staff figures show manufacturing employment dropped 21 percent between 1986 and early 1991. Service employment during the same period rose 32 percent.

Productivity patterns reflect this reorientation of the economy toward services. In manufacturing, labor productivity gains have been exceptionally rapid, averaging a little more than 10 percent per year for the last five years. Much of this undoubtedly reflects out-sourcing of lower value-added activities rather than improvements in technical productivity.

Productivity growth in the service sector has lagged. Statistics presented by the staff show that, despite the very rapid growth in manufacturing productivity, overall productivity growth has slowed in the last couple of years to about

3 percent per year. Pretty clearly the manufacturing sector has accounted for most of the economy's productivity gains.

The rapid growth in manufacturing productivity has permitted a rapid growth of wages in manufacturing without corresponding increases in unit labor costs. Despite recent wage gains of 10-12 percent, unit labor costs have recently been rising by less than 3 percent; in 1986 and 1987 unit labor costs actually dropped by 5 percent. The wage gains in manufacturing have been matched by similar increases in the service sectors. Lacking comparable productivity gains, unit labor costs in the nonmanufacturing sector appear to have been increasing recently at around 10 percent.

In the face of this strong undertow of sectoral transformation, the fixed exchange rate link to the dollar has not been sufficient to achieve overall inflation control. The dollar link has, however, as would be expected, succeeded in keeping traded goods prices in line with the general trend of dollar inflation. Annual export and import unit value increases have ranged from 2-5 percent since 1986. In contrast, the overall consumer price index, where nontradeable goods predominate, has been inflating at annual rates of over 10 percent in each of the last three years.

An exaggerated version of this pattern was observed in Japan during this growth era. We disagree with the suggestion that what we see in Hong kong is imported and inflationary because the currency peg to the dollar undervalues the currency. If this was the case, we should have seen both stronger upward pressure on the Hong Kong dollar price of tradeables and intensification of activity in traditional exports, using traditional techniques.

The wide divergence between the trends in the tradeable and nontradeable goods sectors presents a serious dilemma for monetary policy in Hong Kong. Pegging the Hong Kong dollar to the U.S. dollar can and does stabilize the price of tradeable goods. It does not, however, contain the CPI or GDP deflator to low levels. If, instead, monetary policy were directed at achieving a low level of CPI inflation, this would, on present productivity trends, require lower nominal wage settlements and falling prices for tradeable goods. Presumably, the eventual result would be a requirement for gradual and continuing currency appreciation. Thus, I would disagree with suggestions by some speakers this morning that there be a steep appreciation and relink to some other currency. In the current economic environment the arithmetic laws are in conflict with the combined objectives of a stable CPI and a stable exchange rate. As a footnote, I might comment that if there were to be any discussion of relinking, one ought to be careful about relinking to a currency with a higher rate of inflation than the U.S. dollar.

We have no quarrel with the Honk Kong authorities' forceful commitment to maintaining the dollar link for its currency. As Mr. Peretz suggests in his statement, there are important elements of financial stability, continuity, and confidence that might not be easily replicated by alternative monetary arrangements. For our discussions here, however, I think it is worth taking on board the lesson of recent Hong Kong experience: an exchange rate anchor works to align the domestic price of tradeable goods with the foreign currency price of tradeable goods. Whether or not it also aligns the internal inflation rate with that of its currency partner depends on additional circumstances. If the inflation results of a firm exchange anchor are imperfect in a country as open and free of trade and regulatory distortions as Hong Kong, we believe we should be a little cautious about claiming too much for exchange rate anchors in more restricted economies.

While the exchange link circumscribes Hong Kong's monetary maneuvering room, the staff makes a reasonable case that fiscal policy, at the margin, has been relatively expansionary, adding fiscal stimulus of about 1 percent of GDP per year. This stimulus has been introduced by narrowing a fiscal surplus rather than resorting to deficit financing, so that Hong Kong has continued to maintain an enviably strong budgetary position. The swing in the fiscal stance, however, added to resource pressures at a time when internal inflationary pressure was already strong.

The airport development project now getting underway will sustain this recent trend for expanded public sector absorption of available resources. Despite the Government's secure financial position, there appears to be a good macroeconomic case for mobilizing current revenue to cover these expenditures in order to keep total demand consistent with the supply potential of the economy.

As Mr. Peretz notes in his statement, there is also scope for a variety of supply-side actions, such as releasing additional land and encouraging the supply of specialized labor that is now in short supply. Some of this is already being done and should help relieve localized price pressures in specific markets. This is all to the good, but care will need to exercised to avoid overloading an economy that, on the whole, continues to perform splendidly.

The staff representative from the Southeast Asia and Pacific Department considered that it was perhaps setting the objective too narrowly to focus on lowering the rate of inflation, even though that was the most immediate economic problem and political issue facing the authorities. The aim of the authorities was, in a broader sense, to promote stability and prosperity in Hong Kong. To that end, controlling inflation could make an important contribution, but in focusing narrowly on the options for controlling inflation, especially in the choice of a monetary policy strategy, the authorities would run the danger of compromising the underpinning of confidence, thereby prejudicing Hong Kong's stability and prosperity and, in the end, undermining the ability to achieve low inflation as well.

Hong Kong was in many ways unique, the staff representative remarked. It could be said with justification that every economy depended on confidence as an ingredient for stability and prosperity, but that truism was especially applicable to Hong Kong, probably because the Hong Kong economy, like the society itself, was less solidly based than many others and was uniquely vulnerable to rumor and instability. Recent history was full of examples of that vulnerability. For example, in 1983 the future of Hong Kong after 1997 had seemed particularly uncertain. It was worth recollecting that, at that time, the Hong Kong dollar fell in value by almost 50 percent in just one week. In addition, the banking system suffered persistently from rumors of loss of confidence. The staff report noted five runs on banks in the past six months, including two runs on two of the largest international banks in Hong Kong. At the same time, it should be noted that it would be wrong to interpret those runs as a sign of weakness or underlying difficulties in the financial system or in banking supervision. Hong Kong had the same problems in those areas as other countries, but Hong Kong's problems were not greater than the problems elsewhere.

The authorities were considering the introduction of deposit insurance, the staff representative noted; they had circulated narrowly within the financial community a document outlining the pros and cons of implementing such insurance at the present stage. They and the financial institutions were not very enthusiastic about deposit insurance because of the issues of moral hazard involved, and the staff expected that any scheme that was introduced would be narrowly based.

Also with respect to financial supervision, while the staff agreed that capital adequacy was not the only yardstick to use, it was perhaps useful to note that the aggregate capital ratio of Hong Kong banks was 14 percent at the end of 1990, substantially above the 8 percent BIS standard, the staff representative commented. Profits had been rising significantly, and the fact that lending rates had not fallen to the same extent as U.S. dollar interest rates reflected the adjustment taking place in Hong Kong's banking system, as the banks felt that their best interests were served by adjusting their portfolios in the face of the run-up of property prices.

With respect to the specific question on bank supervision raised by Mr. Tabata, the authorities employed on-site inspections, along with periodic reports on, and discussions with, local branches of foreign banks, the staff representative commented. In addition, the authorities were currently reviewing detailed aspects of their supervisory system, including, for example, a comprehensive monitoring of off balance sheet items.

Short-term bills had been introduced only very recently in Hong Kong as a means of monetary management, the staff representative remarked. The amount of outstanding bills in the past 12 months had risen to HK$13 billion, up 70 percent over the previous year. In addition, the authorities had started to issue bills for maturities of longer than the three and six months that were originally used.

The authorities saw the linked exchange rate system as the rock upon which the whole economy was fixed in a very unstable world, the staff representative remarked. The fact that they were committed to doing whatever was necessary to defend the exchange rate, so that holders of Hong Kong dollars could get one U.S. dollar for every 7.8 Hong Kong dollars that they held, was the anchor that, in the authorities' view, was essential to providing stability and confidence in the economy at large. Indeed, to that end, the policy had actually worked extremely well.

Directors had explored various alternatives that might lead to a better outcome on the inflation front without sustaining confidence; that line of enquiry was natural, and the staff, too, had explored the matter, the staff representative commented. Mr. Spencer had suggested the possibility of periodic appreciation, and Mr. Bonzom had spoken of a one-shot revaluation. The staff agreed with Mr. Abbott's response to Mr. Bonzom's suggestion. If the link was maintained, interest rates would remain too low to contain inflation, which, over time, would again become a problem. The authorities would stress, with some justification in view of the history concerned, that a revaluation would undercut the commitment to sustain the link. They would underscore that the credibility of the ability to withstand downward pressure when it came would be severely undermined.

In the circumstances, the choice of exchange rate policy was a matter of judgment, the staff representative continued. The authorities' judgment was clear. They recognized the costs of the linked exchange rate in much the same way as the Directors had described them. The link created inflationary problems, but it provided the rock upon which the authorities had set their policies. The staff agreed with Mr. Peretz that the linked exchange rate system set a kind of ceiling on inflation. It was inconceivable that the rate of inflation--currently 10 percent--could reach a level as high as, say, 20 percent. The link provided a cap--not a fixed cap, but a cap nevertheless. As a result, a runaway inflationary spiral was not possible.

In 1992, the cap on inflation had, for one reason or another, apparently been lifted, which was a cause for some concern, the staff representative from the Southeast Asia and the Pacific Department went on. Monetary policy had probably diverged further over the past year from the one that was consistent with a low rate of inflation, because of events outside Hong Kong. The cyclical position of the United States had brought interest rates down at a time that was not appropriate in terms of Hong Kong's domestic situation. Hence, as Mr. Spencer had noted, the staff was less sanguine about the balance of risks that it had seen the previous year. During the previous consultation discussions, the staff had clearly seen the benefits of the linked exchange rate system. The staff still saw those benefits as being undiminished, but the authorities currently faced a more difficult dilemma than during the previous year, as the inflationary consequences of their policy stance were even more in evidence than they had been 12 months earlier.

Mr. Spencer commented that the potential moral hazard cost of deposit insurance referred to by the staff had been clearly evident in other countries--for example, the United States, where those costs had been substantial. He wondered whether the Hong Kong authorities were considering a private deposit scheme and who would underwrite the scheme. It was important to avoid placing the Hong Kong Government in the position of having to underwrite such a scheme.

The staff representative from the Southeast Asia and Pacific Department responded that the staff had not yet seen the document being circulated in Hong Kong for consideration.

Mr. Peretz said that he, too, was as yet unaware of the details of the authorities' proposal concerning deposit insurance. However, Mr. Spencer's point in that connection was well taken. Most of the senior supervisors in Hong Kong had worked in the Bank of England, and the proposed scheme was therefore likely to be very similar to the British one and would therefore not involve the Government in underwriting the deposit insurance.

Mr. de Groote made the following statement:

> With the Hong Kong economy again solidly on the track of economic expansion in 1991, after two preceding years of a real GDP growth rate below 3 percent, which is regarded in this area of the world as recessionary, the balance of economic risks for the country has clearly shifted toward inflation. Already last year, at the time of Hong Kong's first Article IV consultation, this Board engaged in a lively discussion on the issue of the need for, and the content of, an anti-inflation strategy for the country. Today's well-written staff report offers all the ingredients for a renewed focus on this policy area. Before dealing with it in greater detail, let me say at the outset that we are in a sense fortunate to have this problem at hand. If not, Hong Kong would

be without any major economic concern, which might lead us to wonder whether economic policy serves any purpose, at least for the case of small open economies, or whether one should instead stick to a so-called stance of positive nonintervention. In any event, let me seize this opportunity to congratulate the Hong Kong authorities for their continued economic success on all fronts, with the sole exception of the inflation performance, on which I will concentrate my further remarks.

As with many aspects of the Hong Kong economy, its inflation problem derives from an unusual situation: its monetary policy credibility is anchored through the exchange rate peg, on that of the U.S. Federal Reserve, which can hardly be deemed a bad choice, when looking at the latter's track record and notwithstanding recently expressed reservations about the Federal Reserve's future ability to control inflation. Yet, double-digit inflation figures look unlikely to disappear in the short run. Budget policy is likely to have a broadly neutral impact on the economy during the coming year, and the prospect of an emerging deficit is more than explained by government capital expenditure, not current spending. Yet, the staff paper sounds a note of caution on the medium-term fiscal outlook and its likely effect on inflationary pressures. The limited availability of land and labor is acting as a supply constraint that fuels inflation through wage and cost increases in both the tradeables and nontradeables sectors. Yet the country is adjacent to, and will soon become part of, a region where land and labor are in abundant supply, even though it will remain a separate part, as Mr. Peretz explained. Why then is there an inflation problem?

Or is it not a problem after all? Maybe it is simply the necessary adjustment mechanism to bring about a real effective exchange rate appreciation as a compensation for the trend divergence of productivity growth between the country and its monetary anchor, the U.S. economy. Maybe it is just a necessary by-product of the process of structural change, as Mr. Peretz suggested. Or maybe it is a problem, but one which carries less weight than the negative consequences of some remedial measures to do away with inflation, such as a currency revaluation.

As to the first question--whether it is a problem--I believe that we can all agree that a string of high inflation figures over a number of years is never a good thing. The staff report points to the ensuing unfavorable distributional impact on wealth and incomes, the adverse effect on resource allocation, the danger for entrenchment of inflationary expectations, and the threat to the economy's high degree of flexibility. To this could be added other negative elements, as mentioned for instance in the spring 1990 World Economic Outlook, which dealt explicitly with the case for price stability. For the special case of Hong Kong, I would single out two elements: first, in order to continue Hong King's development as a major financial center, financial confidence and stability need to be strengthened further, which must include efforts to enhance monetary stability; and second, a high inflation environment increases the probability of sharp cyclical downturns, to the extent that adverse shocks will push up inflation much quicker into a range that necessitates measures aimed at reducing absorption. Given that Hong Kong is already prone to sharp cyclical swings, any element adding to this feature should be addressed quickly.

As to the second question--whether the problem carries less negative consequences than its potential remedies--a careful cost/benefit analysis needs to be performed of the suggested remedial policy actions. Measures to tackle the supply-side aspect of the problem--the limited availability of land and labor--have their merit but may lead to a different set of problems and are, in any case, unlikely to bring about substantial relief in the short term for these long-standing bottlenecks. To allow a better understanding of the limits of this type of policy action, I would like to ask the staff for clarification on the following two issues. First, how much leeway does the Government have in trying to dampen property speculation in a context of negative real rates, before triggering a loss of confidence in the domestic banking sector, which has increased its exposure to the property market? Second, how much leeway does the Government have in allowing imported labor, before triggering an unwanted disturbance in the existing wage structure?

Measures to tackle the demand side of the inflation problem essentially relate to fiscal and monetary cum exchange rate policy. The staff seems to prefer the former course of action by advocating the inclusion of stabilization considerations in Hong Kong's short- and medium-term fiscal policy. Tax increases are considered necessary in this context. While I can see the merit of a broad-based consumption tax in general, its introduction in the current inflationary environment would not be very appropriate. I can accept the case for a more broad-based income tax, but I would prefer not to envisage such a reform as a revenue-raising measure. It could even backfire to the extent that it will encourage fiscal emigration. In general, it might well be that every effort to increase tax revenues in Hong Kong, aimed at dampening demand, might subsequently be used to accommodate a rise in spending in such areas as social services and infrastructure.

That leaves essentially monetary cum exchange rate policy to do the job. The staff report and Mr. Peretz's statement echo the authorities' strong views against tinkering with the pegged exchange rate system. While I accept that a sudden change in exchange rate regime, the choice of a new anchor, or even an unexpected revaluation of the Hong Kong dollar would negatively affect confidence and might increase the economy's vulnerability to financial instability in the future, I still believe that exchange rate action can be undertaken without impairing the credibility of Hong Kong's pegged exchange rate system. The conditions for a successful undertaking are exactly the same as the ones invoked for a successful devaluation: the exchange rate policy action must be embedded in an array of accompanying measures that are all intended to serve the same purpose. It is precisely the combination of various actions in different policy areas that establishes the credibility of the move and contributes to its ultimate success, bringing the real exchange rate to a new base without allowing it to be eroded subsequently by inflation. This is no different for the case of Hong Kong.

In this perspective, the current situation of highly negative real interest rates, ensuring essentially from an exceptionally wide cyclical divergence between the U.S. and the Hong Kong Economies, can be corrected by a one-time revaluation of the Hong Kong dollar, necessitating higher nominal and, therefore, positive real interest rates, and underpinned by other measures aimed at bringing down inflation or increasing the credibility of the exchange rate move. Among such measures would probably have to figure some fiscal retrenchment aimed at increasing the country's positive savings/investment balance, some additional measures to reduce inflationary pressures in the labor and property markets, as well as a policy to make public the level of official reserves as a further underpinning of the credibility that the new peg will be defended at all times.

In ending, let me recall that it is up to the Hong Kong authorities to make a judgment on such a policy option, which might seem to them too far estranged from their preferred stance of position nonintervention. I wish them well in the period ahead.

Mr. Al-Tuwaijri made the following statement:

Hong Kong's economic success illustrates the benefits of fiscal discipline, limited regulations, low taxes, and a supportive social infrastructure. These enlightened government policies have harnessed the entrepreneurial skills of the population and the adaptability of management and labor to changing circumstances.

Recent economic developments indicate that confidence has been restored, and that the economic recovery has been solidified. However, the authorities remain confronted with unwavering inflationary pressures. As indicated in the staff paper, these pressures are derived from an increase in foreign demand for goods and services, mainly due to the opening of China to foreign trade and a decline in the supply of labor. The resulting wage and price pressures had previously been held in check by the need to maintain the competitiveness of the manufacturing sector. However, the development of out-processing facilities in Southern China has diminished the link between wage-price pressures and concerns for competitiveness. As a result, the short-term costs of inflation have been partly concealed.

Clearly, the authorities face a major policy dilemma in formulating an anti-inflationary package. The hitherto successful link of the exchange rate to the U.S. dollar has resulted in a more expansionary monetary policy than would otherwise be warranted. Moreover, it appears from the staff report that between 1989-90 fiscal policy imparted a stimulative impulse equivalent to 3 percent of GDP. The recent agreement on the airport and port development project has also constrained the authorities' ability to use fiscal policy in the fight against inflation.

Conceptually, a flexible exchange rate offers the possibility of absorbing excess demand and containing inflation through greater control of the money supply and lower economic growth. Nonetheless, the previous experience with a flexible exchange rate regime, as well as the need to avoid major instability in the system, as Hong Kong moves towards 1997, strongly argue against the adoption of a flexible exchange rate regime.

Some speakers have proposed the possibility of a one-time appreciation of the exchange rate. I concur with those who argue that such a one-time adjustment need not reduce the credibility of the authorities' commitment to defend the exchange rate when it faced downward pressures. Indeed, the motivation an upward adjustment is not symmetric to the motivation for a downward adjustment, particularly since a hard-currency option could actually strengthen the credibility of the authorities' commitment to defend the currency when confronted with downward pressures.

This being said, I do not believe that a one-time adjustment would adequately address the problem of inflation in Hong Kong, as it would merely cause a one-time change in the price level. Indeed, the excess demand pressures emanate from the nontraded sector, which confronts a binding labor constraint. Hence, although the use of the exchange rate could dampen external demand, it may not substantially alleviate the labor constraint, nor necessarily reduce markedly the demand for nontraded goods, particularly when the public sector was increasing its demand for such services. Moreover, the Chinese demand for complementary goods and services from Hong Kong may not be significantly reduced through an exchange rate revaluation, since there does not appear to be an immediate substitute source for such services. Furthermore, after the one-time revaluation took place, the authorities would remain unable to control monetary policy, not to mention the difficulty they would have in determining the magnitude of such a revaluation. Consequently, the benefits of a one-time appreciation do not appear large enough to offset the potential risks of instability.

In sum, the authorities should attempt to relax the land and labor constraints, while restraining the fiscal stimulus as much as possible. Clearly, the maintenance of confidence and relative financial stability outweighs the short-term need to contain inflation. Over the medium term, as expenditures on the airport and port project end, fiscal consolidation would become more feasible, and inflation should abate.

Mr. Végh made the following statement:

I would like to comment on two issues: first, the inflation question that has been the main topic of the Board discussion today; and, second, some innovations in policy matters that are mentioned in the staff report. In both cases, my recommendation to the Hong Kong authorities would be to do nothing, as they have been doing for many years now with such excellent results.

On the inflation issue, if my understanding is correct, the exchange rate and monetary policies of the Hong Kong Government since 1983 represent a modern version of the specie-flow mechanism, as described by David Hume, Robert Mundell, and others, with the U.S. dollar substituting for gold. Under these conditions, and as Mr. Peretz puts it in page 3 of his opening statement, "the linked exchange rate system builds in discipline to the monetary system, under which money supply adjusts to balance of payments pressure...." In other words, monetary policy is passive in nature, and the public imports and exports liquidity through the balance of payments. The correct implementation of this policy approach is, therefore, to let the automatic stabilizers work smoothly and without interference. It might be interesting to look at some indicators in order to analyze this question.

Let me call the attention of the Board to Charts 3 and 5 on pages 4b and 8a of the staff report. In Chart 3, we can follow the evolution of the real effective exchange rate in the period 1980-91. The relevant period for our analysis is, of course, after the peg to the U.S. dollar in 1983 and up to the present. If we look at the curve in Chart 3, we can conclude that the flexibility of the real exchange rate has been quite large and, together with inflation differentials, productivity patterns, and other elements vis-à-vis the main trading partners, has allowed the market mechanisms to operate towards the restoration of equilibrium on each occasion. Thus, we see that after a starting point of about 90, the real exchange rate of the U.S. dollar appreciated to 110 in mid-1985, depreciated to a bottom level of 83 in mid-1988, and appreciated with minor oscillations in the period thereafter to about 104 by the end of 1991. If we look at the second chart (Chart 5 on the money supply, on page 8a), the situation does not look as good, although I would quite agree that a more careful examination should be made before arriving at a definite conclusion. However, at first sight, one would expect more volatility in money and credit growth than can be found in Chart 5, and I would also expect occasional occurrence of negative changes in nominal figures.

It is, of course, quite clear that this specie-flow mechanism on the basis of the dollar standard requires for its success a severe degree of fiscal discipline, and in this context I agree with the remarks by Mr. Wei.

I am concerned by some remarks on page 13 of the staff report. As a general proposition, I would argue that the economic success of Hong Kong for many decades is explained by its singularity. As Mr. Peretz says at the beginning of his statement, "a number of important factors have contributed to the favorable developments and strong growth in the Hong Kong economy in recent years. The good investment climate reflects relatively low levels of taxation, strict fiscal discipline, and limited government regulation of the economy, as well as a free regime for international trade and finance." If this is so, why would the authorities change course and move to more complicated and burdensome tax systems that have been in place for many years in more advanced economies and which have been economically less successful than the policies in Hong Kong? I am thinking mainly of the income tax, with all its administrative costs and complications and its interference with the privacy and freedom of individuals.

The same kind of reasoning can be applied to the proposition to introduce a deposit insurance scheme in the banking sector. This kind of scheme has been proved a failure in many cases, because of moral hazard and other problems, and it severely limits the operation of the market mechanism and the exit of inefficient firms.

Change is not equivalent to progress, and at a time when the whole world is moving in the direction of traditional Hong Kong economic policy, why would Hong Kong start to move in the opposite direction?

Mr. Torres commented that, even though the current exchange rate link had undoubtedly contributed to the present relatively high inflation rate in Hong Kong, the benefits of providing an underpinning of confidence for the economy as a whole, and the financial system in particular, were far more important than the associated welfare cost implied by the presence of inflation. He fully shared the authorities' concern about Hong Kong's vulnerability to downward pressure on the exchange rate if the Hong Kong dollar was revalued. Given the unique Hong Kong society and economy, an adjustment of the exchange rate would definitely increase the likelihood of a movement in the other direction, thereby undermining confidence and increasing uncertainty in the financial sector, especially as 1997 drew closer.

Introduction of a limited deposit insurance in Hong Kong might well play an important role in strengthening financial confidence and stability in the years ahead, Mr. Torres commented. Conceptually, either the capital adequacy standards already in place, or a limited deposit insurance scheme could reduce the risk of insolvency of banks. It was recognized that having both policies in place could mitigate the common problem of moral hazard. Therefore, the authorities' examination of the issues involved was welcome.

He wondered whether the introduction of the Basle capital adequacy standards in 1989 had been partly responsible for the visible portfolio shift that had been taking place in the banking sector, as mentioned in footnote two on page 8 of the staff report, Mr. Torres said. There was a coincidence between the increase in exposure in the property sector, which the staff related to the presence of negative real interest rates, and the increase in exposure with the adoption of the capital standards. Therefore, from a moral hazard viewpoint, there were incentives to minimize the cost impact of adopting the Basle rules through a more aggressive or risky lending policy in the case of the banks. In that connection, there was no clear theoretical or empirical evidence, and staff comment would be helpful.

Needless to say, the scheduled program of expenditures relating to the airport project came at a particularly bad time, as the fiscal stimulus would leave the economy with an already high inflation rate, negative real interest rates, and a real effective exchange rate already comparable with the highest level observed in the past ten years, Mr. Torres remarked. The risk of significant pressure on prices called for a more restrictive fiscal policy. The phasing of the complex airport project should be planned and monitored carefully, and broadening the base for direct and indirect taxes should be considered to enhance the needed fiscal consolidation.

The lack of statistical data seemed to continue to hinder the Fund's and the Board's evaluation of economic developments in Hong Kong, Mr. Torres noted. Although he recognized the authorities' efforts in that area, further improvement was warranted.

The Acting Chairman commented that the recent movement in the real effective exchange rate, as shown in Chart 3 on page 4b, had been due partly, if not primarily, to the large movements in the U.S. dollar. Hence, in effect, the Hong Kong dollar had been floating with the U.S. dollar. In retrospect, and given the authorities' wish to maintain stability, he wondered whether they should perhaps have chosen in 1983 to peg the Hong Kong dollar to say, the yen, instead of the U.S. dollar. That approach was a slight variation on Mr. Spencer's suggestion. He wondered how the authorities should decide what was a relevant anchor for an economy like that of Hong Kong.

The staff representative from the Southeast Asia and Pacific Department said that, in retrospect, it was clear that, given the performance of the yen in the past, the inflationary consequences of linking to the dollar would have been lessened if, in the whole period under review, the Hong Kong dollar had been linked to the yen rather than the U.S. dollar. Of course, perhaps early in the part of the period in question, when the yen was a weaker currency, a link to that currency might have been more difficult.

In any event, the staff representative, went on, past experience need not always be a good guide for the future. The choice of a link was a strategic one that was not open to frequent change. The authorities could perhaps adjust the rate once, but once they had made a choice of a particular link, they had to stick with it.

In considering the exchange rate issue, it was helpful to bear in mind that although Hong Kong was located in the very middle of Asia, the U.S. dollar link and the transparent nature of the link were of crucial importance to the Hong Kong people, who for many years had not been as highly sophisticated in financial matters as they were at present, the staff representative from the Southeast Asia and Pacific Department commented. The public had come to feel very comfortable with the U.S. dollar and the link to the dollar. Indeed, the current important links between Hong Kong and Japan were surprisingly narrow and surprisingly recent. Hence, the authorities probably had had little choice but to link the Hong Kong dollar to the U.S. dollar rather than some other currency.

Mr. Peretz remarked that he had been involved in the decision in 1983 on the choice of the exchange rate link, as the Hong Kong authorities had

Mr. Peretz remarked that he had been involved in the decision in 1983 on the choice of the exchange rate link, as the Hong Kong authorities had sought advice from the U.K. authorities at that time. The Hong Kong authorities had seriously considered a number of options, but in the end a clear link with the U.S. dollar had seemed far and away the best choice. They had wanted a transparent link that the public could understand; a link to a basket of currencies was not as readily understandable as a link to a single currency. In addition, at that time, as well as at present, the U.S. dollar was used in Hong Kong almost as a second currency; it could be used in the street for most daily expenditures, such as taxi fares. In 1983, about half of Hong Kong's money supply was in foreign currency, and of that amount nearly the whole amount was U.S. dollars. In addition, about 40 percent of Hong Kong's exports were to the United States, and probably half or more were denominated in U.S. dollars. Even at present, Hong Kong's exports to Japan accounted for only 5 percent of the country's total exports. Hence, the yen was not as attractive an option as the U.S. dollar. If the choice of a link were made anew in 1992, the authorities would in all likelihood again choose the U.S. dollar for the same reasons that had been cited in 1983.

Mr. Abbott said that he wondered what the trade-weighted basis was on which the real effective exchange rate shown in Chart 3 was calculated. If the weight of the yen was only about 5 percent, the movements shown in Chart 3 did not reflect predominantly movement of the Hong Kong dollar against the yen. His impression was that the movements in Chart 3 were deflated by consumer prices, so that tradable goods prices--for which the only index available was the unit value of imports and exports--in Hong Kong dollars had moved in line with U.S. dollar prices. Thus, the net movement deflated in that manner presumably would yield a fairly flat trajectory for the curve.

The staff representative from the Southeast Asia and Pacific Department commented that Mr. Abbott had noted the Achilles heel in the staff's presentation of exchange rate developments. The footnote on page 2 explained that the real effective value of the Hong Kong dollar had risen by 17 1/4 percent between 1988 and 1990. The staff also observed that "it should be noted that this measure of the real exchange rate is based on relative consumer prices, and, as such, is likely to overstate the decline in competitiveness." As a result, the usefulness of much of the information in Chart 3 was called into question.

Mr. Spencer said that he did not fully agree with the staff representative's last comment. In measuring the real exchange rate, relative price measures that included an overall measure of prices in the economy--in the traded and nontraded sectors--were typically used. It was instructive to look at an index based on some measure of wholesale prices or consumer prices that included prices of nontraded items. Chart 3 clearly showed that, at least from 1985 to 1988, the real depreciation of the Hong Kong dollar was driven by the peg and the decline in the U.S. dollar in real through monetary expansion. The evidence suggested that the Hong Kong dollar in real terms was becoming more and more undervalued and wanted to adjust upwards but was being pushed down as a result of the peg to the dollar. The exchange rate movement had started heading in the right direction (i.e., upwards) only from 1988 through to 1991, when inflation had been accelerating, thus tending also to push the real exchange rate up. So while the real exchange rate had moved around quite a bit through the 1980s, it had been headed in a stabilizing direction only since 1988. It was important not to assume that all real exchange rate adjustments were necessarily stabilizing.

The staff representative from the Southeast Asian and Pacific Department responded that he agreed that in the earlier period the decline in the measured real effective exchange rate included the effects of the weakening dollar. In the same period, Hong Kong had been growing rapidly, as it was starting to make use of the opening of the China trade and similar possibilities. But it was only toward the end of that period that the limits on Hong Kong's production capacity were reached. At that time, the inflationary pressure coming from the linked exchange rate had really begun to have an effect, and there had been some upward movement in the measured real exchange rate.

Mr. Végh remarked that the distinction between tradable and nontradable goods and services was useful but was becoming less and less important in a world of increasing global integration. That conclusion was particularly applicable to neighboring countries with very open borders where most goods and services were tradeable, such as Hong Kong and southern China.

The staff representative from the Southeast Asia and Pacific Department said that he agreed with those points. Many goods and services that had been nontradable were becoming tradable--a conclusion that was particularly relevant in the case of Hong Kong. However, the discussion should be in the context of the rapidity of change in the structure of the economy. Items that were becoming tradeable would see a rapid increase in domestic prices in Honk Kong followed by their rapid disappearance from Hong Kong's industrial structure. Indeed, one could easily see in Hong Kong a rapid change in the structure of the economy as traditional industries died away and new ones took their place.

As Mr. Torres had implied, there might be a link between the introduction of the new capital adequacy ratios and the rising proportion of lending to property, the staff representative commented. The staff had not yet actually seen evidence of such a link in Hong Kong. It seemed likely that the acceleration in the rate of inflation, especially since 1988, had made investment in property particularly attractive. The movement in the economy toward services and the growing affluence of the economy in recent years had made property, especially residential property--where the rise in property prices was mainly concentrated--particularly attractive investproperty prices was mainly concentrated--particularly attractive investments; hence, the demand for credit extension into property, including residential property, clearly existed.

The question had been raised whether inflation was a real problem in Hong Kong, the staff representative recalled. Inflation was of course a problem, but there were special circumstances in Hong Kong that should be taken into account. First, inflation was not a problem for a large part of the economy, including the traded goods sector, the exporting sector, a large part of the manufacturing sector, and a substantial part of the services sector; as Mr. Abbott had noted, U.S. dollar prices in Hong Kong were rising at a rate of less than 3 percent. Second, as Mr. de Groote had remarked, the inflation forced adjustment on the real economy; that was one reason why inflation probably did not have the same consequences in Hong Kong as it did elsewhere. The Hong Kong economy had shown an unusual degree of flexibility in prices--which moved up and down with equal freedom--and in the speed of adjustment, which tended to minimize, in relative terms, the costs of adjustment, which were not seen in Hong Kong to be as great as in more rigid economies.

As to the leeway on the labor side, outsiders seemed to see more leeway than the authorities themselves perceived, the staff representative commented. The authorities seemed cautious about allowing imports of labor in more than a very limited way, apart from the airport project, for which they saw a possibility of more substantial imports as the imported labor was thought to be physically controllable. One could easily see the authorities' point of view: Hong Kong was already overcrowded, and there were limits on allowing labor imports without creating further problems. However, the staff had recommended that there seemed to be every reason to take a liberal approach to imports of skilled labor where the lack of such labor was creating a bottleneck.

It was difficult to say how successful the authorities' efforts would be to dampen the pressure in the property market, the staff representative remarked. More time would have to pass before judgments could be made.

He wished it to be clearly understood that the staff did not regard fiscal policy as an alternative that would realistically allow the authorities both to maintain the linked exchange rate and reduce the rate of inflation, the staff representative from the Southeast Asia and Pacific Department said. Fiscal policy did not provide an opportunity for that kind of balancing. That approach would imply, for example, growing fiscal surpluses with the resultant pressure for spending and rising tax rates that, if acceded to, would in effect create a new and different Hong Kong without some of the advantages it currently enjoyed. The staff was not arguing that the authorities' current fiscal policy was in any way unsustainable or was not solidly based. In fact, fiscal policy was very solidly based, indeed, with substantial reserves and a continued surplus position. The objective of fiscal policy should be to stop things from careful, fiscal policy could add to problems that were already present in the economy. For example, shifts of a constitutional nature and the rise of representative government would make it more difficult for the authorities to resist spending demands than had been the case in the past. Those pressures, combined with the ever-present danger of cost overruns associated with the huge airport project, made the staff cautious and suggested that fiscal policy should be kept under very close watch.

Mr. Spencer commented that, with respect to the capital adequacy system, the fact that residential lending had a 50 percent risk weight, while commercial lending had a 100 percent risk weight, could well have contributed to the growth in residential lending and pressure in the housing market from the time of the introduction of the BIS system.

The costs of inflation in Hong Kong was an open question in terms of the extent of inflation over the coming years and the damage that it might do, Mr. Spencer remarked. There did appear to be pressures building up with the existing differential--which seemed likely to continue--in productivity growth between Hong Kong and the U.S. and the very low interest rates in the United States, which were causing very negative real interest rates in Hong Kong, as well as the massive fiscal stimulus that was on the horizon. While he agreed with the staff that the exchange rate mechanism would place a limit on inflation, one could not say how great the limit would be; and there was no way of knowing how great the inflationary pressures would become before that cap came into operation. His concern was accentuated by the history of Hong Kong's economy, which had been extremely cyclical in nature, in the sense that a steep upturn in the economy tended to be followed by the potential for a large drop. Hence, the authorities should be concerned about trying to dampen the current upward stretch on the business cycle roller coaster.

The staff representative from the Southeast Asia and Pacific Department said that he agreed with Mr. Spencer.

Mr. Abbott remarked that he doubted whether the large productivity growth differential the United States and Hong Kong was an important factor in assessing inflation under a pegged exchange rate regime. Higher productivity was the basis on which rising real incomes and wealth were created; a higher productivity rate should lead only to higher real wages and a higher standard of living in Hong Kong, with no particular implications one way or the other for the rate of inflation in that country.

Mr. Spencer responded that the differential would not lead to a permanent increase in the rate of inflation in Hong Kong. The higher productivity in Hong Kong would warrant an increase in wages, and as wages rose, and, therefore, as the prices of nontraded goods increased, there would be a bout of inflation. If the adjustment could be made to occur quickly, then the bout of inflation would be short. If the differential persist and adjustments were continually required, the inflation could continue for some time--as seemed to be happening in Hong Kong.

Mr. Peretz said that Hong Kong was a shining example of the benefits of free and open markets and of limited state regulation and intervention, all of which were preconditions for an active and healthy private sector. Over the past 15-20 years, the rate of growth of per capita income in Hong Kong had been about two and a half times the developing country average, and average per capita income in Hong Kong was currently 30 times that of China. As the staff report noted, some of the benefits of Hong Kong's system were beginning to spread across the border into China.

He welcomed Mr. Wei's reaffirmation of his authorities' commitment to the one country, two systems approach after 1997, Mr. Peretz continued. Personally, he wondered whether, over time, Mainland China would not increasingly draw the lessons from Hong Kong's economic success and pursue economic reform to a point at which the differences between the two economic systems actually began to disappear, resulting in an approach based on one country, one system, an outcome that would benefit the whole world, as well as the people of China.

As to the shorter-term situation, on which speakers had concentrated during the current discussion, there had been interesting comments on what he would call the temporary inflationary problems, Mr. Peretz recalled. Those problems appeared temporary because, whatever its defects, the exchange rate regime--provided it was adhered to and the anchor currency itself was properly managed--meant that the situation could not collapse into an inflationary spiral. The exchange rate system thus gave, in a very basic sense, a guarantee that the value of the currency would be maintained. In that connection, Mr. de Groote had asked the right questions, and the staff had provided useful answers.

In his view, the real risk in Hong Kong was not of a continuing, steady increase in the rate of inflation in the nontraded goods sector, Mr. Peretz continued. That trend would of course be undesirable but, in Hong Kong's circumstances, it was the not of overriding concern, provided there was no risk that the inflation would accelerate into very rapid inflation or hyperinflation. The real risk in Hong Kong currently was what the authorities in Hong Kong faced in 1983, just before the link was brought into place, namely, that external events would lead to a collapse in confidence, which would in turn lead to a collapse in the currency that the authorities would be unable to stem, however large their reserves were, and which in turn would lead to accelerating domestic inflation and a further fall in confidence. In the circumstances, keeping the exchange rate link unchanged was the best way to guard against those risks.

As several Directors had commented and the figures in the staff report showed, the inflationary pressures were, to large degree, structural in origin and affected different sectors to different degrees, Mr. Peretz commented. Mr. Abbott had noted the relatively low rate of inflation in the exporting sector; exporters also faced positive real rates of interest. At the same time, there had been much more rapid rates of inflation in domestic services and in the property sector; of course, in many countries it was not unusual for the rate inflation in the property sector to differ from rates of inflation in the rest of the economy. In the circumstances, the supply-side measures that the Hong Kong authorities had introduced were particularly relevant; the various measures taken to cool down the property sector, both by increasing land supply and by tax and other measures to restrain speculation in the property sector, and also measures to increase labor supply, were all particularly noteworthy. Perhaps the scale of those various measures could have been larger, as some speakers had suggested. However, it was important to note that the target net increase in 1992 accounted for half of the labor force. The types of labor to be imported were directed at particular bottlenecks and shortages. As the staff had noted, very large-scale imports of labor would certainly impose social strains in Hong Kong's circumstances, which might cause some difficulties. There was clearly already a land and housing shortage.

In addition, Mr. Peretz went on, fiscal policy was being kept tight. He had noted what Directors and, in a sense the staff, had said about that policy not being tight enough. Certainly the authorities were looking at ways in which to broaden the tax base in the future--perhaps by increasing property taxes or through a broader-based consumption tax. Several speakers had correctly pointed out the risks involved in raising taxes too much in the circumstances of Hong Kong. He wished to assure Mr. Spencer that the Hong Kong authorities would not act on fiscal policy like a child in a candy store--indeed, the reverse would be true, as maintaining stability was the major preoccupation of policymakers in Hong Kong.

The exchange rate link played the role as anchor for expectations over a period of great underlying political uncertainty, Mr. Peretz noted. Some Directors seemed to underestimate the crucial importance of that role in Hong Kong, which, as the staff had stressed, was prone to financial speculation and financial panics. A clear exchange rate anchor provided a very important point of stability for the system. That anchor had proved its worth again over the past year, when there had been a number of runs on banks, including some on the largest banks in Hong Kong. Those runs had not been associated with any concerns in the currency market, which was a measure of how well established the link was in the public's mind. A revaluation, however firmly described as a one-shot adjustment, would undoubtedly give rise to speculation that the adjustment could be reversed in the future. In general, he tended to favor fixed but adjustable exchange rate arrangements, but, in the circumstances of Hong Kong, that approach would be a great mistake. He fully agreed with Mr. Torres and Mr. Végh that the authorities needed to keep absolutely firm the expectation that the exchange rate would stay fixed at HK$7.8 to US$1.00 dollar.

A second point concerning the choice of exchange rate policy in Hong Kong was that, assuming that monetary policy required an anchor, there did not seem to be another possible anchor in the circumstances of Hong Kong, Mr. Peretz said. Hong Kong had a very open economy and sophisticated financial market. The country was small in relation to the size of its markets, and measures of the domestic money supply were unlikely to provide a good guide to monetary policy. In those circumstances, even excluding the particular confidence problems in Hong Kong, the authorities would be driven to use an exchange rate peg as the guide for monetary policy.

The Hong Kong authorities found the annual discussions with the Fund staff and in the Board very helpful, Mr. Peretz commented. They accepted the reasons for moving temporarily to the bicyclic consultation procedure, which meant that no Board discussion on Hong Kong would be held in the coming year, but they looked forward to having discussions with the staff again.

The Acting Chairman made the following summing up:

> Directors noted that Hong Kong's economy appeared well into recovery, with the revival of growth underpinned by a strengthening of confidence. While wage-cost pressures had eased in the first half of 1991, and the inflation rate was declining, this relief may be short lived, given the tightening of the labor market and the prospect of a continued strong expansion. In these circumstances, Directors commented extensively on the roles of monetary policy, exchange rate management, and structural policies in dealing with inflationary pressures. Directors noted the authorities' firm commitment to maintain an exchange rate system linked to the U.S. dollar and agreed that the orientation of monetary policy toward this objective had buttressed financial confidence and served Hong Kong well since its adoption in 1983. Directors noted that, with sensitive political changes on the horizon and in view of the fact that Hong Kong is an important world financial center which depends greatly on continued external confidence in its currency, the authorities viewed the linked exchange rate to be of critical importance to the future stability and long-term prospects of the Hong Kong economy.
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> Directors noted, at the same time, that the linked exchange rate policy constrained the ability of monetary policy to contain inflation. Indeed, the level of interest rates consistent with maintaining the exchange rate link appears to have fallen further below that required to keep demand within levels needed for low inflation. Moreover, real interest rates in Hong Kong have now become substantially negative, thereby aggravating the tendency toward an overinvestment of resources in the property sector as well as having potentially undesirable consequences on distribution. While on balance most Directors supported the view of the

authorities, a few Directors saw merit in a change in the exchange rate and a rise in interest rates to reduce inflationary pressures.

Directors also focused on structural measures, including the role that structural measures could play in reducing inflation. In particular, they encouraged the authorities to adopt measures to alleviate the principal supply constraints, i.e., the availability of land and labor. They noted in this regard that, in the past year, imports of labor had contributed significantly to the easing of labor market pressures, and they called for a continued flexible and liberal approach, particularly with regard to inflows of skilled labor.

Directors stressed the essential role of fiscal restraint. While the 1991/92 budgetary operations are likely to have a broadly neutral impact on aggregate demand, they noted that fiscal policy has been an expansionary force in recent years. Looking ahead, they expressed concern that the construction of the airport core projects is likely to give rise to fiscal deficits which would in turn impart a large expansionary impetus to aggregate demand. Noting also the pressure to improve social infrastructure, Directors believed that a more restrictive fiscal policy would be needed if inflation was to be brought down. Directors thus supported the authorities' plans to rationalize spending priorities, and some support was expressed for the staff's suggestion of a review of the tax system to broaden the tax base. However, it was also noted that significant tax increases in Hong Kong could negatively affect confidence and economic activity.

Several Directors noted the volatility of Hong Kong's financial sector and welcomed the authorities' examination of further steps to strengthen financial confidence and stability. While some Directors encouraged the authorities to consider deposit insurance, others encouraged the authorities to take into account the moral hazard risks associated with deposit insurance.

Finally, Directors noted the growing complementarity and interdependence between Southern China and Hong Kong. Economic reform and stabilization in China and the propitious investment climate in Hong Kong had been mutually reinforcing. Hong Kong's entrepreneurs have increasingly relocated labor-intensive business activities in Chinese coastal areas, and this has enhanced Hong Kong's ability to deal with labor tensions. The new airport project should further strengthen confidence in Hong Kong's economic future. The policy of "one country, two systems," which would continue to be pursued after 1997, should help to ensure the long-term prosperity and stability of Hong Kong.

Hong Kong has been placed temporarily on the bicyclic consultation procedure, and it is expected that the interim consultation discussions will take place within 12 months of the completion of this 1991 Article IV consultation.

APPROVED: July 28, 1992

LEO VAN HOUTVEN
Secretary