FOR AGENDA

SM/08/332

November 13, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **People's Republic of China—Hong Kong Special Administrative Region—Staff Report for the 2008 Article IV Consultation Discussions**

Attached for consideration by the Executive Directors is the staff report for the 2008 Article IV consultation discussions with the People's Republic of China—Hong Kong Special Administrative Region, which is tentatively scheduled for discussion on **Monday, December 1, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the People's Republic of China—Hong Kong Special Administrative Region indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Chalk (ext. 38281), Mr. Porter (ext. 37316) and Mr. Vitek (ext. 37393) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Friday, November 21, 2008; and to the European Commission, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA—HONG KONG
SPECIAL ADMINISTRATIVE REGION

Staff Report for the 2008 Article IV Consultation Discussions

Prepared by the Staff Representatives for the 2008 Consultation Discussions with the People's Republic of China—Hong Kong Special Administrative Region

Approved by Steven Dunaway and Tamim Bayoumi

November 13, 2008

Mission. A staff team visited Hong Kong SAR, October 20−30, 2008 consisting of N. Chalk (Head), N. Porter, F. Vitek (APD) and O. Unteroberdoerster (Resident Representative). V. Arora (Senior Resident Representative, Beijing) participated in the policy discussions and Messrs. He and Yung (OED) joined the mission.

Economy. Growth has slowed in the first half of this year, as external conditions have worsened. Inflation remains elevated, driven by food prices and housing costs. The fallout from the global credit turmoil has spilled into local markets, with equity prices falling markedly and signs of stress in interbank markets. The authorities have responded with a range of measures to provide liquidity, stimulate domestic demand, and bolster confidence.

Focus. The mission's central focus was on how the real economy and financial sector are holding up in the face of spillovers from the ongoing upheaval in international financial markets and the appropriate policy response to such extraordinary global events. The mission also examined three salient structural challenges currently facing Hong Kong SAR: the introduction of a minimum wage, the rising costs of healthcare, and ongoing economic changes in the Pearl River Delta.

Past advice. The Fund has generally supported the authorities' policies and reforms.

Exchange arrangement. Currency board with a trading band of HK$7.75−7.85 per U.S. dollar. Obligations under Article VIII have been accepted for Hong Kong SAR and the exchange system is free of restrictions for current transactions.

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EXECUTIVE SUMMARY

The 2008 Article IV consultation discussions took place against the backdrop of extraordinary volatility in international financial markets. The impact of these external conditions on Hong Kong's financial markets and the real economy, as well as the appropriate policy response, was the central focus of discussions.

The primary risk to Hong Kong SAR is through a self-fulfilling, financial contagion that damages confidence and propagates itself through the domestic financial system. The authorities have recognized this risk and acted decisively to contain the fallout from ongoing global turmoil. They have ensured there is ample liquidity in the financial system, bolstered confidence through deposit guarantees, and enhanced supervision of financial institutions.

Despite these efforts, as an open economy that is fully integrated into the global financial system, Hong Kong SAR is set for a significant economic slowdown. The weaker global economy, international financial volatility, the slowdown in the Pearl River Delta, a scarcity of credit, and weakening consumer confidence are all going to present significant headwinds. Growth is expected to fall to 2 percent next year and unemployment will steadily rise.

To support the economy, the authorities have put in place a sizable fiscal stimulus package that will boost demand and protect those most exposed to an economic slowdown. A similar sized package will likely be required in the coming fiscal year. Over a more medium-term horizon, it will be critical for the government to reform the healthcare system to maintain the quality of care, particularly for the elderly and vulnerable groups. In order to avoid a sizable increase in the tax burden, the government will need to ensure that the private sector bears a larger share of healthcare spending.

Hong Kong SAR's Linked Exchange Rate System continues to be an anchor of monetary and financial stability. The level of the real exchange rate appears to be valued broadly in line with economic fundamentals.

The prospective introduction of a minimum wage will need to be managed carefully to ensure the living standards of the working poor are preserved without materially affecting their employment prospects. Over a longer horizon, growth prospects will depend critically on managing both financial and real sector integration with Mainland China.

I. MACROECONOMIC BACKDROP

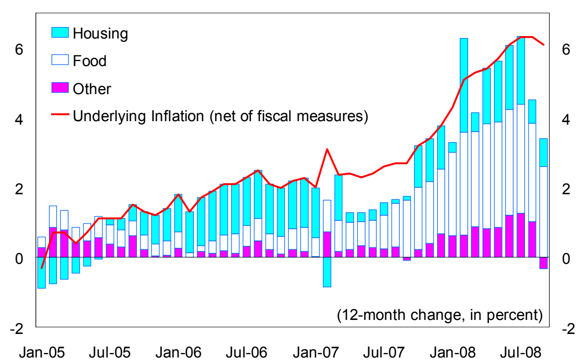
1. ***Context***. Hong Kong SAR's economy has undergone a remarkable metamorphosis over the past decades. These changes have resulted in almost all manufacturing operations moving to the Pearl River Delta. At the same time, the economy has leveraged its strong institutional framework, flexible labor and product markets, and status as a global financial center to transform itself into a dynamic, knowledge-based, service economy (Figure 1). Hong Kong SAR has emerged from this process of deep-rooted change with an enviable growth performance that has averaged 7 percent over the past four years. Unemployment reached its lowest point in more than a decade, rising disposable incomes have propelled forward private consumption, and productivity growth has been high.

2. ***Growth***. However, as one of the most open economies in the world and with its focus on financial and trade services, Hong Kong SAR is highly exposed to the unfolding crisis in international financial markets and to the slowdown in the global economy. There are now clear signs of economic deceleration largely attributable to falling private consumption growth and declines in financial services (Figure 2).

3. ***External position***. Net exports of goods and services fell in the first half of 2008, as the terms of trade worsened and demand from the E.U., Japan and the U.S. weakened. However, the current account has declined only modestly, in part due to higher investment income. Official reserves were slightly lower in the second quarter—due to losses on Exchange Fund investments—but have since remained stable. Portfolio flows have rotated out of equities and into local currency and deposit holdings.

4. ***Inflation***. Consumer price inflation has increased over the past two years, driven by imported food inflation and an upward trend in the cost of housing. Headline figures have fallen rapidly in recent months, to 3 percent at end-September. However, after adjusting for the effect of recent budgetary measures, underlying inflation appears to have only just peaked.

Food and housing have been the main contributors to inflation

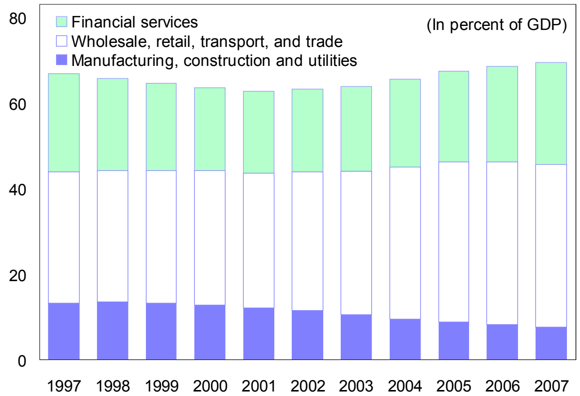


Source: CEIC Data Co., Ltd.

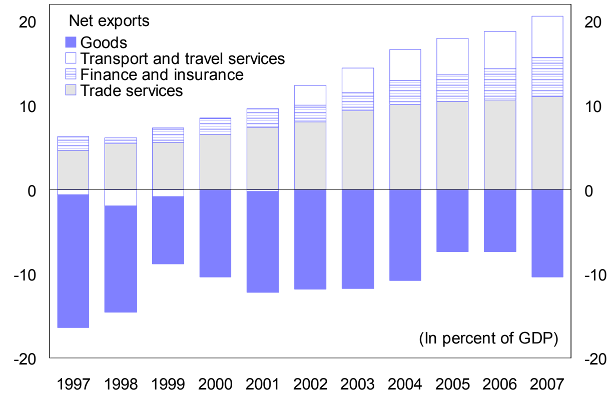
Figure 1. Structural Transformation

Main Message: Hong Kong SAR has evolved from a low cost manufacturer to a service economy, fully integrated into the global system, and reliant on its strong institutions and human capital.

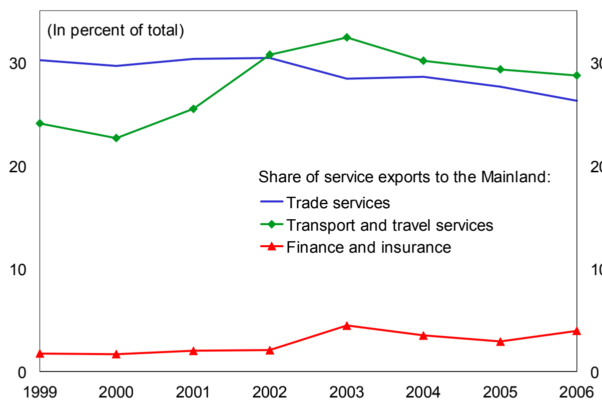
The service sector, particularly trade and financial services, accounts for a rising share of output as industry has declined…



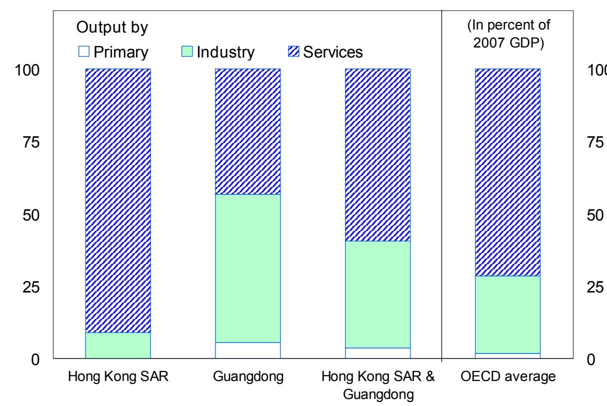
…and rapid service export growth has more than offset the net import of goods.



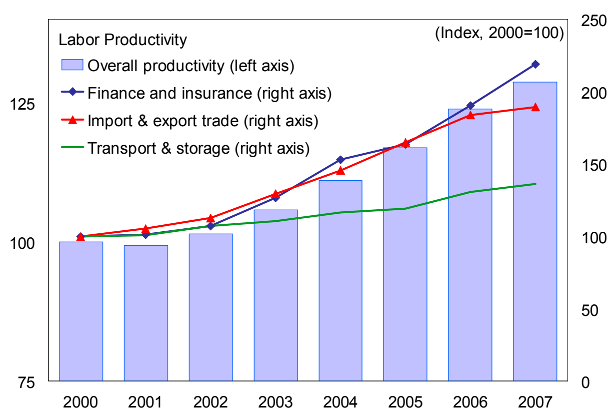
Mainland China remains central to the service economy, although there is ample space to increase the provision of financial services to the Mainland.



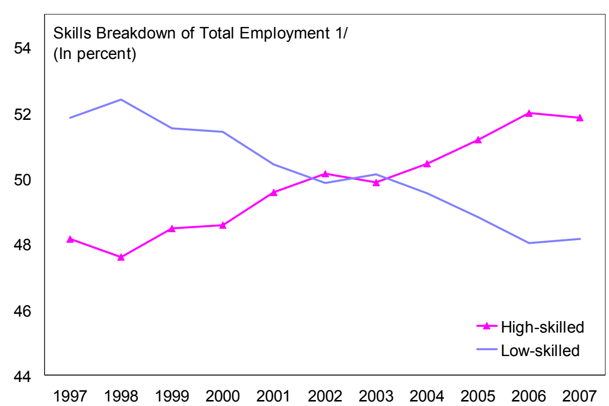
Hong Kong's service sector is closely integrated with manufacturing operations in the Pearl River Delta.



A competitive, externally-oriented service sector has been central to raising economy-wide productivity…



… putting an increasing premium on skills and human capital.



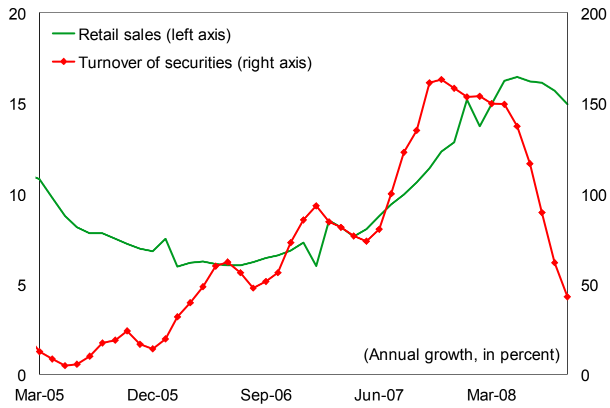
Source: CEIC Data Company Ltd.

1/ High skilled workers are managers, administrators, professionals, associate professionals and clerks; low skilled are service/shop sales workers, craft related workers, machine operators/assemblers, and elementary occupations.

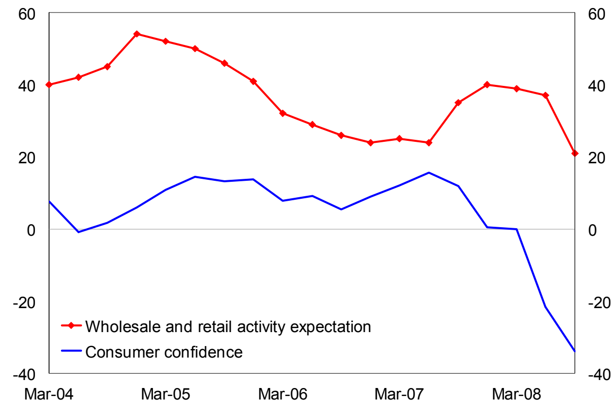
Figure 2. Macroeconomic Developments

Main Message: Output growth shows clear signs of slowing, impacted by global financial volatility and a slowing world economy. While inflation has risen, fueled largely by external factors, it appears to have peaked.

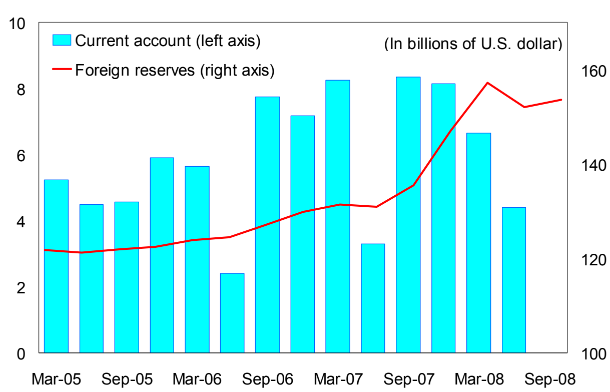
Private consumption is moderating, and financial service activity, a lead indicator for the broader economy, has weakened.



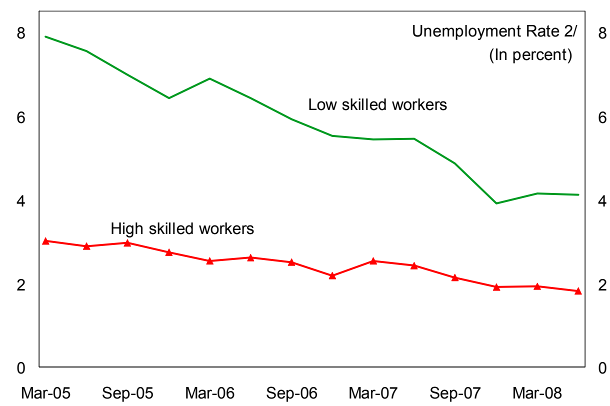
Consumer and business confidence have fallen.



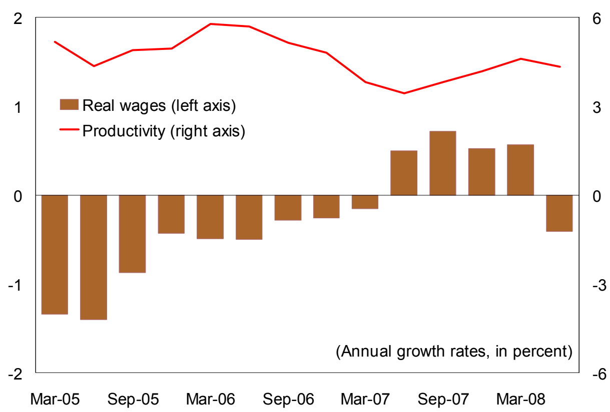
The external position remains strong, with a sizeable current account surplus.



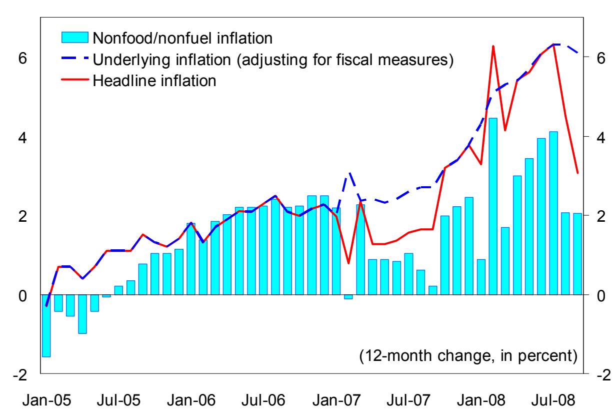
Unemployment has fallen to multi-year lows but is likely to turn upwards in the coming months.



Productivity growth has been strong, more than offsetting the very modest growth in real wages.



Consumer price inflation has risen but appears to have peaked.



Source: CEIC Data Co., Ltd.; and staff estimates.

1/ Net balance refers to the difference between the percent of respondents expecting an improvement and those expecting a decline.
2/ High skilled workers are managers, administrators, professionals, associate professionals and clerk; low skilled are service/shop sales workers, craft related workers, machine operators/assemblers, and elementary occupations.

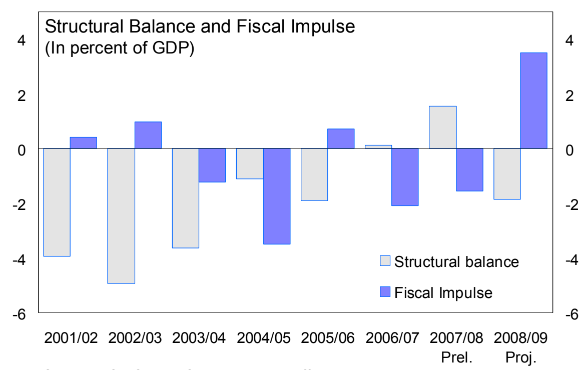
5. ***Fiscal policy***. In the 2007/08 fiscal year, the consolidated fiscal surplus was 7¾ percent of GDP, overperforming the budget target by 6 percent of GDP. The fiscal position was helped greatly by the stock and housing market boom and by buoyant land sales (which generated 3.2 percent of GDP in stamp duties and almost 8 percent of GDP in nontax revenue). This year's budget, and a supplementary fiscal package announced in July, introduced a sequence of measures to return fiscal resources back to Hong Kong SAR's citizens, protect lower income groups from food and fuel price increases, and expand infrastructure spending. As a result, the combined budget and supplement now target a fiscal deficit of ¾ percent of GDP for the 2008/09 fiscal year. This headline figure does, however, include 1½ percent of GDP in lump sum transfers to individual retirement accounts and the establishment of an endowment to finance university research as well as 1½ percent of GDP in construction projects that will get underway only in 2009. Netting out these factors, yields a fiscal impulse of around 3½ percent this fiscal year.

Main Measures in the Budget and Supplementary Fiscal Package 1/
(In percent of GDP)

Revenues	
Lower salaries tax rate to 15 percent and widen bands 2/	0.2
Lower corporate tax rate to 16.5 percent 2/	0.2
Up to a ceiling, waive 75 percent of the liability for:	
Corporate taxes	0.1
Salaries taxes	0.7
Property taxes and rates	0.7
Transfers to households	
HK$1,800 to every electricity account	0.5
HK$6,000 to MPF account (if earning below HK$10,000/month)	0.6
HK$3,000 to recipients of old age allowance	0.3
Rent reduction for those in public housing	0.2
Additional social assistance payment	0.1
Investment in infrastructure and human capital	
Investment in rail and road network	1.2
Universal free senior secondary education	0.1
Establish Research Endowment Fund	1.0

1/ Around 0.7 percent of GDP in stimulus is from the supplementary fiscal package.
2/ Indicates permanent tax reduction.

The planned fiscal impulse for FY 2008/09 is close to 3½ percent of GDP



Sources: CEIC Data Co., Ltd.; and staff estimates.

6. ***Growth outlook***. The economy is expected to slow markedly through the remainder of this year, to around 2 percent in 2009 with significant downside risks to that forecast. The slowdown is, in large part, a result of lower private consumption growth—as consumer confidence falls amid global economic uncertainty and declines in local asset prices—and weaker external demand. The government's 2008/09 budget and the more recent fiscal stimulus package should help mitigate the anticipated softening of consumption growth in the short term and the planned ramp-up in public infrastructure spending will provide support to growth over a somewhat longer horizon. Beyond that, growth prospects will depend critically on the trajectory of economic and financial integration with the mainland and on how those interdependencies are managed. However, a long-run growth rate of around 5 percent seems

feasible given the consistent improvements in productivity and overall dynamism and adaptability of the economy.

7. ***Inflation outlook***. Staff models indicate that inflation should fall below 3 percent over the next 1−2 years as food inflation, and to a lesser extent energy prices, work through the system and housing costs moderate. However, the outlook is complicated by the expiration of temporary fiscal measures—such as waivers of rents and rates, and transfers to cover the cost of electricity—which, as they are unwound, may add to inflation. On the other hand, the slowing economy should dampen price pressures.

8. ***Risks and spillovers***. Given Hong Kong's openness and status as an international financial center, the main growth risks relate to a further worsening of market turbulence. This could evolve through two broad channels. First, global volatility may directly spill into local financial markets causing further declines in equity markets, strains in hedge funds and other asset management companies, and potential dislocation in money markets. Heightened risk aversion would accompany such volatility leading to a sudden stop in the provision of bank credit. Second, international financial developments may precipitate a sharper growth decline in the global economy. This would accelerate the already-evident growth downturn in the Pearl River Delta region of Mainland China and spillover into Hong Kong SAR due to the extensive trade, logistics, and related services that are provided to Mainland producers. Over a longer horizon, a global downsizing of financial intermediation may be reflected in a smaller financial system in Hong Kong SAR. There are already signs that the size of the local asset management and hedge fund industry will shrink in the coming years. However, the bulk of financial system assets are banking related and should withstand a global downturn fairly well. More importantly, though, there are significant opportunities for expansion of financial service provision to Mainland China making the risk of a major retrenchment in Hong Kong's financial service business over the longer term seem relatively modest.

II. THE IMPACT OF THE GLOBAL FINANCIAL TURMOIL

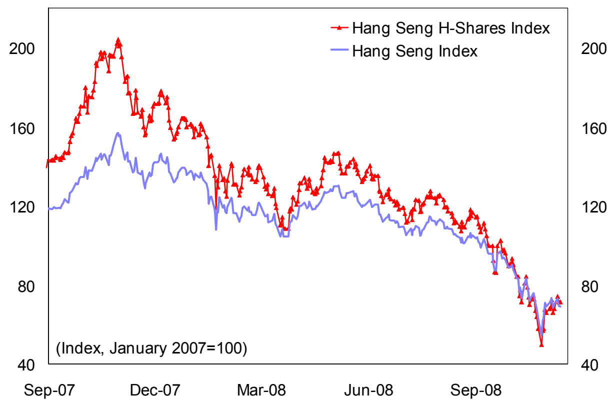
A. The Effect of Recent Volatility

9. ***Initial phase***. Starting from the second half of 2007, Hong Kong SAR's financial system coped well with the sharp increase in volatility in international financial markets. This resilience was, in large part, a result of robust supervision and regulation as well as local financial institutions' own internal risk management. There was relatively little exposure to the securitized products at the epicenter of the global volatility and ample room for the financial system to absorb those losses that were revealed. Nevertheless, lingering concerns over counterparty risk did raise interbank rates for lending at longer (3−6 month) maturities. In addition, equity markets were a visible casualty of the volatility, losing one-third of their value from the market peak in October 2007 to end-August 2008. The unfavorable market conditions stymied planned IPOs, resulting in a loss of fee income for the banks (Figure 3).

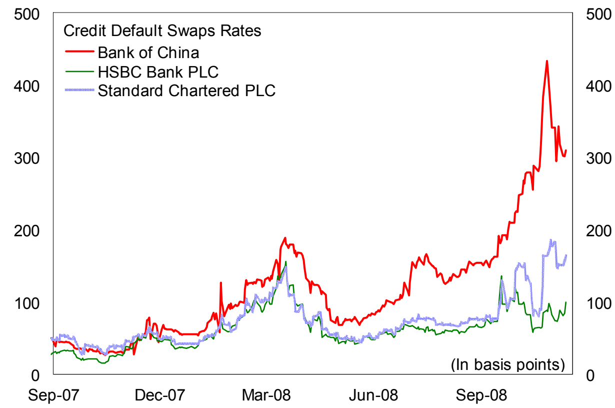
Figure 3. Financial Market Developments

Main Message: The financial system has been battered by global financial shocks. Equity prices have fallen and money markets have been under pressure. Renewed strains have become evident since late September.

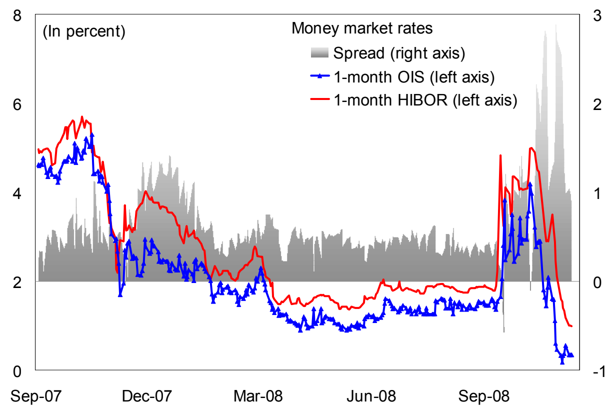
Initially, global financial volatility was primarily manifested through a sell off in local equity markets…



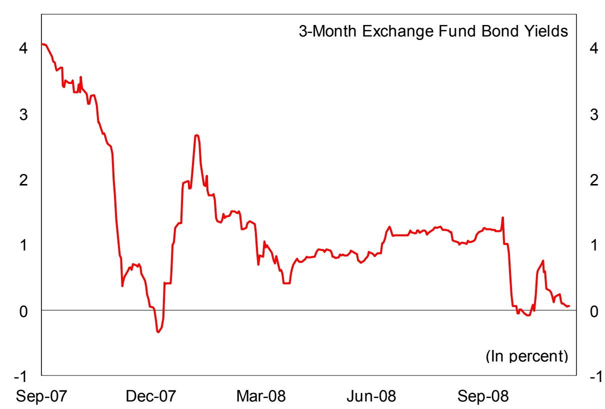
…and an increase in costs of funding for some local banks.



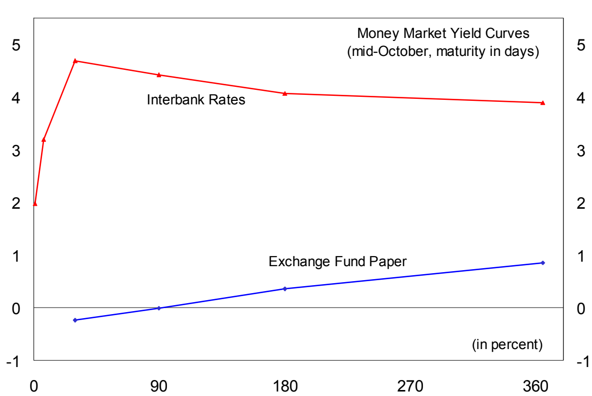
As in other jurisdictions, interbank spreads widened as a result of concerns over counterparty credit risk.



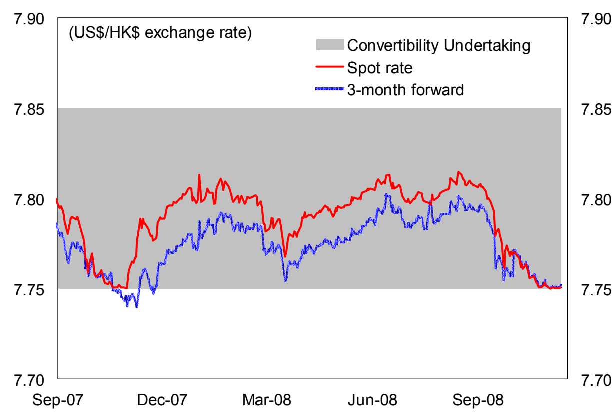
Since late September, extraordinary liquidity conditions have pushed up local interest rates and resulted in a strong demand for Exchange Fund paper.



And the gap between interbank rates and the yields on safe assets widened markedly.



The HKMA has used its limited flexibility to inject Hong Kong dollar liquidity within the convertibility band.



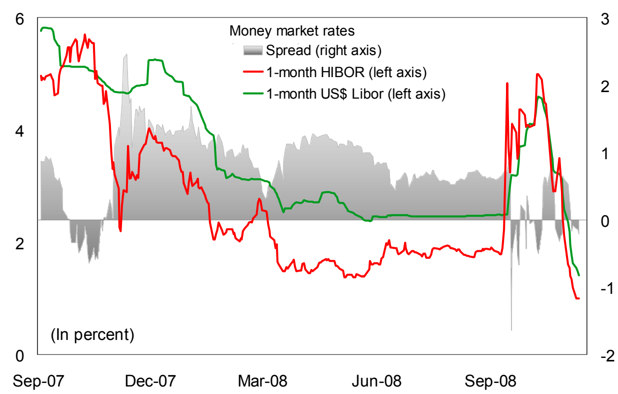
Sources: Bloomberg L.P.; Hong Kong Monetary Authority; CEIC Data Company Ltd.

10. ***Second phase***. Since late September, the dramatic increase in the intensity of the global crisis has resulted in a discernibly more potent pass through to local markets.

- On September 24, unfounded rumors of liquidity problems and losses from international exposures catalyzed a fleeting retail deposit run at the Bank of East Asia. This highlighted the fragility of investor confidence despite the sound fundamentals of the financial system.

- Shortly afterwards, as pressures built in international markets, Hong Kong interbank rates spiked upwards due to rising concerns over counterparty risk, higher risk aversion, and some degree of liquidity hoarding. The market for term interbank lending dried up with significant tiering among counterparties.

Interbank rates increased even beyond comparable U.S. dollar rates



- Equity markets recorded extraordinary volatility, falling a further 35 percent during September-October with sometimes double-digit daily percentage moves in the Hang Seng index. Short selling activity remained subdued throughout this period at around 7 percent of total market turnover.

- Rising risk aversion and liquidity preference precipitated a flight to quality. High quality collateral, such as the government's Exchange Fund Paper, became particularly valuable—not least because such instruments were potentially usable to access Hong Kong Monetary Authority (HKMA) lending facilities—and nominal interest rates on such instruments turned negative for several days.

- The spot exchange rate appreciated towards the strong side of the convertibility undertaking, hitting the band in late October and early November. Local currency interest rates remained high despite the capital inflows.

- Retail investors, who had suffered significant losses on complex financial products linked to Lehman Brothers (so-called "Minibonds"), staged street demonstrations against alleged mis-selling of such instruments by local financial institutions.

B. The Policy Response

11. ***An array of tools***. The government tackled the serious financial situation on multiple fronts, mobilizing a broad range of instruments, some already existing within its toolkit, others that were custom-designed for the contagion at hand:

- *FX intervention*. In September and October, the HKMA reacted to upward spikes in local interest rates by intervening within the exchange rate band, injecting HK$25 billion in liquidity through spot purchases of foreign currency. After nominal interest rates on Exchange Fund Paper remained negative for an extended period in October, the HKMA also announced an extraordinary issue of HK$4 billion in Exchange Fund bills. In addition, over the past two weeks, the HKMA undertook a combined HK$15½ billion spot purchase of U.S. dollars as the currency hit the strong side of the band.

- *Discount window*. The HKMA announced an enhancement of its discount window operations in late September to normalize conditions in interbank markets. Accepted collateral was expanded to include U.S. Treasury securities, maturities were extended to up to three months, and the rate for discount window borrowing was reduced (to 50 basis points above U.S. federal funds rates) and de-linked from interbank rates.

- *New facilities*. The HKMA also offered two new discretionary facilities, available upon request from licensed banks: foreign exchange swaps and a term lending facility that would provide Hong Kong dollar liquidity against approved collateral for up to three months.

- *Deposit guarantee and capital facility*. On October 14, the government announced a blanket guarantee of all customer deposits, including those of foreign bank branches, as well as a new contingent facility to provide capital to banks, upon request from the banks and subject to supervisory scrutiny. The form and terms of such capital injections will be decided on the basis of individual circumstances. Both will remain in place until end-2010, backed by the substantial resources of the Exchange Fund.

- *Supervision*. The HKMA and Securities and Futures Commission (SFC) stepped up their supervisory role, including greater monitoring of banks' liquidity risk management frameworks and contingency funding plans, an expanded scope for stress testing, and active supervision of local brokers, including through more on-site visits. The authorities have also initiated investigations into alleged misrepresentation of the risks associated with Minibonds. In the meantime, the banks that had marketed these products to retail investors have agreed to buy them back at market prices.

- *Mortgage purchase*. If there is renewed interest from local banks, the Hong Kong Mortgage Corporation stands ready to provide liquidity to the financial system through purchase of residential mortgages from bank balance sheets. To facilitate this, a fast-track procedure for such purchases has been instituted.

- *Insurance*. Hong Kong's insurance regulator ring-fenced the assets of the local subsidiary of AIG to protect local policyholders. The government also increased inspections of insurers and plans to establish a protection scheme for insurance policy holders in order to increase confidence. In addition, there are plans to convert the current insurance regulator into an independent and autonomous body, with increased staffing.

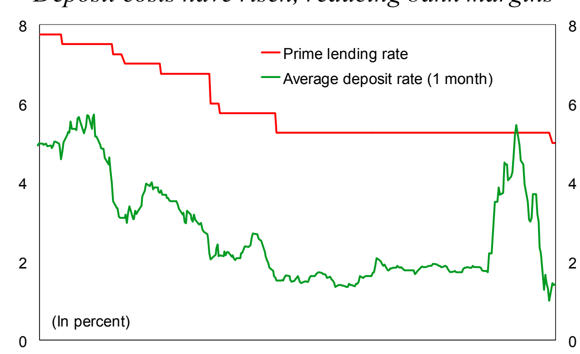
- *Task force*. The Chief Executive has formed a high-level task force, which he chairs, to follow developments in global markets, assess their impact on local and global markets as well as the local economy, and suggest policy options. Fund staff participated in the inaugural meeting of this group in early November.

12. ***Assessment***. The authorities and staff shared a common diagnosis of the underlying source of financial strains and fully agreed on the range of actions taken to counter global spillovers. The authorities rightly recognized that, while fundamentals in the Hong Kong financial system are strong, the current global climate presents a serious risk of self-fulfilling contagion to local markets. Hong Kong SAR has long had in place a comprehensive system for crisis management and has done extensive contingency planning to prepare for a range of possible scenarios. This allowed the authorities to move rapidly and preemptively to contain such contagion risks. The authorities have complemented their decisive actions with an effective communication strategy to reassure investors and clearly explain the rationale behind each new policy step.

C. The Outlook for the Financial System

13. ***Banks***. Despite the market volatility, Hong Kong banks remain profitable, liquid, and well capitalized. Loan-to-deposit ratios average 60 percent, among the lowest in the region, average capital is 14 percent of risk-weighted assets (Tier 1 capital is 11 percent of risk-weighted assets), and liquid asset holdings make up 48 percent of total assets. In addition, banks' funding is predominantly through their extensive deposit base and they rely little on wholesale sources of funding. While some banks have incurred losses in U.S. subprime securities and structured assets, total exposure to such assets—as well as to special investment vehicles and monoline insurers—remains low (well below ½ percent of banking system assets). Looking forward, there was broad consensus that

Deposit costs have risen, reducing bank margins



Sources: Bloomberg L.P.; and staff estimates.

banks will face pressure on profits from declining margins between funding costs—which are invariably linked to interbank rates—and loan rates as well as the loss of fee income from a decline in both IPOs and wealth management business. Credit quality will likely decline in the coming months, a result of the slowing domestic economy. However, at present, these pressures look manageable for the banking system as a whole. The HKMA has undertaken extensive stress testing and, even under an extremely stressed scenario (whereby property and equity values fall by around one-half, bank financing costs rise substantially, and growth is below that seen during the Asia crisis), no bank will see its capital fall below 8 percent of risk-weighted assets (although some banks will suffer losses).

14. ***Credit***. While credit expanded rapidly in 2007 as a result of equity-related lending, much of that has now been unwound. In discussions with the private sector, it seemed that a marked credit crunch is now evolving in Hong Kong SAR although, so far, this view appears largely based on anecdotal information with official data not yet available. Increased risk aversion, rising liquidity preference, and concerns over the real economy are leading financial institutions to consolidate their balance sheets and cut back on new credit to consumers, corporates, and even other financial institutions. This is affecting both local entities and Hong Kong companies operating in Mainland China. It is difficult to predict how long this phenomenon will continue but there was a general sense that it would be well into next year before some normalization of lending behavior gets underway.

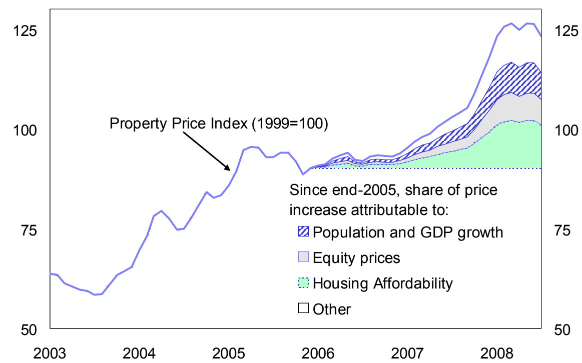
15. ***Equity markets***. The equity markets and the related trading and settlement systems have worked effectively despite sometimes extraordinary volatility. There is already a prohibition on naked short selling and an uptick rule in place. The authorities believed there was no reason to modify the current system or introduce additional restrictions on short-selling but were continuing to carefully track short selling activity to identify potentially destabilizing activity. Staff agreed with this measured approach.

16. ***Asset management***. Hedge funds and wealth managers make up a sizable part of the Hong Kong financial system with assets under management at end-2007 of around US$830 billion. Private banking, corporate fund advisory, and REITs add a further US$400 billion to this total. Discussions with private participants indicate that Hong Kong hedge funds are, on the whole, not highly leveraged and have built significant cash positions to meet redemptions. Nonetheless, the funds as a group have performed poorly over the past year and withdrawals should be expected going forward, which may put some pressure on the local financial system. However, the lack of comprehensive data on these funds makes it difficult to predict the channels by which such spillovers may emerge.

17. ***Property***. Hong Kong real estate prices have risen 30 percent over the past three years. The staff's assessment, which is shared by the authorities, is that the bulk of this increase can be explained by the fundamentals of a strong local economy, low real mortgage rates, and rising rental costs. This implies that, as those fundamentals weaken, average property values will move downward. Recent declines in the Hang Seng property index and a

declining number of transactions—both of which have historically been lead indicators of property market trends—support this view. Declining property prices will depress new construction, adding to the downward pressure on growth. In addition, they may present a further risk to bank balance sheets, given that around one-half of Hong Kong bank lending is property-related. Mitigating this risk, however, is the fact that even at the post Asian financial crisis peak, when a sizable share of homeowners had negative equity, default rates on residential mortgages were less than 3 percent. Since then, loan-to-value ratios for property lending have been managed conservatively. In addition, property developers, which account for around one-half of all property lending, have manageable financing needs over the next few years and substantial rental income to provide them with a stable source of liquidity.

Staff's models indicate three-quarters of the increase in property prices is explained by fundamentals



Sources: CEIC Data Co., Ltd.; and staff estimates.

III. The Role of Macroeconomic Policies

18. ***The need for a macroeconomic policy response***. The financial policies taken to stem the crisis have been effective but can only prevent dislocation and disorderly adjustment in local financial markets, not resist movements in asset prices as they adjust to their new equilibrium. At this point, the shockwaves to growth from financial and trade channels are largely unavoidable and will have significant, albeit uncertain, fallout for the Hong Kong economy well into 2009. There was agreement that, in addition to expanding its financial policy tools, the government would need to make full use of the macroeconomic policies at its disposal as a countervailing force to the deteriorating external environment.

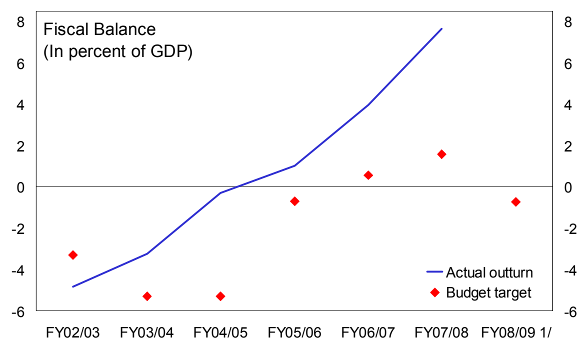
19. ***The scale of fiscal stimulus***. There is certainly room in the near term for discretionary fiscal stimulus to guard against the emerging growth slowdown. While monetary conditions—imported from the United States—are currently supportive, staff and the authorities recognized that broader financial conditions were much tighter. The large fiscal stimulus intended for the current fiscal year, if realized, will provide a welcome impetus. There was a shared view that the risks to growth should predominate in the setting of fiscal policy and that there were negligible downside risks to erring on the side of too much fiscal stimulus, given the strong financial position of the public sector (net reserves of the government are almost 30 percent of GDP). Staff argued that the fiscal position for the 2009/10 fiscal year should remain expansionary with the government targeting either fiscal balance or a modest deficit in the upcoming budget. This would yield a moderate fiscal impulse of around 1 percent of GDP. The authorities noted it was still early in the budget

preparation cycle but that it would be a difficult budget year. However, at this stage, it seemed that a stimulus of the order suggested by staff was probably appropriate.

20. ***Structure of the stimulus***. The 2008/09 fiscal package and the July 2008 supplement contain many measures that merit support. The increase in government investment in transport infrastructure will be essential to better integrate Hong Kong SAR with the mainland, opening up opportunities for both economies. The introduction of free secondary school education and establishment of a university-level research endowment will further innovation and raise educational standards, meeting the increasing demand for skills. In addition, increased social assistance to low income households and the elderly appears to be well targeted and will help protect vulnerable groups. Staff, however, believed that the temporary waiver of income taxes, property taxes, and rates, as well as the transfers to individual electricity accounts and the rent reductions for the 50 percent of the population that live in public housing were likely to benefit mostly middle-income groups and may do little to spur domestic demand. The mission advocated, instead, taking a more medium-term perspective in the 2009/10 budget, favoring fiscal stimulus through an acceleration of infrastructure spending and a reduction in direct tax rates rather than an extension of the temporary measures that were introduced over the past two fiscal years.

21. ***Fiscal anchor***. The budget's very conservative forecasts—understandable given the volatility of fiscal revenues—have under-predicted the fiscal surplus by a large margin over the past several years. This year, it appears that at most a modest overperformance is likely, given weaker growth and asset price declines. However, there remains some confusion among analysts as to what the likely fiscal outcome will be. As a result, official projections provide little anchor for expectations, complicating private sector planning. This is of particular importance given that the fiscal position is the primary discretionary policy tool available to the government. Staff argued that, given recent measures to reduce underlying revenue volatility, the government should begin publishing official intra-year forecasts of the fiscal outturn. This would be important, particularly at the current juncture, to guide expectations on the degree of stimulus that is likely in the coming year and, ultimately, to increase the effectiveness of fiscal policy.

Annual budget targets have consistently underestimated actual outturns in recent years.



Sources: CEIC Data Co., Ltd.; and staff estimates.
1/ Budget target includes the effect of fiscal stimulus package.

IV. Recent Competitiveness Trends

22. ***Developments***. Over the past year, the Hong Kong dollar has depreciated around 2−3 percent in both real and nominal effective terms, alongside the depreciation in the U.S. dollar. During this same period, the terms of trade have deteriorated modestly, reflecting rising costs of imported food and fuel. Other factors that influence the underlying equilibrium exchange rate—including productivity and economic structure—have moved relatively little.

23. ***Exchange rate assessment***. On balance, the Hong Kong dollar continues to be valued broadly in line with fundamentals (Box 1). The current account surplus is consistent with Hong Kong's demographic structure and status as a financial center and the net external asset position, while large (at 250 percent of GDP), has been relatively stable. In addition, intervention in foreign currency markets has been relatively modest (US$7 billion over the past three years) and reserve growth has been largely a product of the accrued returns on assets and the accumulated fiscal surpluses. The authorities concurred with this assessment. It was also clear, in discussions with both the government and the private sector, that the Linked Exchange Rate System continues to work well, acting as an important anchor of monetary and financial stability.

V. Adjusting to Longer Term Structural Changes

A. Maintaining the Flexibility to Adapt to Shocks

24. ***Motivation***. Hong Kong SAR is currently approaching decision points on two important reforms that will shape the economy's ability to adapt to shocks well into the medium term. First, as a result of prospective demographic trends and rising costs, changes to the current system of healthcare provision and financing are now needed. Second, increasing inequality has prompted a decision to adopt a minimum wage.

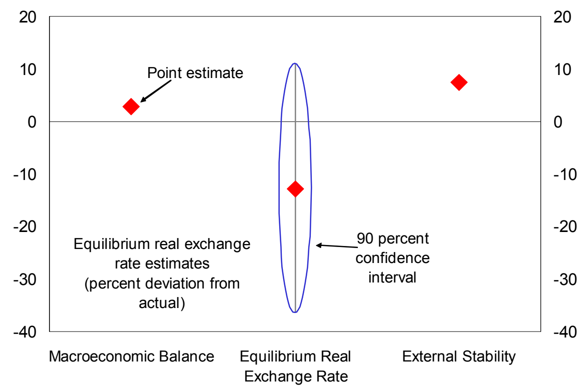
What are the Implications of Healthcare Financing Reform?

25. ***Background***. At present, the public sector covers, from general revenues, nearly 56 percent of total health costs (around 2.9 percent of GDP) and almost 90 percent of the costs of in-patient care. There is insufficient attention paid to preventative care and little price-based rationing through co-payments, particularly for hospital care. Without action, spending on healthcare is projected to almost double to 5½ percent of GDP by 2035 and to 9 percent of GDP by 2050. Continuing with the current health system will lead not only to a worsening quality of services, which will be mostly incident on the elderly and lower income groups, but also an unsustainable burden on the fiscal accounts.

26. ***Reform options***. In March of this year, the government released a consultation paper that laid out the various alternatives to improve cost effectiveness, increase private provision, and shift a greater share of healthcare financing to individuals (Box 2).

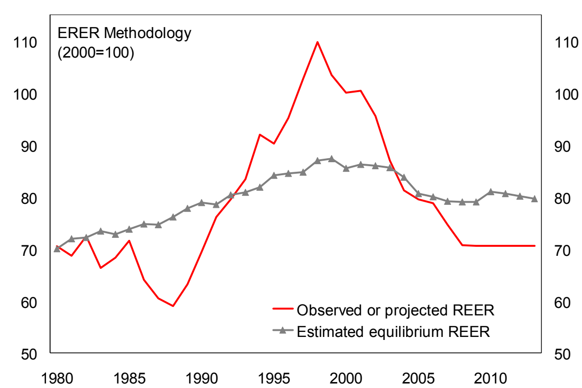
Box 1. Hong Kong SAR: Empirical Assessment of the Exchange Rate

Empirical estimates indicate that the current value of the Hong Kong dollar is neither meaningfully above or below the level suggested by medium-term fundamentals.



Three alternative approaches were employed to assess the current level of the Hong Kong dollar.[1/] These assessments are based on a cross-section of international financial centers. Like Hong Kong SAR, these service-oriented economies have high saving rates, reflecting low dependency ratios, and are largely driven by investments in human rather than physical capital. They are, therefore, the appropriate set of comparator countries to use. However, the findings are broadly unchanged if one benchmarks Hong Kong SAR against a full sample of advanced and emerging economies.[2/]

Under the ***macroeconomic balance approach***, estimates suggest that the medium-term current account equilibrium is a surplus of the order of 8½ percent of GDP, reflecting a low dependency ratio and high net foreign asset position. This suggests that the Hong Kong dollar is around 3 percent overvalued in real effective terms. However, once one accounts for the uncertainty surrounding the size of trade elasticities, this point estimate has fairly low precision.



The ***equilibrium real exchange rate approach***, on the other hand, indicates the Hong Kong dollar is currently undervalued by around 13 percent although the uncertainty surrounding this point estimate is large.

Finally, the ***external sustainability approach*** suggests that the medium-term trade balance equilibrium consistent with the estimated, medium-term net foreign asset equilibrium is about 7½ percent of GDP. This is somewhat larger than the projected trade surplus (of 5 percent of GDP) and implies an overvaluation of the currency of around 7 percent.

[1/] Assessments are based on restricted panel regressions, estimated by the generalized method of moments, covering six international financial centers and using end-June 2008 as the reference period. See R. Guimarães Filho, N. Porter, and F. Vitek, "Exchange Rate Assessments for Financial Centers: Lessons from Hong Kong SAR and Singapore," IMF Working Paper (forthcoming) for more detail and a comparison with Singapore.

[2/] Point estimates from a broader sample of 55 advanced and emerging countries indicate an undervaluation of 4 percent under the macroeconomic balance approach and 9 percent using the equilibrium exchange rate approach. The external sustainability approach, on the other hand, suggests an overvaluation of 5 percent. All estimates have large error bands.

Box 2. Hong Kong SAR: Government Proposals for Healthcare Reform

The government has proposed a menu of reform options, drawing on international experience and outlining the relative advantages and disadvantages of each. It is likely the final reform proposal will involve a combination of the various alternatives.

Provision of primary care. Increase the emphasis on preventative care by leveraging the system of family doctors and offering subsidies via primary care vouchers; improve targeting of particular age, gender, and disease groups.

Private participation. Purchase primary care and some hospital services (e.g., cataract surgeries) from the private sector; engage private doctors in public hospitals; consider developing new hospitals under private-public partnerships.

Supplementary financing. Options include:

- *Social health insurance*. Mandatory contributions (of around 3−5 percent of earned income) to fund either publicly or privately-provided health insurance.
- *Higher out-of-pocket payments*. Reducing the level of public subsidy from 95 percent to 60 percent of costs by 2030 with fee waivers for low-income groups or those with chronic conditions.
- *Medical savings accounts*. Mandatory savings accounts (of a fixed share of earned income) that can be used for payment of health costs or private health insurance premiums.
- *Voluntary private health insurance*. Through an expansion of the current employer-provided and/or individually purchased private insurance.
- *Mandatory private health insurance*. To increase risk pooling, the scope of required coverage would be specified by law; contributions would be de-linked from income level.
- *Personal healthcare reserve (PHR)*. Mandatory contributions (of a fixed share of income) would be made into a PHR deposit that would fund (i) compulsory health insurance with a flat premium for all citizens and (ii) other out-of-pocket healthcare payments; PHR contributions would potentially be tax deductible; there would be a public safety net for those who have exhausted the funds in their PHR.

27. ***Assessment***. From a macroeconomic perspective, staff expressed concern that any voluntary financing scheme would lead to excessive consumption volatility and undersaving, particularly by lower income group in the early part of their working lives.[1] This ultimately could put renewed pressure on the fiscal accounts. Given that only around one-third of the labor force are in the income tax net, even full tax deductibility of healthcare-related savings would be an insufficient incentive to prevent such under-provisioning for future health costs. Therefore, staff believed it is likely that some form of mandatory scheme will be needed. In addition, the government would also need to continue to finance health coverage for those at the lower end of the income distribution as well as individuals with extraordinary healthcare needs. The authorities emphasized that they see the reform of healthcare financing as geared towards providing a supplement to the existing publicly financed scheme and that any changes would aim to preserve the freedom of choice of the current system. However, they noted that the consultation was at an early stage and, as it evolves, the proposals would become more concrete.

How Will a Minimum Wage Affect Hong Kong SAR's Flexible Labor Market?

28. ***Background***. Two years ago, amid growing concerns over a worsening income distribution, Hong Kong SAR introduced the Wage Protection Movement with a voluntary minimum wage for security guards and cleaners. It has become clear that the voluntary nature of the scheme made it rather ineffective. Therefore, the Legislative Council will soon consider a proposal to introduce a minimum wage for selected low-wage occupations.

29. ***Design of the minimum wage***. The mission underlined the importance of ensuring that any legislation to introduce a new minimum wage be designed in a way that maintains the ability of Hong Kong's labor markets to adjust to shocks.

- *Level of the minimum wage*. The higher the level of minimum wage, the larger the impact on macroeconomic and employment volatility as quantities are forced to adjust to changing conditions, rather than wages and prices. Staff simulations[2] suggest that raising the coverage of the minimum wage would noticeably amplify swings in employment and output.

- *Adjustment mechanism*. Staff noted that any discretionary adjustment scheme—such as that decided by a minimum wage council—would find it difficult to reduce the minimum wage in the face of an economic downturn, as may be necessary. Staff simulations indicate that maintaining a fixed nominal minimum wage or indexing it to

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[1] See D. Botman and N. Porter, "The Macroeconomic Impact of Healthcare Financing Alternatives: Reform Options for Hong Kong SAR," IMF Working Paper (forthcoming).

[2] See N. Porter and F. Vitek, "A Structural Analysis of the Effects of Introducing a Minimum Wage in Hong Kong SAR," IMF Working Paper (forthcoming).

the consumer price index would put a greater burden of adjustment on employment flows. Automatically adjusting the minimum wage alongside changes in average wages or unit labor costs would generate relatively less volatility.

- *Coverage*. The mission fully supported the government's decision to extend the minimum wage to the whole economy, rather than confining it to specific professions. The latter approach would result in distortions to the low-income labor market and create incentives for evasion of the minimum wage requirement.

- *Supplemental schemes*. The mission argued for initially setting the minimum wage conservatively and assessing its macroeconomic and social implications. If needed, consideration could be given to supplementing a lower minimum wage with additional support for the working poor through the social assistance system. The relatively narrow coverage of the income tax system would probably argue against any form of tax-related support (such as an earned income tax credit).

The authorities noted that there had, as yet, been no decision on either the design or level of the minimum wage. The next few months would be spent intensively improving the quality of the data on the economic conditions of the working poor. The government will establish a Minimum Wage Commission—drawing from unions, business, academia, and the government—which will consider this data and make recommendations on the design of the system during the course of the current legislative session.

B. Reacting to Economic Change in the Pearl River Delta

30. ***Background***. At the center of the major structural changes over the past decade has been a growing integration with the Pearl River Delta region of Mainland China (PRD). Manufacturing capacity has been mostly shifted into the PRD and Hong Kong SAR has, instead, leveraged its comparative advantages to provide services such as logistics, merchandizing, and finance to PRD enterprises (around 50 percent of all outward FDI went to the PRD during 2001−06). Guangdong province has also become a major source of imports for Hong Kong SAR.

31. ***Recent trends***. There was a uniform sense from both private and public sector counterparts that changes in the PRD are moving quickly. Low value-added, labor-intensive producers are being crowded out by rising labor costs, stricter enforcement of labor rights, and more rigorous environmental standards. The broader global economic slowdown is now accelerating this adjustment process. The direct spillovers from these rapid changes in PRD

put additional pressure on Hong Kong SAR to adapt and ensure that the economic benefits of integration are maximized while associated risks are avoided. Staff saw the main issues as:[3]

- *Infrastructure*. Much of the economic development in PRD has been concentrated in the eastern region closest to Hong Kong SAR. Expanding communications networks offers significant potential for further growth for both Hong Kong and the Mainland. The government's efforts to further improve infrastructure linkages with the PRD are commendable.

- *Business environment*. Frictions in customs approvals and border traffic are an obstacle to further integration. On the other hand, the authorities are making efforts to put in place investment policies—including through expansion of the Closer Economic Partnership Agreements—that will allow Hong Kong firms to raise their share of domestic Mainland sales and more seamlessly transact across the border.

- *Pollution*. The rising pollution spillovers from rapid industrialization in the PRD threaten to undermine the benefits from further integration. Greater cross-border efforts are needed to reduce pollution.

- *Human capital*. Staff argued for further steps to invest in tertiary education and to open Hong Kong's universities to more Mainland students in order to help sustain the local skills base and build a pool of well-trained professionals with knowledge of both the Hong Kong and PRD economies.

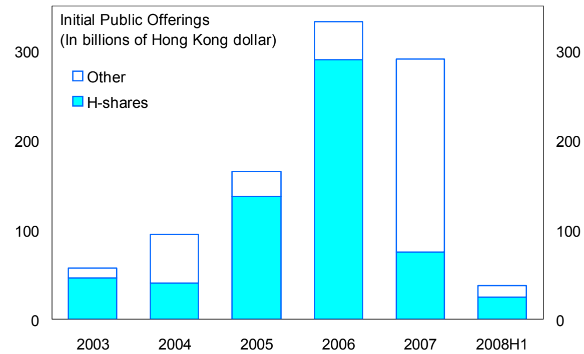
- *Financial integration*. The shifts in trade and goods markets and real sector interactions with the Mainland have catalyzed financial integration. However, in part due to the volatility in global financial markets, progress along certain dimensions has slowed of late (Box 3). Staff saw continued and steady financial integration with the Mainland as essential, particularly if global financial systems shrink in the coming years. It was clear that the authorities remain fully committed to making further progress in this area.

[3] See H. Chen and O. Unteroberdoerster, "Hong Kong SAR Economic Integration with the Pearl River Delta," IMF Working Paper (forthcoming).

Box 3. Hong Kong SAR: Financial Integration with the Mainland

Following progress along several fronts in 2007, the momentum for increased financial integration has slowed somewhat, partly a result of policy but mainly due to the downturn in international capital markets.

Equity markets. The listing of Mainland firms has grown rapidly since 2002 and now accounts for over 50 percent of both stock market turnover and market capitalization. However, the pace of new equity issuance has fallen in 2008, largely as a result of unfavorable global market conditions.



Source: Securities and Futures Commission.

Renminbi deposits. Renminbi deposits have grown rapidly but are still a relatively small share of total deposits. Demand has been somewhat restrained by an increase in the bid-ask spreads charged by the authorized clearing bank that handles these deposits and the HK$20,000 per day limit on deposit conversion. Growth has slowed more recently due to expectations of a slower pace of Renminbi appreciation.

Qualified domestic institutional investors. While US$64 billion has been approved under the QDII scheme, only around one-half of that quota has been invested. Information on fund managers indicates that the bulk of QDII flows are invested in Hong Kong SAR listed equities. However, negative returns on these funds since their inception has cooled demand and led to a sluggish uptake of the QDII quota.

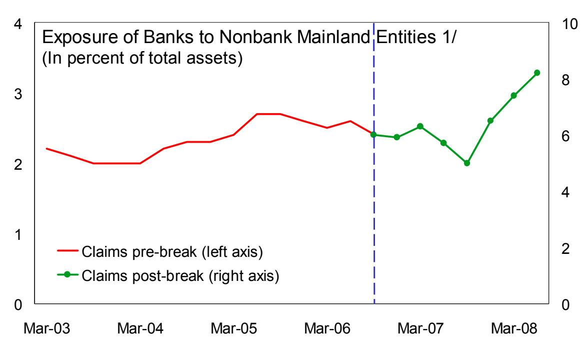
Investment of QDII Fund Managers

Fund Name	Outstanding Value 1/ (RMB billions)	Returns (In percent) 2007	2008 2/
Harvest Overseas	10.1	-12.1	-62.8
China Southern International Selection Allocation	16.2	-6.3	-50.4
China AMC Global Selection	16.5	-10.7	-55.0
Sitico Morgan Priority Equity Investment	14.2	-15.0	-66.1
Total value/average return	57.0	-10.8	-57.8

Source: Websites of each individual Funds.

1/ As of end-September 2008.
2/ From issuing date to October 2008.

Banks. Integration through the banking system has been proceeding at a fast pace. Aggregate exposure of Hong Kong SAR banks to nonbank Mainland entities is now 8 percent of assets, as banks have expanded their branch network and opened new subsidiaries on the Mainland. Second tier Mainland banks are also showing increasing interest in using Hong Kong SAR as a portal to develop their overseas business.



Source: CEIC Data Co., Ltd.
1/ From September 2006, the authorities revised their definition to more accurately capture China exposure.

VI. Staff Appraisal

32. ***Macroeconomic outlook***. Growth should fall noticeably in the coming months. The slowdown will be reflected in labor markets and unemployment will rise across the course of the next year or more. Declining asset prices will add to the drag on economic growth. The easing of domestic demand and declining food and fuel prices should mean that consumer price inflation falls below 3 percent next year.

33. ***Risks***. The foremost macroeconomic risk is the turbulence that is still unfolding in international financial markets. While asset prices have adjusted downwards, the domestic financial system has proved itself resilient. Nevertheless, in the current environment, complacency would be a mistake and the authorities will need to be prepared to act expeditiously should global market volatility further disrupt the workings of the local financial system or if the negative impact on Hong Kong's growth prospects becomes more profound.

34. ***Banking sector***. All available indicators suggest that Hong Kong's banking system remains sound. Bank credit portfolios will probably worsen in the coming months and credit growth will slow sharply. Hong Kong's banks have, however, managed risk prudently, provisioned for losses, and are well positioned to handle a worsening in credit quality. The authorities are fully prepared to act decisively if necessary. In this regard, the announcement of a time-bound, blanket deposit guarantee and a contingent facility, that can be activated in the event there is a need to provide capital to Hong Kong banks, was fully warranted in the current extraordinary global circumstances.

35. ***Interbank markets***. Hong Kong's interbank markets have faced heightened stress since late September. In large part, this reflects conditions in offshore, (particularly United States) markets, an increase in global risk aversion, and concern over counterparty risk. The HKMA's actions to increase the attractiveness and flexibility of its facilities to provide liquidity support under extraordinary circumstances were fully appropriate. Along with steps taken in other jurisdictions, these measures have begun to restore the workings of local interbank markets, although term lending has yet to normalize. Nevertheless, the scope to affect Hong Kong dollar interest rates is limited and interbank rates will continue to be largely determined by external conditions.

36. ***Exchange rate regime***. The mission continues to support the Linked Exchange Rate System. It is a simple, transparent exchange rate arrangement that has, over the past 25 years, proved to be an anchor of monetary and financial stability in Hong Kong SAR.

37. ***Financial stability***. The financial system has performed well, without significant market dislocation. The authorities have taken various steps to bolster stability and these have been carefully considered and calibrated to the situation at hand. This resilience is no accident. Over the past several years, the government has steadily established a more robust system of financial supervision and regulation and a sophisticated financial infrastructure. The ability of the regulatory authorities to step up their supervisory activities in recent

months has been impressive. In addition, the substantial attention to contingency planning and the authorities' continued willingness to look critically at their current system and explore areas for further improvement are now fully paying off.

38. ***The 2008/09 Budget***. Fiscal policy is the principal demand management tool available to the government. Given the clear downside risks and Hong Kong's healthy fiscal position, fiscal stimulus is warranted. The 2008/09 Budget and the supplementary package of measures introduced in July should help guard against a more dramatic economic slowdown. The emphasis on improving infrastructure to better integrate Hong Kong SAR with the Mainland economy will provide long-term benefits. Similarly, investing in human capital through free secondary school education and support to university level research will help meet the future demand for skills. Finally, the provision of timely and targeted social assistance to the elderly and lower income groups is welcome, particularly given the elevated costs of basic foodstuffs.

39. ***The 2009/10 Budget***. Continued fiscal stimulus will be needed in the upcoming budget. The government should target budget balance or a small fiscal deficit for the year as a whole. The one-off measures of the past couple of years have run their course and should be allowed to expire. Instead, the time has come for a more fundamental evaluation of the revenue needs of the government, the appropriate tax structure, and the likely fiscal outlays over the medium term. Such a medium-term perspective would lead to providing the needed stimulus through an acceleration of infrastructure investments and possibly a permanent reduction in direct tax rates. Further adjustments to the tax structure will likely need to be considered in the coming years. There is also merit in the government providing updated fiscal forecasts during the course of the year in order to guide expectations, helping to increase the effectiveness of fiscal policy.

40. ***Healthcare***. The authorities have rightly recognized that continuing indefinitely with the current healthcare system is simply not tenable. Doing so will result in a worsening quality of care that will be particularly incident on lower income groups and on the older members of Hong Kong's population. In addition, without change, healthcare will place an unsustainable burden on public finances, crowding out needed spending or necessitating a large increase in the tax burden. Any reform would need to tackle three broad areas: to ensure cost containment and efficient provision of services; to discourage unnecessary spending through some form of user fees or other price-based rationing; and, if an increase in the tax burden is to be avoided, to revise the healthcare financing model such that a significantly larger share of the final cost, particularly for in-patient care, is picked up by the private sector. From a macroeconomic perspective, some form of mandatory scheme will be required. Voluntary schemes run the risk of under-provision for future health costs and greater volatility in consumption, particularly for lower income groups. An integral part of any reform should be to maintain public support for those with chronic illnesses, with disabilities, or who have incomes that are insufficient to generate enough savings to cover their healthcare needs.

41. ***Competitiveness***. Both quantitative models and macroeconomic indicators indicate that the Hong Kong dollar continues to be valued broadly in line with economic fundamentals. The current account surplus is consistent with Hong Kong's position as an international financial center with a reliance on services and a rapidly aging demographic profile. The level of the currency is not the only factor determining long-run competitiveness. Hong Kong SAR has continuously been able to innovate in various areas of the services industry, steadily raising productivity as a result. In addition, recent progress in moving towards the adoption of a new competition law that is in line with international best practice will help enhance competitiveness.

42. ***Minimum wage***. Rising income inequality and a relatively high share of the population in lower wage occupations make it natural that society should consider the introduction of a minimum wage. It is appropriate to make the minimum wage legislation uniform across employment groupings. Any minimum wage should be set at a level to protect lower income workers without unduly damaging their employment prospects. Achieving this balance will be greatly helped by the government's efforts to improve the data on low wage labor markets, in order to better understand the structure of the existing wage distribution. To provide greater employment stability, the authorities should consider a simple, automatic scheme to adjust the minimum wage over time, based on changes in relevant indicators such as wages or unit labor costs. In addition, the minimum wage could be complemented by additional social assistance for the working poor, to better support lower income groups while mitigating some of the rigidities that may be associated with a minimum wage.

43. ***Developments in the Pearl River Delta***. A broader expansion of communications and infrastructure offers significant potential for further growth and development in the region. Recent announcements to improve transport linkages and allow Hong Kong companies to increase their activities in the Mainland will allow that potential to be realized. At the same time, obstacles such as congestion at customs control points, border traffic, as well as rising pollution threaten to undermine future prospects. Coordinated efforts will be needed to minimize these risks and provide a stable and predictable policy environment. In addition, further investments in tertiary education and in opening Hong Kong's universities to Mainland students will help sustain the local skills base and build a pool of well-trained professionals with knowledge of both Hong Kong SAR and the Pearl River Delta.

44. ***Financial integration***. Much headway has been made in recent years. While conditions in international capital markets are difficult, the authorities should continue to find opportunities to move the process forward, to capitalize on Hong Kong SAR's first-mover advantage, and to allow it to play a catalytic role in the modernization of the Mainland's financial system and its integration with global capital markets.

45. It is recommended that the next Article IV consultation discussions take place on the standard 12-month cycle.

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 2005–09 1/

Nominal GDP (2007): US$207.2 billion
Main domestic goods exports (percent of total, 2007): textiles and clothing (39); electronic products (18)
GDP per capita (2007): US$29,914
Unemployment rate (2007): 4.0 percent
Net FDI (2007): US$ 6.7 billion
Public debt (2007): 1.3 percent of GDP
Foreign public debt (2007): 0.8 percent of GDP

	2005	2006	2007	2008	2009
				Staff proj.	
Real GDP (percent change)	7.1	7.0	6.4	3.7	2.0
Contribution					
Domestic demand	1.4	5.2	6.9	4.2	2.4
Private consumption	1.8	3.5	4.6	1.5	1.1
Government consumption	-0.3	0.0	0.2	0.7	0.4
Gross fixed capital formation	0.9	1.5	0.9	2.0	0.9
Inventories	-0.9	0.2	1.2	0.0	0.0
Net exports	5.6	1.8	-0.5	-0.4	-0.4
Inflation (percent change)					
Consumer prices	1.0	2.0	2.0	3.9	2.7
GDP deflator	-0.1	-0.3	3.0	5.6	1.2
Employment (percent change)	1.9	1.9	2.4	1.3	0.2
Unemployment rate (percent, period average)	5.6	4.8	4.0	3.6	4.3
Real wages	-0.4	-0.3	0.5	…	…
Government budget (percent of GDP) 2/					
Revenue	17.9	19.5	22.2	18.2	17.5
Expenditure	16.9	15.4	14.5	18.2	17.6
Consolidated budget balance	1.0	4.0	7.7	0.0	-0.1
Fiscal reserves as of March 31	22.5	25.0	30.5	27.7	26.6
Money and credit (percent change, end-period)					
Narrow money (M1)	-10.3	13.1	25.4	...	...
Broad money (M3)	5.2	15.5	20.6	...	...
Loans for use in Hong Kong SAR	7.7	2.3	15.2	...	...
Interest rates (percent, end-period)					
Best lending rate	7.8	7.8	6.8	...	...
Three-month HIBOR	4.2	3.8	3.3	...	...
Asset prices					
Hang Seng stock index (period average, 1964=100)	14,344	16,880	23,172	...	...
Hang Seng stock index (percent change)	11.0	17.7	37.3	...	...
Residential property prices (percent change)	17.9	0.8	11.7	...	...
Merchandise trade (percent change)					
Export volume	10.4	9.3	7.0	3.9	2.2
Import volume	8.0	9.2	8.8	4.7	2.8
External balances (percent of GDP)					
Merchandise trade balance (in billions of US$)	-7.6	-14.0	-19.7	-22.1	-26.7
Merchandise trade balance	-4.3	-7.4	-9.5	-9.7	-11.4
Domestic exports	9.9	9.4	7.3	6.9	6.9
Re-exports	153.0	157.8	159.7	161.8	163.0
Imports	167.2	174.6	176.5	178.5	181.3
Current account	11.4	12.1	13.5	12.5	11.2
Foreign exchange reserves 3/					
In billions of U.S. dollars, end-of-period	124.3	133.2	152.7	158.6	163.8
In months of retained imports	19.8	18.6	19.5	18.3	17.6
In percent of broad money (M3)	21.9	20.3	19.4	...	...
Exchange rate					
Linked rate (fixed)					
Market rate (HK$/US$1, period average)	7.777	7.768	7.801	...	...
Real effective rate (period average, 2000=100) 4/	79.5	78.7	74.6	...	...

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

1/ Unless otherwise stated, all growth rates are for year-on-year.
2/ Authorities' FY 2007/08 budget estimates.
3/ Includes Land Fund assets from 1997 (US$17.5 billion at end-1997).
4/ IMF Staff estimates.

Table 2. Hong Kong SAR: Consolidated Government Account, 2005/06–2012/13 1/

(In percent of GDP, unless otherwise stated)

	2005/06	2006/07	2007/08	2008/09 Budget 6/	2008/09 Proj.	2009/10 Staff projections	2010/11	2011/12	2012/13
Revenue	17.9	19.5	22.2	17.8	18.2	17.5	17.7	18.4	18.8
Taxes	12.7	12.8	14.2	10.7	13.0	...	...	...	...
Direct taxes	8.1	7.8	8.3	6.5	6.2	...	...	...	...
Of which:									
Salaries tax	2.7	2.6	2.3	1.5	...	...	...	...	...
Profits tax	5.0	4.9	5.7	4.8	...	...	...	...	...
Indirect taxes	4.6	4.9	6.0	4.2	…	…	…	…	…
Nontax	5.2	6.8	7.9	7.0	5.2	...	...	...	...
Of which:									
Land premium	2.1	2.5	3.9	2.5	1.1	...	...	...	...
Investment income	0.8	2.0	1.7	2.5	2.5	2.3	2.1	2.1	2.3
Expenditure	16.9	15.4	14.5	18.5	18.2	17.6	16.9	16.3	16.4
Current 2/	13.9	13.1	12.8	15.2	15.3	13.9	13.6	13.4	13.6
Capital	2.9	2.4	1.8	3.3	2.9	3.7	3.3	2.9	2.8
Overall balance	1.0	4.0	7.7	-0.7	0.0	-0.1	0.8	2.2	2.4
Memorandum items:									
Operating balance 3/	0.9	2.7	-0.9	-0.9	0.3	0.3	1.0	1.9	2.1
Primary balance 4/	0.3	2.0	5.9	-3.2	-2.4	-2.4	-1.3	0.1	0.1
Structural balance 5/	-1.9	0.1	1.6	...	-1.9	-3.1	-2.6	-2.1	-1.8
Fiscal reserves	22.5	25.0	30.5	27.7	27.7	26.6	26.3	27.1	27.7
(Months of spending)	16.0	19.3	25.2	17.9	18.3	18.1	18.7	20.0	20.3

Sources: Hong Kong SAR authorities; and staff estimates.

1/ Fiscal year begins on April 1.
2/ This refers to the authorities' measure of operating expenditure.
3/ Operating balance, as defined by the authorities, is akin to the current balance.
4/ Balance excluding investment income.
5/ Staff estimate used to measure the impact of fiscal policy on domestic demand. It excludes asset transactions and cyclical fluctuations.
6/ The "budget estimate" includes the assumed impact of the fiscal stimulus package announced in July 2008. The FY 2008/09 budget includes a HK$26.5 billion transfer to endow a research fund and supplement MPF contributions, as well as HK$22.6 billion in capital spending that will be spent in subsequent years. Excluding these items would bring the overall balance to a surplus of around 2.0 percent of GDP.

Table 3. Hong Kong SAR: Medium-Term Balance of Payments, 2005–2013

	2005	2006	2007	Projections 2008	2009	2010	2011	2012	2013
	(In billions of U.S. dollars)								
Current account	20.2	22.9	28.0	28.4	26.1	23.7	23.4	23.1	23.4
Goods balance	-7.6	-14.0	-19.7	-22.1	-26.7	-31.7	-35.9	-40.0	-43.9
Services balance	29.7	35.7	42.3	48.2	48.1	51.1	55.3	59.7	64.2
Income balance	0.2	3.5	8.0	5.3	7.9	7.7	7.7	7.9	8.3
Transfer balance	-2.1	-2.2	-2.6	-2.9	-3.1	-3.4	-3.7	-4.5	-5.2
Capital and financial account	-23.5	-27.0	-32.1	-24.4	-26.1	-23.7	-23.4	-23.1	-23.4
Capital account	-0.6	-0.4	1.4	1.3	1.2	1.1	1.1	1.1	1.0
Financial account	-22.8	-26.6	-33.5	-25.7	-27.3	-24.9	-24.5	-24.2	-24.4
Net direct investment	6.4	0.1	6.7	5.5	0.6	-3.7	-7.6	-11.4	-15.4
Inflow	33.6	45.1	59.9	61.7	59.6	60.5	61.4	62.3	63.2
Outflow	-27.2	-45.0	-53.2	-55.7	-58.2	-64.2	-69.1	-73.7	-78.6
Portfolio investment	-31.5	-26.7	4.7	-19.3	-17.6	-8.8	-4.5	-0.9	2.3
Financial derivatives	3.9	3.3	7.5	8.1	8.7	9.3	10.6	11.9	13.5
Other investment	-0.3	2.7	-37.7	-14.0	-13.8	-13.6	-14.1	-14.6	-15.2
Reserve assets (net change)	-1.4	-6.0	-14.7	-5.9	-5.2	-8.1	-8.8	-9.2	-9.7
Net errors and omissions	3.3	4.1	4.1	-4.1	0.0	0.0	0.0	0.0	0.0
	(In percent of GDP)								
Memorandum items:									
Current account	11.4	12.1	13.5	12.5	11.2	9.7	9.1	8.4	7.9
Goods balance	-4.3	-7.4	-9.5	-9.8	-11.4	-13.0	-13.9	-14.5	-14.8
Services balance	16.7	18.8	20.4	21.2	20.5	21.0	21.4	21.6	21.7
Income balance	0.1	1.9	3.9	2.3	3.4	3.2	3.0	2.8	2.8
Transfer balance	-1.2	-1.2	-1.2	-1.3	-1.3	-1.4	-1.4	-1.6	-1.8
Capital and financial account	-13.2	-14.2	-15.5	-10.8	-11.2	-9.7	-9.1	-8.4	-7.9
Capital account	-0.4	-0.2	0.7	0.6	0.5	0.5	0.4	0.4	0.4
Financial account	-12.8	-14.0	-16.2	-11.3	-11.7	-10.2	-9.5	-8.8	-8.2
Net direct investment	3.6	0.0	3.2	2.4	0.3	-1.5	-3.0	-4.1	-5.2
Portfolio investment	-17.7	-14.1	2.3	-8.5	-7.5	-3.6	-1.7	-0.3	0.8
Financial derivatives	2.2	1.8	3.6	3.6	3.7	3.8	4.1	4.3	4.6
Other investment	-0.2	1.4	-18.2	-6.2	-5.9	-5.6	-5.5	-5.3	-5.1
Reserve assets (net change)	-0.8	-3.2	-7.1	-2.6	-2.2	-3.3	-3.4	-3.3	-3.3
Net errors and omissions	1.8	2.2	2.0	-1.8	0.0	0.0	0.0	0.0	0.0

Sources: Hong Kong SAR authorities; and staff estimates.

Table 4. Hong Kong SAR: Medium-Term Macroeconomic Framework, 2005–2013

				Staff Projections					
	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP (percent change)	7.1	7.0	6.4	3.7	2.0	2.6	4.0	4.8	5.0
Contribution									
Real domestic demand	1.4	5.2	6.9	4.2	2.4	3.0	3.7	4.6	4.7
Private consumption	1.8	3.5	4.6	1.5	1.1	1.8	2.6	3.4	3.5
Government consumption	-0.3	0.0	0.2	0.7	0.4	0.5	0.2	0.2	0.1
Gross fixed capital formation	0.9	1.5	0.9	2.0	0.9	0.7	0.9	1.0	1.1
Inventories	-0.9	0.2	1.2	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	5.6	1.8	-0.5	-0.4	-0.4	-0.3	0.2	0.2	0.3
Output gap (in percent of potential)	0.0	1.7	2.8	1.7	-0.2	-1.5	-1.6	-0.9	0.0
Growth rates									
Real domestic demand	1.6	5.9	7.8	4.6	2.7	3.2	4.1	5.0	5.1
Private consumption	3.0	6.0	7.8	2.5	2.0	3.0	4.5	5.8	5.9
Government consumption	-3.2	0.1	2.3	8.7	4.4	5.6	2.0	2.2	1.6
Gross fixed capital formation	4.1	7.0	4.2	9.2	4.1	3.2	3.9	4.3	4.7
Saving and investment (percent of GDP)									
Gross national saving	31.9	33.8	34.8	34.6	34.2	33.0	32.3	31.5	30.8
Gross investment	20.6	21.7	21.3	22.1	23.0	23.3	23.3	23.1	22.9
Saving-investment balance	11.4	12.1	13.5	12.5	11.2	9.7	9.1	8.4	7.9
Inflation (percent change)									
Consumer prices	1.0	2.0	2.0	3.9	2.7	1.8	1.8	2.1	2.3
GDP deflator	-0.1	-0.3	3.0	5.6	1.2	1.5	1.8	2.1	2.3
Employment (percent change)	1.9	1.9	2.4	1.3	0.2	0.1	0.8	1.2	1.2
Unemployment rate (percent)	5.6	4.8	4.0	3.6	4.3	5.0	5.2	4.9	4.6
Real wages	-0.4	-0.3	0.5	...	...	...	...	...	...
Government budget (percent of GDP) 1/									
Revenue	17.9	19.5	22.2	18.2	17.5	17.7	18.4	18.8	18.8
Expenditure	16.9	15.4	14.5	18.2	17.6	16.9	16.3	16.4	16.4
Consolidated budget balance	1.0	4.0	7.7	0.0	-0.1	0.8	2.2	2.4	2.4
Accumulated fiscal reserves (end-year)	22.5	25.0	30.5	27.7	26.6	26.3	27.1	27.7	28.4
Merchandise trade (percent change)									
Export volume	10.4	9.3	7.0	3.9	2.2	2.9	4.1	5.1	4.9
Of which: Re-exports	10.7	9.7	8.6	4.2	2.3	3.0	4.3	5.2	5.0
Import volume	8.0	9.2	8.8	4.7	2.8	3.5	4.5	5.5	5.3
Export value	11.1	9.6	9.4	10.7	3.9	4.8	6.2	5.1	4.9
Import value	10.1	11.5	10.7	10.8	4.9	5.7	6.7	5.5	5.3
External balances (in billions of US$)									
Trade balance	-7.6	-14.0	-19.7	-22.1	-26.7	-31.7	-35.9	-40.0	-43.9
In percent of GDP	-4.3	-7.4	-9.5	-9.7	-11.4	-13.0	-13.9	-14.5	-14.8
Exports of goods	290	318	346	383	398	417	443	465	488
Imports of goods	297	332	366	405	424	448	479	505	532
Current account	20.2	22.9	28.0	28.4	26.1	23.7	23.4	23.1	23.4
In percent of GDP	11.4	12.1	13.5	12.5	11.2	9.7	9.1	8.4	7.9
Foreign exchange reserves (end-year)	124.3	133.2	152.7	158.6	163.8	171.9	180.7	189.9	199.6
In percent of GDP	69.9	70.1	73.7	69.9	70.0	70.5	70.1	68.8	67.3

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

1/ The budget numbers refer to the fiscal year (April through March).

Table 5. Hong Kong SAR: Vulnerability Indicators

	2000	2001	2002	2003	2004	2005	2006	2007	2008-Latest	
Public sector										
Fiscal deficit (in percent of GDP)	-0.6	-4.9	-4.8	-3.2	1.7	1.0	4.0	7.7	-2.8	Sep.
Accumulated fiscal surplus (in percent of GDP)	32.7	28.7	24.4	22.3	22.9	22.5	25.0	30.5	25.7	Sep
External sector										
Total export volume (percent change)	16.9	-3.3	8.6	14.0	14.9	10.4	9.3	7.0	4.4	Jun.
Domestic exports	7.2	-10.2	-11.0	-6.9	2.2	6.1	3.0	-19.3	-22.3	Jun.
Re-exports	18.3	-2.4	10.9	15.9	15.8	10.7	9.7	8.6	5.6	Jun.
Total import volume (percent change)	18.4	-1.9	7.9	13.1	13.7	8.0	9.2	8.8	4.9	Jun.
Current account (in billions of U.S. dollar)	7.0	9.8	12.4	16.5	15.7	20.2	22.9	28.0	4.4	Jun.
Net equity inflow (in billions of U.S. dollar)	29.4	-23.5	-14.4	-4.2	-28.5	-18.0	-1.1	-17.8	12.6	Jun.
Gross official reserves (in billions of U.S. dollar)	107.6	111.2	111.9	118.4	123.6	124.3	133.2	152.7	160.6	Sep.
In months of retained imports	18.0	20.4	22.6	23.3	21.2	19.8	18.6	19.5	19.1	Jun.
In percent of monetary base	388.7	377.0	354.0	314.6	325.7	340.1	354.7	394.3	359.6	Sep.
In percent of broad money 1/	23.0	24.4	24.8	24.2	23.1	22.1	20.5	19.5	20.7	Sep.
In percent of Hong Kong dollar M3	41.9	43.0	43.6	43.4	43.4	41.2	37.0	36.1	39.4	Sep.
Short-term debt (in billions of U.S. dollar) 2/	...	…	223.8	250.5	308.5	310.4	364.8	506.3	508.5	Jun.
In percent of gross reserves	...	…	200.0	211.6	249.6	249.8	273.9	331.6	322.7	Jun.
One-year forward exchange rate premium (in pips, annual average)	-35.5	52.7	138.8	33.9	-704.8	-448.9	-599.7	-552.3	-435.3	Sep.
Real exchange rate (percent change)	-3.3	0.3	-4.8	-9.0	-6.6	-2.1	-0.9	-5.3	-5.3	Oct.
Financial sector										
HIBOR(3M)-LIBOR (3M) (in basis points, per annum)	-44.0	-3.9	0.6	-25.0	-128.9	-64.6	-102.4	-100.3	-71.1	Sep.
Hang Seng index (percent change, end-year) 3/	-11.0	-24.5	-18.2	34.9	13.2	4.5	34.2	39.3	-49.8	Oct.
Residential property prices (percent change, end-year) 3/	-14.5	-9.8	-12.2	0.9	27.4	8.2	4.1	25.7	2.4	Sep.
Banking sector 4/										
Deposit-loans ratio 5/	143.3	155.9	159.8	175.3	179.3	175.9	192.8	198.2	170.7	Sep.
Domestic credit growth 6/ 7/	2.3	-3.8	-2.6	-2.0	4.9	7.7	2.3	15.2	7.9	Sep.
Real credit growth	4.5	-0.3	-1.2	-0.1	4.6	6.2	0.0	11.0	4.7	Sep.
Capital adequacy ratio 6/	17.8	16.5	15.7	15.3	15.4	14.8	14.9	13.4	14.2	Jun.
Nonperforming loans (in percent of total loans) 8/ 9/	7.3	6.5	5.0	3.9	2.3	1.4	1.1	0.8	0.9	Jun.
Net interest margin (in percent of interest-bearing assets) 9/	2.1	2.0	2.1	1.9	1.7	1.7	1.8	1.9	1.9	Jun.
Return on assets (post-tax) 9/	1.2	1.0	1.2	1.2	1.4	1.4	1.4	1.5	…	Jan.
Net open spot position (in billions of U.S. dollar)	25.7	24.7	18.2	15.9	28.2	30.7	52.0	78.8	39.3	Aug.
Net open forward position (in billions of U.S. dollar)	-18.7	-14.6	-6.7	-6.4	-24.5	-25.9	-46.2	-71.8	-32.3	Aug.
Exposure to the Mainland (in percent of total assets)	2.9	2.4	2.2	2	2.3	2.6	5.9	6.5	8.2	Jun.
Exposure to property sector (in percent of domestic credit) 10/	49.2	50.7	51.8	50.9	50.4	50.6	51.5	49.9	49.0	Jun.
Deposits (in percent of liabilities)	53.0	55.4	55.3	55.0	54.2	56.1	57.3	56.7	55.2	Sep.
Contagion indicator										
HK$-renminbi forward exchange rate correlation (daily)	-0.1	0.1	-0.1	0.9	0.8	0.7	-0.4	0.5	-0.4	Nov.
Hang Seng-NASDAQ correlation (daily)	0.7	0.9	0.8	0.9	0.6	0.8	0.5	0.8	0.9	Nov.

Sources: Hong Kong SAR authorities; Bank for International Settlements; and staff estimates.

1/ Broad Money refers to M2.
2/ Official statistics on Hong Kong SAR's external debt are available from the first quarter of 2002.
3/ Refers to year-to-date change since end of previous year.
4/ For all authorized institutions, unless otherwise specified.
5/ Figures have been revised due to a change in the definition of customer deposits to include short-term Exchange Fund placements.
6/ For all locally incorporated authorized institutions.
7/ Domestic credit refers to loans for use in Hong Kong SAR.
8/ Refers to total gross classified: "substandard," "doubtful," and "loss."
9/ For retail banks, which comprise all the locally incorporated banks plus a number of the larger foreign banks whose operations are similar to those of the locally incorporated banks, in that they operate a branch network and are active in retail banking.
10/ Exposure to property sector includes loans to finance property investment and development as well as residential mortgage loans.

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Public Information Notice (PIN) No. 08/xx
FOR IMMEDIATE RELEASE
December 1, 2008

Appendix I: Draft Public Information Notice
IMF Executive Board Concludes 2008 Article IV Consultation Discussions with People's Republic of China — Hong Kong Special Administrative Region

On December 1, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions with People's Republic of China—Hong Kong Special Administrative Region.[1]

Background

Hong Kong SAR's economy has undergone a remarkable metamorphosis over the past decades. These changes have resulted in almost all manufacturing operations moving to the Pearl River Delta. At the same time, the economy has leveraged its strong institutional framework, flexible labor and product markets, and status as a global financial center to transform itself into a dynamic, knowledge-based, service economy. Hong Kong SAR has emerged from this process of deep-rooted change with an enviable growth performance that has averaged 7 percent over the past four years. Unemployment has fallen to the lowest point in more than a decade, rising disposable incomes have propelled forward private consumption, and productivity growth has been high.

However, as one of the most open economies in the world and with its focus on financial and trade services, Hong Kong SAR is highly exposed to the unfolding crisis in

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

international financial markets and to the slowdown in the global economy. There are now clear signs of economic deceleration.

Net exports of goods and services fell in the first half of 2008, as the terms of trade worsened and demand from the E.U., Japan and the United States weakened. However, the current account has declined only modestly, in part due to higher investment income. Portfolio flows have rotated out of equities and into local currency and deposit holdings.

Consumer price inflation has increased over the past two years, driven by imported food inflation and an upward trend in the cost of housing. While headline figures have fallen rapidly in recent months, after adjusting for the effect of recent budgetary measures, underlying inflation appears to have only just peaked.

In the 2007/08 fiscal year, the consolidated fiscal surplus was 7¾ percent of GDP, overperforming the budget target by 6 percent of GDP and helped greatly by the stock and housing market boom and by buoyant land sales (which generated 3.2 percent of GDP in stamp duties and almost 8 percent of GDP in nontax revenue). The 2008/09 budget, and a supplementary fiscal package announced in July, introduced a sequence of measures to return fiscal resources back to Hong Kong SAR's citizens, protect lower income groups from food and fuel price increases, and expand infrastructure spending. The combined budget and supplement now target a fiscal deficit of ¾ percent of GDP for the 2008/09 fiscal year.

Since the second half of 2007, equity markets have lost two-thirds of their value and lingering concerns over counterparty risk have raised interbank rates for lending at longer maturities. In September, unfounded rumors of liquidity problems and losses from international exposures catalyzed a fleeting retail deposit run. This was followed by an increase in interbank rates and tight liquidity conditions, particularly for term lending. A flight to quality also pushed nominal interest rates on the government's Exchange Fund Paper negative for several days. The spot exchange rate appreciated towards the strong side of the convertibility undertaking, hitting the band in late October and early November.

Executive Board Assessment

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Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise