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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 (SAR).[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.

[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.

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.

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 surplus 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 (April–March), 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 at one major retail bank. 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

Following several years of impressive economic performance marked by robust growth and rising disposable incomes, the Hong Kong SAR economy is headed for a marked slowdown reflecting the crisis in international financial markets and the global economic downturn. Executive Directors recognized that the authorities' sound economic policies and steady strengthening of financial sector regulation and supervision in recent years have provided valuable protection in dealing with the consequences of the global financial turmoil. In addition, the various steps that the authorities have taken in recent months have bolstered stability and buttressed the economy's resilience to spillovers. These actions, alongside comprehensive and effective contingency planning, have allowed the authorities to react quickly and pre-emptively to unfolding developments. In particular, Directors welcomed the authorities' implementation of a range of measures to stimulate domestic demand through a sizable fiscal stimulus package, and to preserve stability by providing liquidity and sustaining confidence in financial markets.

Looking ahead, Directors considered a possible worsening of international financial market turbulence as the key risk for Hong Kong SAR over the short term. They expressed confidence that the government is set to act expeditiously if global market volatility creates further disruption in the workings of the local financial system, or if the negative impact on Hong Kong SAR's growth prospects becomes more profound.

Directors were reassured by the resilience of Hong Kong SAR's banking system to date, but cautioned that credit growth could slow sharply and credit quality could deteriorate alongside the economic downturn. Hong Kong SAR's banks have managed risk prudently and provisioned for losses, and are well positioned to handle such conditions. Directors considered the introduction of a time-bound, blanket deposit guarantee and a contingent facility to provide capital to Hong Kong SAR's banks as timely and warranted.

Directors reiterated their support for the Linked Exchange Rate System. They viewed it as a simple, transparent exchange rate arrangement that has, over the past twenty-five years, provided an anchor for monetary and financial stability in Hong Kong SAR. The exchange rate arrangement has demonstrated remarkable resilience during the recent period of turmoil, underpinned by the flexibility of the Hong Kong SAR's economy. Directors agreed with the staff's assessment that the exchange rate is valued broadly in line with fundamentals.

Directors recognized that fiscal policy is the principal tool to respond to slower growth, and agreed that the recent stimulus package will help provide support to the economy. The well-targeted infrastructure investments should boost the economy's potential by further increasing skill levels and productivity. Continued fiscal stimulus will also be needed for the coming year. In the upcoming budget, Directors encouraged the authorities to take a more medium-term perspective in setting fiscal policy, favoring a move away from the one-off measures of recent years.

Most Directors agreed that, if substantial increases in the tax burden are to be avoided, steps will need to be taken to increase private financing of healthcare spending. Greater cost containment, more efficient provision of services, and some form of user fees will also likely be needed. An integral part of reform would be to maintain public support for those with chronic illnesses or disabilities, or for those who have insufficient means to cover their healthcare needs.

Directors noted the authorities' intention to take forward the introduction of a minimum wage in a prudent and pragmatic manner. They suggested that such a minimum wage policy should be designed carefully to avoid distortions and preserve labor market flexibility. It should be applied uniformly across employment groups, be set at a level to protect lower-income workers without unduly damaging their employment prospects, and include a simple, automatic adjustment scheme based on changes in wages or unit labor costs. The minimum wage should also be complemented by additional social assistance for the working poor.

Directors saw an expansion of communications and infrastructure aimed at better integrating with the Pearl River Delta region of Mainland China as an important catalyst for future growth and development in the region. At the same time, they drew attention to remaining frictions, including customs control and border traffic as well as rising pollution, as risks that could undermine future prospects. Opportunities should also be found to accelerate the process of financial integration with the Mainland.

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 decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation with People's Republic of China — Hong Kong Special Administrative Region is also available.

People's Republic of China, Hong Kong Special Administrative Region: Selected Economic and Financial Indicators, 2005–2009

	2005	2006	2007	2008 Proj.	2009 Proj.
Real GDP (percent change)	7.1	7.0	6.4	3.7	2.0
Real domestic demand (contribution)	1.4	5.2	6.9	4.2	2.4
Foreign balance (contribution)	5.6	1.8	-0.5	-0.4	-0.4
Saving and investment (percent of GDP)	11.4	12.1	13.5	12.5	11.2
Gross national saving	31.9	33.8	34.8	34.6	34.2
Gross domestic investment	20.6	21.7	21.3	22.1	23.0
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)	5.6	4.8	4.0	3.6	4.3
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
Expenditure	16.9	15.4	14.5	18.2	17.6
Consolidated budget balance	1.0	4.0	7.7	0.0	-0.1
Reserves at March 31	22.5	25.0	30.5	27.8	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 2/	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	...	...
Merchandise trade (percent change)					
Export volume	10.4	9.3	7.0	3.9	2.2
Of which: re-exports	10.7	9.7	8.6	4.2	2.3
Import volume	8.0	9.2	8.8	4.7	2.8
Export value	11.1	9.6	9.4	10.4	3.9
Import value	10.1	11.5	10.7	10.8	4.9
External balances (in billions of US$)					
Merchandise trade balance	-7.6	-14.0	-19.7	-22.1	-26.7
In percent of GDP	-4.3	-7.4	-9.5	-9.7	-11.4
Current account balance	20.2	22.9	28.0	28.4	26.1
In percent of GDP	11.4	12.1	13.5	12.5	11.2
Foreign exchange reserves 2/					
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

Sources: Data provided by the Hong Kong SAR authorities; and IMF staff estimates and projections.
1/ Fiscal year.
2/ Figures exclude trade financing.