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December 29, 1997

To: Members of the Executive Board

From: The Secretary

Subject: **People's Republic of China—Staff Report for the Article IV Consultation Discussions Held in 1997 in Respect of the Hong Kong Special Administrative Region**

Attached for consideration by the Executive Directors is the staff report for the Article IV consultation discussions held in 1997 in respect of the Hong Kong Special Administrative Region, which is tentatively scheduled for discussion on Monday, January 26, 1997.

Mr. Towe (ext. 38489), Mr. Mihaljek (ext. 38539), or Mr. Husain (ext. 34941) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation 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 Thursday, January 8, 1998.

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INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Staff Report for the Article IV Consultation Discussions Held in 1997 in Respect of the Hong Kong Special Administrative Region[1]

Prepared by the Staff Representatives for the Consultation Discussions Held in 1997 in Respect of the Hong Kong Special Administrative Region

Approved by David Goldsbrough and Joaquin Ferrán

December 24, 1997

- Consultation discussions were held in the Hong Kong Special Administrative Region of the People's Republic of China during October 28–November 5, 1997.
- The staff team comprised C. Towe (Head), A. Husain, D. Mihaljek, and V. Cerra (EP), all APD; Mr. Goldsbrough (APD) joined the mission for the final policy discussions. Mr. Zhang Zhixiang, Executive Director, also attended the discussions.
- The mission met with the Chief Executive Tung Chee-hwa, Financial Secretary Sir Donald Tsang, the Chief Executive of the Hong Kong Monetary Authority (HKMA) Joseph Yam, as well as a range of government and private sector representatives.
- Relatively comprehensive and high quality data are available for Hong Kong SAR on a timely basis, but some deficiencies exist, which hamper the analysis of economic developments (Annex II).
- The principal author of this report is Mr. Towe.

[1]The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

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EXECUTIVE SUMMARY

- The **transition to Chinese sovereignty**, which took place on July 1, 1997, has occurred smoothly.

- Following the slowdown in 1994–95, **GDP growth** accelerated to 5 percent in 1996 and 6¼ percent in the first half of 1997, reflecting strong domestic demand. Although margins of economic slack appear to have been exhausted (the unemployment rate fell to 2¼ percent in the third quarter), inflation remains stable at 6 percent.

- Reflecting spillovers from the regional crisis, the Hong Kong dollar—which is linked to the U.S. dollar—came under **speculative attack**. These pressures were successfully resisted by means of foreign exchange market intervention and a tightening of domestic monetary conditions, but higher interest rates have contributed to a drop in stock prices of nearly 40 percent and a decline in property prices.

- The trade effects of the **regional crisis** and the rise in domestic interest rates are expected to cause GDP growth to slow in 1998 to about 3¾ percent, from 5¼ percent in 1997. However, in view of the continued turmoil in the region, this baseline outlook is subject to considerable downside risks.

- The staff endorses the authorities' commitment to the **exchange rate link**, owing to its importance for maintaining confidence in the commitment to free-market policies. A period of high interest rates seems necessary, given the fragility of market sentiment, but will facilitate a desirable unwinding of overheating pressures.

- The **banking sector** appears sufficiently strong to weather the recent regional crisis. Nonetheless, further steps to enhance disclosure and reduce the banks' exposure to the property market would help reduce market uncertainty and the risk of unwarranted contagion.

- The staff endorses the commitment to prudent **fiscal policies**. Despite an exceptionally strong outturn in FY 1997, fiscal policies should not be relaxed in FY 1998, since this could delay the needed unwinding of demand pressures and undermine confidence in the authorities' commitment to fiscal prudence.

- On the **structural front**, there is a need to reduce the role of government in the housing sector, and it will be important to resist pressures to adopt programs aimed at promoting specific industries or sectors.

- Hong Kong SAR has made commendable progress in improving the quality of its **data**, but limitations exist in a number of areas, notably with regard to external factor income and capital flows, which hamper analysis.

I. Introduction and Recent Developments

1. **At the conclusion of last year's consultation discussions,** Executive Directors emphasized that, during the transition to Chinese sovereignty, confidence would be best sustained by the firm adherence to the existing rules-based and noninterventionist policy framework. Directors also fully endorsed the linked exchange rate system and emphasized the need to maintain the traditional prudent approach to fiscal policy. In addition, they noted the importance of maintaining a high standard of financial market supervision and regulation.

2. **In the event, the transfer of sovereignty over Hong Kong to the People's Republic of China, which took place on July 1, 1997, has gone smoothly**. The terms of the transfer included the establishment of Hong Kong as a Special Administrative Region (SAR), with a considerable degree of autonomy over economic and other policies, and included a commitment to the continuation of the existing free-market system for 50 years.[2] The first Chief Executive reappointed all senior policy secretaries, and elections for the new Legislative Council are scheduled for May 24, 1998.

3. **Real GDP growth accelerated to 5 percent in 1996, following below-trend growth of 4 percent in 1995**. The pickup in activity reflected strength in private investment and consumption, which helped offset a large negative contribution from stockbuilding (Tables 1 and 2; Figures 1 and 2). Net exports also contributed significantly to growth in 1996

FIGURE 1. GROWTH IN GDP
Four-quarter percentage change

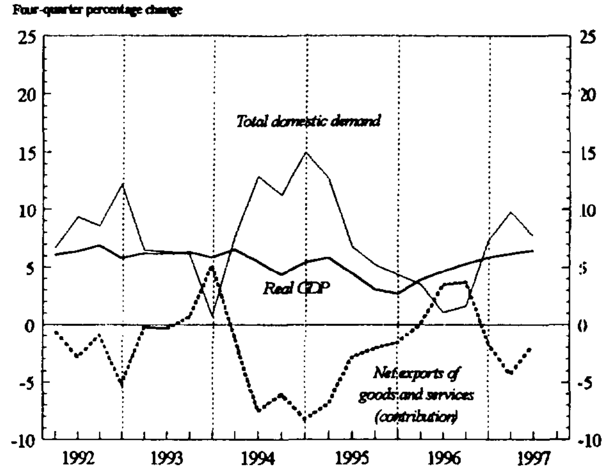
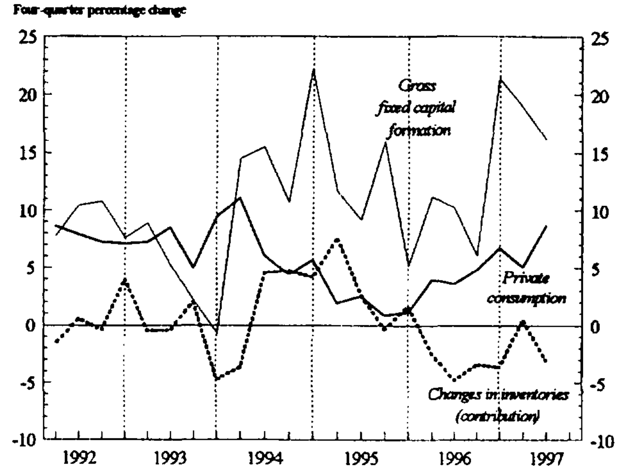


FIGURE 2. GROWTH IN DOMESTIC DEMAND
Four-quarter percentage change



[2] For details of the institutional framework see the background papers or J. Dodsworth and D. Mihaljek, 1997, *Hong Kong, China: Growth, Structural Change, and Economic Stability During the Transition*, IMF Occasional Paper No. 152 (Washington: International Monetary Fund).

and the deficit on goods and nonfactor services trade narrowed from 4¼ percent of GDP in 1995 to 1¾ percent of GDP in 1996 (Figures 3 and 4). The improvement in the trade balance reflected a deceleration of import volume growth—related to a slowdown in import-intensive

FIGURE 3. GROWTH OF MERCHANDISE EXPORT AND IMPORT VALUES

Four-quarter percentage change

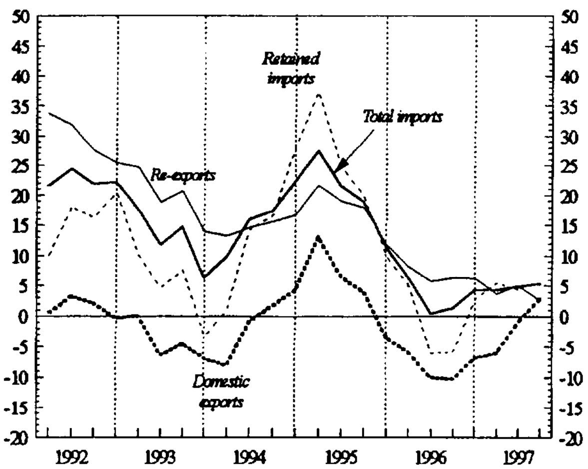
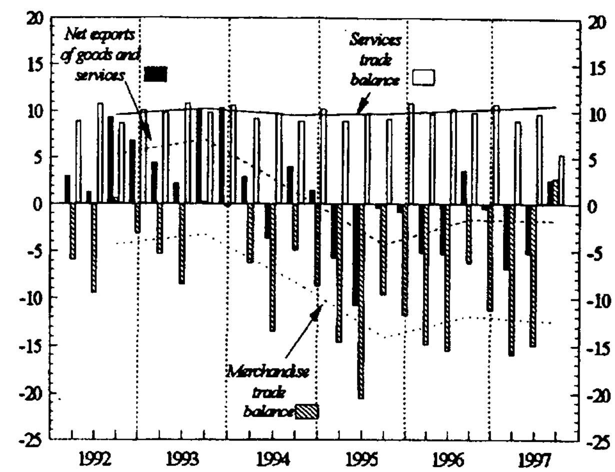


FIGURE 4. TRADE BALANCES

Percent of GDP



public investment—which helped offset the adverse effect of the strength of the U.S. dollar on competitiveness and export growth. Although full current account statistics are not available, net factor income inflows were roughly 1¼ percent of GDP in 1995—the last year data are available—suggesting that the current account deficit was under 1 percent of GDP in 1996.

4. **The economy gathered further momentum in 1997, and GDP growth rose to 6¼ percent in the first half,** owing to an acceleration of both private consumption and investment. The pickup in private domestic demand, which reflected improved confidence ahead of the transition and the effect of higher property and stock prices, offset a widening of the trade deficit. The weaker trade balance resulted mainly from a continuation of the pickup in retained merchandise imports that began in mid-1996, and sluggishness in services exports.

5. **With the pickup in activity, the economic slack that emerged in 1994 and 1995 has been eliminated.** The unemployment rate dipped to 2¼ percent in the third quarter of 1997, compared with 2¾ percent a year earlier, and output at mid-1997 is estimated to have slightly exceeded potential (Box 1 and Figure 5). However, wage and price pressures have been contained. Composite CPI inflation was 6 percent during the first ten months of 1997, roughly unchanged from 1996. Real wage growth was ¼ percent in the twelve months ending March 1997, following ½ percent growth during 1996 (Figure 6). Nonetheless, the strength of

Box 1. Cyclical Position of the Economy

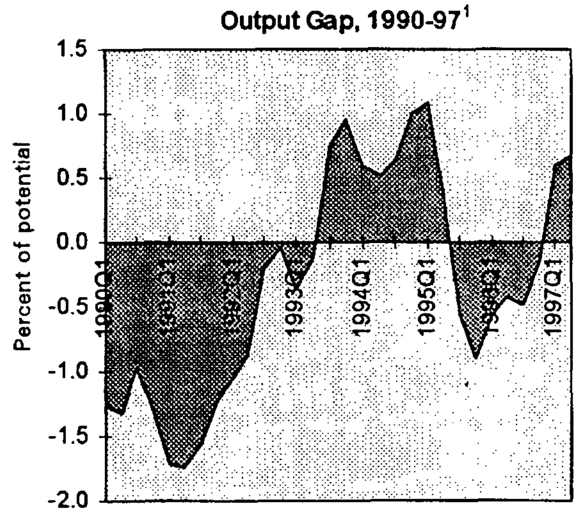
Before the recent turmoil in financial markets, Hong Kong was in an advanced stage of a cyclical recovery that began in mid-1996. After falling to about ½ percent below potential in 1996, actual GDP is estimated to have risen to about ¾ percent above potential in the second quarter of 1997 (Figure 1.1). The staff estimates that potential output is growing at an annual rate of slightly less than 5 percent.

Recent movements in inflation and the unemployment rate have been broadly consistent with movements in the output gap. With an adjustment in real wages and the pickup in activity, the unemployment rate has fallen to 2¼ percent in 1997 (average for the first three quarters), just above the staff's estimate of the nonaccelerating-inflation rate of unemployment (NAIRU) of about 2 percent. Reflecting the effects of slack in the labor market and falling import prices, inflation has declined steadily since the last up-tick in 1995.

The relationship between the unemployment rate and inflation in Hong Kong has become more stable since the introduction of the linked rate system in 1983 (Figure 1.2). Nonetheless, considerable uncertainty exists regarding this link: the level of unemployment in Hong Kong is sensitive to migration flows, which are largely exogenous, while the aggregate price level is highly sensitive to other factors besides wage developments, including import price changes and, to a lesser degree, the output gap.[1] During 1997, labor inflows and falling import prices have helped moderate the impact of asset price inflation and the closing of the output gap on the aggregate price level. In view of the recent trends in the job market and regional trade, these factors, as well as the onset of a downturn in the residential property market and the outlook for below-trend growth in output, will likely continue to restrain inflationary pressures in 1998.

Figure 1.1

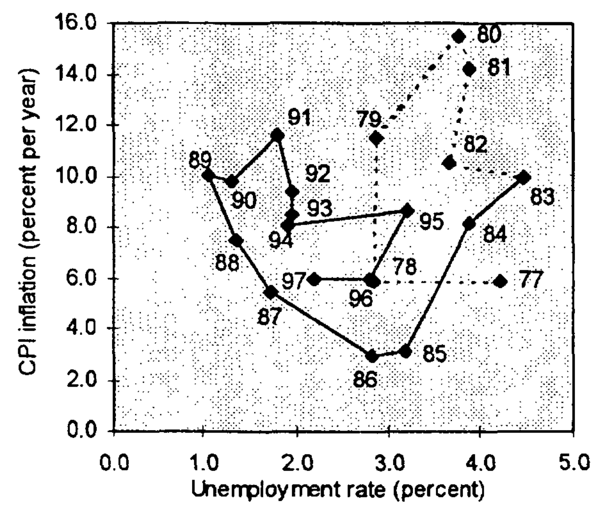
Output Gap, 1990-97[1]



1/ Actual GDP divided by potential GDP.

Figure 1.2

Inflation and Unemployment, 1977-97[1]



[1]See Dodsworth and Mihaljek (op. cit.), Chapter III and Appendix I.

FIGURE 5. EMPLOYMENT AND UNEMPLOYMENT

Four-quarter percentage change

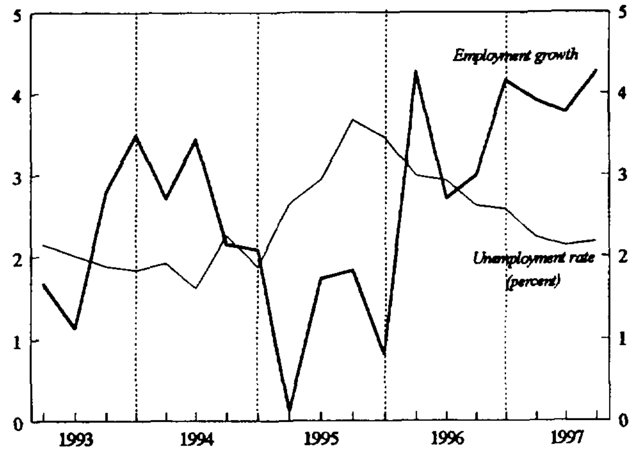
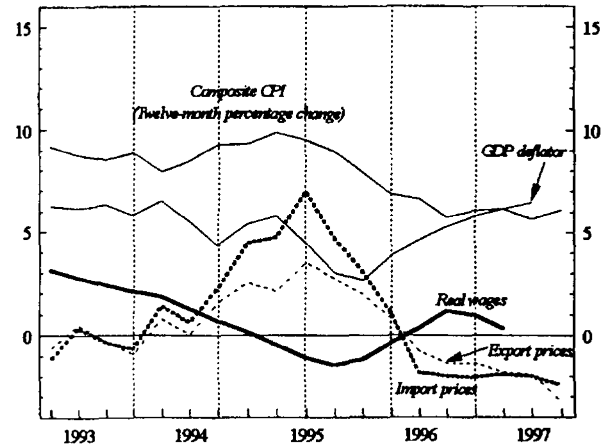


FIGURE 6. PRICES AND WAGES

Four-quarter percentage change



the U.S. dollar against the currencies of partner countries, as well as the SAR's relatively high inflation rate, has caused the exchange rate to appreciate in real effective terms at an average annual rate of about 7 percent during the past two years, faster than the trend appreciation since 1979 (Box 2).

6. **As a result of spillovers from the regional turmoil, the Hong Kong dollar—which is linked to the U.S. dollar under a currency board-type arrangement—came under speculative pressure in July and August.** These pressures were successfully resisted by means of intervention in the foreign exchange market and a corresponding tightening of domestic liquidity (Figure 7). However, speculative pressures re-emerged in late October,

FIGURE 7. INTEREST RATE DEVELOPMENTS

In percent per annum

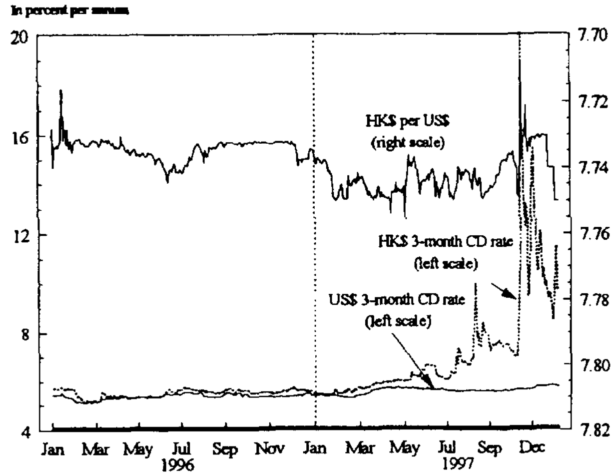
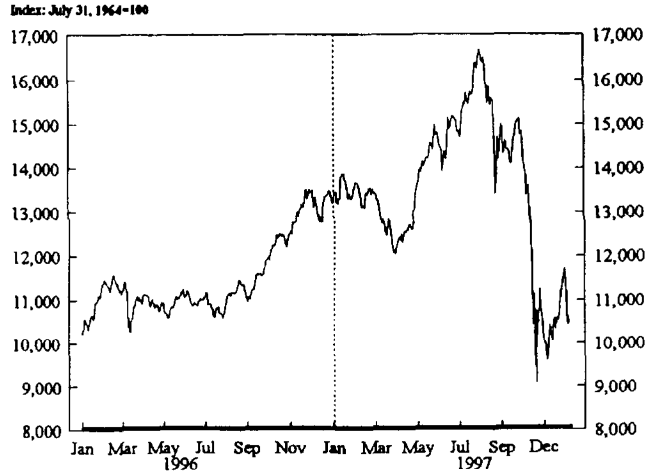


FIGURE 8. HANG SENG INDEX

Index: July 31, 1964=100



Box 2. The Real Exchange Rate and Competitiveness

Higher consumer price inflation than in trading partner countries, together with the exchange rate link to the U.S. dollar, has led to a steady appreciation of the Hong Kong dollar in real effective terms. The cumulative appreciation has been around 45 percent between 1982 and mid-1997 as measured by the Fund's CPI-based real effective exchange rate (REER) index. However, this longer-term trend appears to have reflected an equilibrating phenomenon consistent with rapid productivity growth, and not an erosion in the SAR's external competitiveness.

Alternate indices of the REER yield sharply different conclusions about the extent—and even the direction—of trend real exchange rate changes over the past 15 years. For example, an REER index constructed using export unit values in the SAR and its trading partners has been broadly stable since 1987 (Figure 2.1). By contrast, a REER index based on unit labor costs in the SAR's and trading partners' manufacturing sectors depreciated steadily during 1982-97.[1] This suggests that the appreciation of the CPI-based REER has been associated with the Belassa-Samuelson phenomenon, in which rapid productivity in the tradable sector causes wages and prices to be bid up in the nontradable sector.[2]

Econometric estimates also indicate that the longer-term appreciation of the SAR's CPI-based REER has been in line with economic fundamentals. The estimates indicate that the structural shift toward a high value-added, services-based economy—proxied by the share of manufacturing output in the SAR's GDP—accounted for roughly 90 percent of the appreciation of the equilibrium REER between 1982 and mid-1997. The estimates also identify developments in the SAR's terms of trade, world inflation, and fiscal policy as determinants of the equilibrium REER. The analysis indicates that deviations of the actual REER from its equilibrium have generally remained within a narrow band of ±5 percent, and that the deviations are generally erased within a short period, confirming that goods and factor markets in the SAR are relatively flexible (Figure 2.2).

As regards the more recent experience, the REER is estimated to have been about 3¾ percent above its equilibrium value in the second quarter of 1997. However, the depreciation during July-December of trading partners' currencies—most notably Japan, Taiwan Province of China, Korea, Singapore, and Malaysia—has led to a substantial further real appreciation of the Hong Kong dollar, which would leave the REER over 10 percent above its equilibrium level.

Figure 2.1. REER Indices (1990=100)

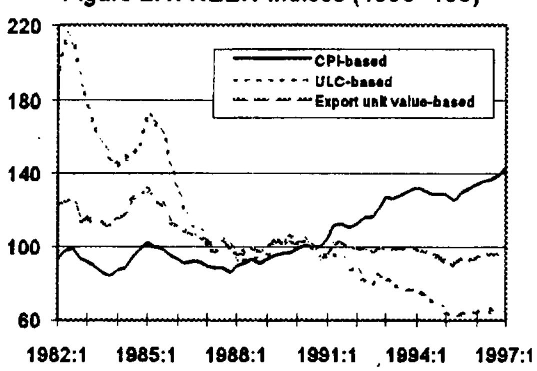
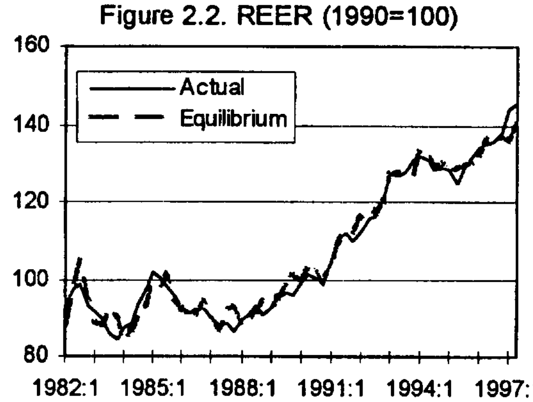


Figure 2.2. REER (1990=100)



[1] Owing to data limitations, the ULC- and export unit value-based indices employ data from nine trading partners, while the CPI-based REER index uses data from 16 trading partners. Movements in the CPI-based index do not appear to be sensitive to data for the seven trading partners that were omitted from the ULC- and export unit value-based indices.

[2] See Chapter V in Dodsworth and Mihaljek (op. cit.).

following the float of the New Taiwan dollar. The pressures were again resisted by substantial foreign exchange market intervention, as well as an associated sharp rise in overnight rates (to 280 percent). While pressures in the interbank market have eased, and foreign exchange reserves increased in October, short-term interest rate spreads remain high (3¼ percentage points in late December).

7. **Higher interest rates and weaker sentiment contributed to a substantial correction in stock and property markets.** The Hang Seng stock price index reached a historical peak in early August, having risen by almost 60 percent during the previous 12 months (Figure 8). Property prices also rose strongly, and by mid-1997 were a third higher than their previous peak in the second quarter of 1994. The surge in asset prices was fueled in part by growth of credit to the property market of over 35 percent during the past year (Figure 9). Anecdotal evidence also suggests that capital inflows from the mainland

FIGURE 9. MONEY AND CREDIT GROWTH

End-of-period percentage change

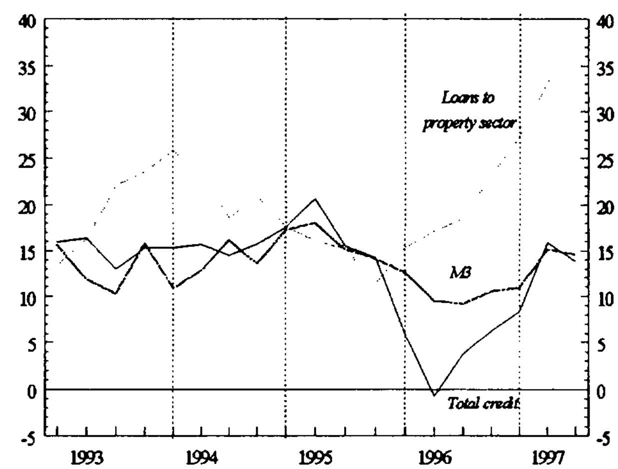
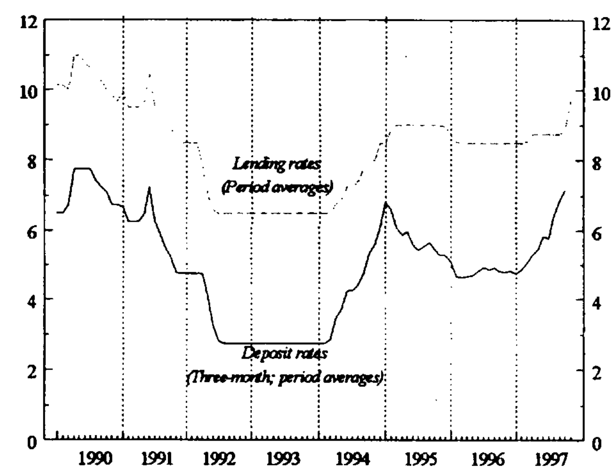


FIGURE 10. INTEREST RATES

Percent per annum



contributed to the stock market boom. However, with the speculative attack on the exchange rate, interest rate spreads widened, causing concern regarding the impact of higher interest rates on earnings. Stock prices fell sharply, and by end-November the Hang Seng index was nearly 40 percent below its August peak. Higher lending rates (Figure 10), as well as the announcement of new housing and land policies, also contributed to a correction in the real estate market. Residential property prices already are estimated to have fallen by about 10 percent since mid-1997, and market participants expect further declines.

II. REPORT ON THE DISCUSSIONS

8. **Hong Kong's enviable economic performance during recent decades is largely the result of the historical commitment to a rules-based and noninterventionist approach to policymaking**. In recognition of this fact, the terms of the transition provide for a continuation of this policy framework, and the authorities' public statements have underlined their commitment to a free market and the rule of law. During the mission, the staff generally supported the authorities' policy framework, including the commitment to the linked exchange rate system and a rules-based fiscal policy.

9. **Nonetheless, the speculative attacks on Hong Kong's exchange rate and the expanding regional crisis have exposed the SAR to considerable economic and financial market pressures**. Consequently, the discussions focussed on: (i) the impact of recent developments on the authorities' monetary policies, in the context of the linked exchange rate system; (ii) the risks that high interest rates, as well as weak stock and property markets, pose for the financial system; and (iii) the required stance of fiscal policies given recent cyclical developments and longer-term demographic trends. In light of the deepening regional crisis, the staff has revised downward its growth projections since the discussions, but this has not materially affected the staff's assessment of policy requirements.

A. Economic Prospects

10. **The authorities expressed confidence in the ability of the economy to respond flexibly to the effects of the recent turmoil**. The impact on external demand was expected to be limited by the fact that the countries most adversely affected were not a destination for a large share of Hong Kong's exports, and—reflecting the service-based nature of the economy—these countries did not compete directly with Hong Kong in third markets. External demand would depend mainly on growth in the industrial countries and in the mainland, which was expected to be largely sustained in 1998. The authorities recognized that domestic demand would slow somewhat as a result of higher interest rates and the correction in the stock and property markets. However, they agreed with the staff that this would help reverse the overheating of labor and asset markets during the past year, and encourage an improvement in competitiveness. Hong Kong's ties to the mainland also were viewed as a strength rather than a risk. In particular, the SAR was uniquely positioned to benefit from domestic demand growth in the mainland, as well as from the reform of state-owned enterprises, which was expected to significantly increase demand for business and financial services.[3]

11. **The mission noted that the unsettled state of financial markets made it unusually difficult to assess prospects**. However, even assuming a relatively early restoration of market sentiment and narrowing of interest rate spreads, growth was not likely to be more than 4¼ percent in 1998, compared with 5¼ percent in 1997. Moreover, the risk of a steeper

[3]See the background papers for a discussion of the linkages between the mainland and Hong Kong economies.

slowdown could not be discounted. If interest rate spreads remained wide (spreads were 3¼ percentage points in late December) and asset prices depressed, a larger slowdown in household consumption and private investment could be expected. Also, although merchandise trade links between Hong Kong and the region were relatively modest, external services receipts, especially for tourism, were vulnerable to the effects of the regional crisis.

12. **Indeed, with the further intensification of the regional crisis, and the fact that interest rate spreads remain high in the SAR, the staff has since revised its 1998 growth forecast down to 3¾ percent.** In particular, regional currency and asset markets have continued to weaken since early November, particularly in Korea. Moreover, although the Hong Kong stock market firmed and interest rates began to decline during November and the first week of December, market sentiment worsened in mid-December, and interest rate spreads widened markedly (Figure 7). Even this baseline projection assumes a relatively rapid improvement in market sentiment and, in the absence of clear signs that confidence has stabilized in the region, the downside risks remain significant (Box 3 contains a discussion of the risks and an alternate scenario).

B. Monetary and Exchange Rate Policies

13. **The authorities stressed their continued firm commitment to the currency board arrangement and the link to the U.S. dollar.** While they recognized the costs of defending the link, in their view these costs were far outweighed by the advantages of the existing system. They were particularly skeptical about the benefits of a more flexible exchange rate system for Hong Kong, given the negative experience with this type of arrangement prior to 1983, and the fact that the move to more flexible exchange rates by many countries in the region had not been accompanied by an improvement in confidence or a narrowing of interest rate spreads. The authorities also noted the crucial role the link—and the rules-based fiscal system that is an integral part of the policy framework—played in maintaining the credibility and the mutual independence of monetary and other policies under the "one country, two systems" approach.

14. **The authorities expressed satisfaction with the recent defense of the exchange rate.**[4] The Real Time Gross Settlement system, which was introduced in December 1996, had significantly improved the Hong Kong Monetary Authority's (HKMA) ability to monitor transactions and provide a timely response to market pressures, while the successful effort during the past few years to deepen the market for Hong Kong dollar debt had enhanced the HKMA's ability to adjust domestic liquidity. Indeed, as a result of the successful squeeze on domestic liquidity in late October, foreign exchange reserves reached US$92 billion (over 50 percent of GDP) by end-October, more than reversing the reserve loss earlier in the month. While questions had been raised in the business community about the need for the sharp rise in overnight interest rates in late October (as high as 280 percent at one point), the authorities

[4]Details of recent monetary policy operations are contained in the background papers.

Box 3. The Regional Crisis and the Downside Risks to the Outlook

The staff's baseline forecast is broadly consistent with assumptions used in the Interim WEO exercise (and equals the private sector consensus forecast for December). Nonetheless, the regional crisis illustrates the considerable vulnerability of such projections to shifts in market sentiment. In order to illustrate this vulnerability, an alternate scenario is presented below that illustrates the following downside risks:

Regional trade-related risks: The direct impact of the regional crisis on Hong Kong's balance of payments is moderated by the fact that Hong Kong is primarily a service-based economy. Moreover, Southeast Asia, Korea, and Japan are the destination for only about 16 percent of the SAR's merchandise exports. The SAR's merchandise exports also are relatively diversified (they include higher value-added clothing and textiles, electrical machinery and appliances, office equipment parts, watches and clocks, and printed matter), and in only a few cases compete in third markets with exports of affected countries. Nonfactor service receipts are more exposed, since spending by tourists from affected countries represents over half of total tourism receipts, or 3½ percent of GDP. Tourism arrivals already fell by 22 percent in September from a year earlier, and hotel occupancy rates have declined sharply. The risks to exports of transportation and financial services may also be significant, but are difficult to quantify in the absence of the data on the direction of services trade.

Financial market risks: The baseline forecast assumes that a relatively early restoration of market confidence will permit Hong Kong dollar interest rates to fall to around 2 percent above corresponding U.S. interest rates early in 1998. Although spreads had narrowed in early December, they increased again in mid-December (to around 6½ percent). The staff's analysis suggests that a one percentage point increase in interest rates lowers real GDP growth by about ½–¾ percent within a year. Anecdotal evidence suggests that economic activity has already started to slow, and there have been a number of highly publicized layoffs in fund management and real estate industries. Residential property prices already have fallen by up to 10 percent since mid-1997, and market commentators expect additional price declines, which would further depress domestic demand.

Mainland-related risks: The impact of the regional crisis on the mainland has been dampened by its limited integration with global financial markets, and because a large share of the mainland's exports are relatively low value-added consumer goods (including many quota items) that do not compete directly with exports from affected countries. Recent cost surveys also indicate that labor costs in the mainland still remain below those in Southeast Asia. Nonetheless, a significant slowdown in the mainland's trade flows or overall growth would affect the SAR's reexport industry and investment income receipts. These risks are partly offset by the fact that the mainland's domestic demand is likely to remain strong following recent interest rate cuts, and reforms of state-owned enterprises are likely to generate demand for financial, accounting, auditing and other business services from the SAR. The baseline assumes a broadly unchanged exchange rate for the renminbi.

An alternative scenario, illustrating the possible impact of these risk factors, is presented below. This scenario assumes a larger erosion of the external trade balance, due to the direct impact of the regional crisis, which withdraws a further 1¼ percentage points from 1998 growth. In addition, a somewhat slower restoration of market confidence, and a correspondingly higher level of interest rates, is assumed, which reduces domestic demand growth by half a percentage point. As a result, 1998 growth falls to 2 percent, compared to 3¾ percent in the baseline.

Alternative Forecast Scenarios

	1996	1997	1998	
			Baseline Projection	Alternative Scenario
Real GDP growth (percent change)	4.9	5.3	3.8	2.0
Domestic demand (percent change)	3.4	8.0	4.0	3.5
Foreign balance (contribution)	1.4	-2.9	-0.5	-1.7
Goods and services balance (percent of GDP)	-1.7	-2.5	-1.7	-2.6

argued that the increase had been required in order to avoid an excessive expansion of Hong Kong dollar liquidity.

15. **The mission broadly endorsed the authorities' policy framework.** However, the mission pointed to signs that the economy had reached or exceeded full employment, and that the real exchange rate may have moved above its longer-term trend (Box 2). In these circumstances, maintaining interest rates above U.S. rates over the shorter term would have the benefit of cooling excess demand pressures. While the slowdown in activity would not be painless—and the deepening regional crisis makes a sharper slowdown more likely—the mission stressed that it was important to avoid seeking an early reduction in interest rates given that market confidence in the exchange rate link still appeared fragile.

16. **The authorities generally agreed that monetary conditions would need to remain restrictive in the period ahead, especially given the need to maintain market confidence in the exchange rate.** They also agreed that higher interest rates were needed to moderate excess demand pressures, which had affected labor market conditions and contributed to the sharp run up in asset prices. In particular, they noted that property prices were increasingly important for competitiveness, since the service sector now represented roughly 85 percent of Hong Kong's GDP and rents were a large share of business costs. The authorities noted, however, that Hong Kong had weathered similar episodes of market turbulence in the past. Thus, they were confident that, given the flexibility of factor and asset markets, the required adjustment in costs and prices would be achieved relatively quickly.

C. Financial Sector Supervision

17. **A critical issue for the discussions was whether the recent rise in interest rates, drop in equity prices, and likely correction in property prices posed systemic risks for the banking system.** The authorities noted that the financial system was well positioned to withstand the recent financial market turmoil, an assessment that appeared to be shared by a broad range of market participants and analysts. Bank profitability would certainly be adversely affected by the rise in interest rates, particularly for banks without a strong retail deposit base, since prime lending rates had been slow to respond to the sharp increase in interbank rates.[5] Nonetheless, the strong financial performance of the banks during the first half of 1997 meant that most would still show profit growth in the year as a whole. More generally, bank balance sheets were extremely strong; problem loans were low, capital-adequacy ratios averaged over 17 percent, well above the BIS-recommended 8 percent minimum, and no bank had a capital-adequacy ratio below 12 percent.

[5]Banks with a large retail deposit base tend to be insulated from higher interest rates, because rates on current deposits are set at zero percent; time deposits of less than seven days maturity are regulated by the Hong Kong Association of Banks but adjusted weekly. During the week of November 11, a small local bank suffered a run, which was successfully resisted following the announcement that the HKMA would provide liquidity support, if needed.

Box 4. Hong Kong SAR Banking Sector Indicators

Capital adequacy ratios for locally-incorporated banks in Hong Kong SAR averaged in excess of 17 percent at end-June, well above the BIS-recommended minimum. **Default rates** have been extremely low, and **nonperforming loans** constitute a small share of total loans, and are largely covered by provisions (loans to a single borrower may not exceed 25 percent of the capital base).

Liquidity is high. Banks are required to maintain 25 percent of their assets in liquid form, and must report liquidity ratios to the HKMA on a monthly basis.

Profitability is high; the average after-tax return on assets has been close to 2 percent in recent years, compared with around 1 percent for banks in the U.S. and the U.K. and less than 0.2 percent for banks in Japan. Pre-tax operating profits of locally-incorporated banks expanded by almost 18 percent during the first half of 1997, over the corresponding period of 1996, although the average after-tax rate of return moderated.

Exposure to the property sector is large, but is less when offshore loans are accounted for—at end-September property loans accounted for 44 percent of loans for use in Hong Kong but only 21 percent of total loans and advances. Risks associated with mortgage loans, which account for over one half of total property lending, also are mitigated by a voluntary maximum loan-to-value ratio of 70 percent for standard residential properties, and 50 percent for luxury apartments. Loss rates on mortgage lending have been extremely low, but the HKMA acknowledges that the historical experience may not be useful for assessing the impact of the recent crisis.

Interest rate risk is mitigated by the preponderance of floating rate mortgages. Estimates by the HKMA suggest that close to 90 percent of assets, and slightly over 90 percent of liabilities, reprice within three months.

Foreign exchange exposure appears modest since the banking sector maintains a net positive open foreign currency position. Although BIS data suggest a large net liability of Hong Kong banks to international banks (US$242 billion at end-June 1997), this may reflect loans to foreign subsidiaries. BIS data also suggests that short-term credits to Hong Kong residents by foreign banks totaled $170 billion at end-December 1996, but the extent to which these assets were matched by similar short-term obligations is unknown.

Exposure to Southeast Asia. Claims on entities in Indonesia, Korea, Malaysia, the Philippines, and Thailand represented about 8 percent of the Hong Kong SAR banking system's total external claims in June 1997 (claims on mainland entities represented an additional 8 percent of total external liabilities).

Banking Sector Indicators[1]

(In percent of average total assets, unless otherwise noted)

	1992	1993	1994	1995	1996	1997 June
Net interest margin	2.14	2.19	2.18	2.33	2.58	2.48
After-tax profits	1.85	1.92	1.85	1.82	1.79	1.62
Nonperforming assets/total credit	...	...	...	1.43	2.31	...
Provisions/total loans	...	...	...	2.04	1.92	...
Default rate (in percent)[2]	0.08	0.23	0.20	0.13	0.10	...
Capital adequacy ratio (in percent)	16.0	17.0	17.4	17.5	17.8	17.1
Open foreign currency position (HK$m.)	12.4	20.9	30.8	44.7	60.9	15.1[3]

[1]Source: Hong Kong SAR authorities; and the HKMA, 1996 *Annual Report*. Data refer to locally-incorporated banks only.

[2] Write offs as percent of average total loans.

[3] August 1997.

18. **The authorities indicated that the banks' exposure to the property sector had been a concern even before the recent market turmoil, and the HKMA had sought to encourage banks to slow the pace of property lending through moral suasion.**[6] They recognized that the importance of this issue had been heightened by the recent hikes in interest rates, and emphasized their determination to implement additional measures, if needed, to reduce the overall exposure to the property sector. They noted, however, the systemic risks were mitigated by the fact that most property loans were household mortgages, where loan-to-value ratios were conservative and default rates had been exceptionally low, even during previous episodes of high interest rates and property market corrections. Also, gearing ratios among the major property market developers were relatively modest—roughly 20 percent—and property developers also had considerable rental income to cover increases in debt service costs.

19. **The authorities noted that bank liquidity would be improved, and systemic exposure to the property market would be reduced, by the development of a market for mortgage-backed securities**. The Hong Kong Mortgage Corporation (HKMC)—a government-owned agency—would begin purchasing qualified mortgages from banks in late 1997 (HK$653 million were purchased in early December). The transactions would first be financed with unsecured debt issued by the HKMC; once the market was receptive, mortgage-backed securities would be issued, and ultimately the HKMC would be privatized. While supporting the objective of establishing a market for mortgage-backed securities, the mission noted that it would be important to avoid transferring the risks associated with mortgage lending to the public sector.

20. **The authorities emphasized their strong commitment to a high standard of bank supervision**. The supervisory system already was broadly in line with the Basle Committee's core principles, and further improvements were expected or are under consideration. For example, capital-adequacy requirements would be amended by end-1997 to take into account market risk, in response to the Basle Committee's recommendations. This was not expected to significantly affect the capital positions of the banks, since most were not significantly exposed to derivative or exchange market risks. The HKMA also had begun to be more proactive in encouraging adherence to its (voluntary) provisioning guidelines, and was reviewing the loan classification system with a view to adopting a formula-based approach.[7]

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[6]Loans to the property sector reached an average of 43 percent of total loans for use in Hong Kong at midyear, above the HKMA's recommended 40 percent benchmark.

[7]The supervisory system in Hong Kong follows the U.K. model, and provisioning is left to the discretion of individual banks, subject to guidelines and supervision by the HKMA. For example, although the HKMA adopted standards in 1994 for classifying loans (performing, special mention, substandard, doubtful, and loss), banks are given discretion in setting loan-loss provisions. HKMA guidelines currently suggest that provisions may need to be set aside

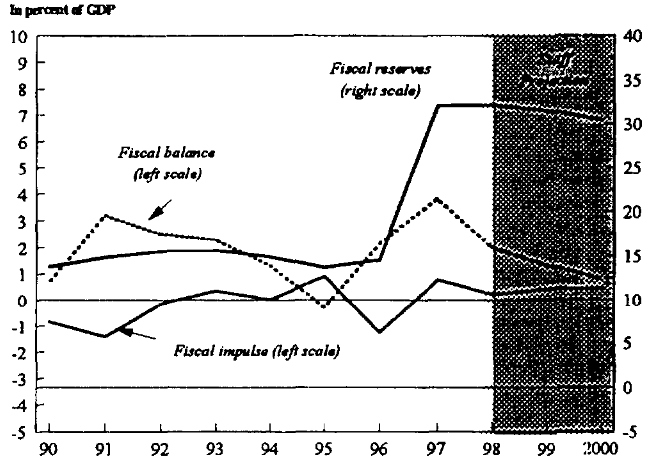
(continued...)

While disclosure standards for locally incorporated banks are quite extensive, the authorities agreed there was scope for increasing the disclosure by individual banks of problem loans, as well as expanding disclosure requirements for foreign banks with a substantial presence in Hong Kong.[8] However, a decision on the former issue would wait for the results of the review of the loan classification system.

D. Fiscal Policies

21. **Fiscal policy historically has been prudent, and the Basic Law requires the avoidance of budget deficits**. The overall fiscal balance returned to a moderate surplus (2¼ percent of GDP) in FY 1996 (April to March), partly owing to a decline in capital spending as the new airport neared completion (Tables 3 and 4; Figures 11, 12, and 13). The FY 1997 budget envisaged a surplus of 2¼ percent of GDP. However, higher asset prices, as well as the increased volume of land sales, contributed to a surge in stamp duties and land-related revenues during the first half of the year. As a result, the staff projects that the FY 1997 surplus will reach 3¾ percent of GDP, causing the fiscal reserves (the sum of past fiscal surpluses and the Land Fund) to rise above 30 percent of GDP by end-FY 1997.

FIGURE 11. FISCAL BALANCE AND RESERVES
In percent of GDP



22. **The Chief Executive's October 1997 Policy Address suggested that the large fiscal reserve provided room for new spending commitments**, and announced measures aimed at, inter alia, alleviating the shortage of housing and improving primary and secondary education, and upgrading the public transportation system. The authorities assured the mission

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[7](...continued)
for substandard loans, and should be set aside for the doubtful and loss categories. Similarly, Hong Kong banks are presently given discretion in deciding when to place past-due loans on a nonaccrual status. Although concerns have not been raised about possible abuses, as banks have generally followed prudent lending practices since the banking crisis of the early 1980s, rating agencies view this as a weakness of the prudential system.

[8]In 1994, banks began to be required to publish data on transfers to inner reserves, and in 1995 banks were required to publish the level of such reserves.

that these initiatives would be accommodated within the government's existing medium-term fiscal framework, and that recurrent spending growth would be kept in line with GDP growth, consistent with the requirements of the Basic Law.[9] The staff projected that—on the basis of present policies—the fiscal surplus would fall to about HK$29 billion (2 percent of GDP) in FY 1998. However, since the decline in the surplus would mainly be due to slower growth of revenues from land sales, the fiscal impulse would be roughly neutral in terms of its impact on domestic demand.[10]

FIGURE 12. EXPENDITURE
In percent of GDP

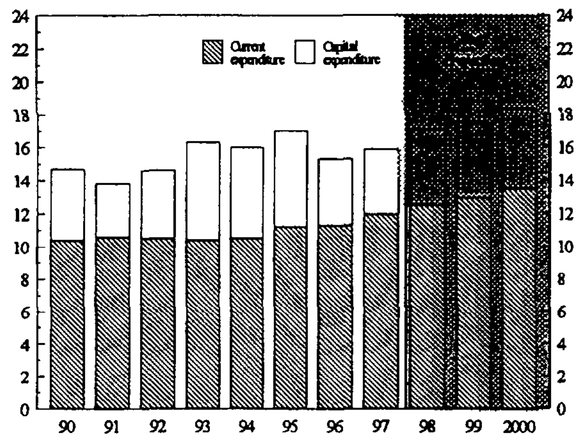
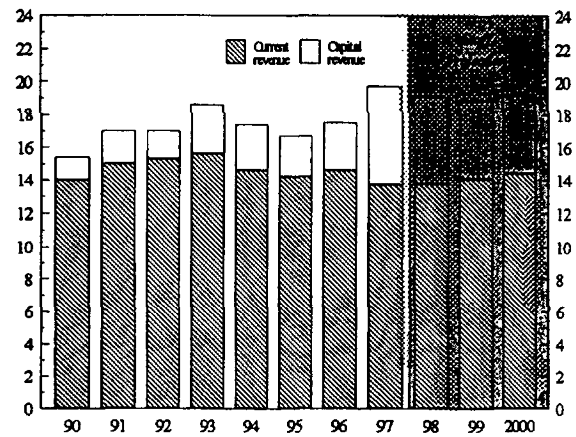


FIGURE 13. REVENUE
In percent of GDP



23. **The mission observed that the strong fiscal position had resulted in calls for a discretionary easing of fiscal policy in FY 1998, including measures to cut tax rates on profits and salaries**. The mission cautioned that a shift away from the traditional policy of substantial surpluses during FY 1998 should be avoided given the present weakness in market confidence. An easing of the fiscal stance could also impede a desirable unwinding of the demand pressures that emerged over the past year. Looking ahead to the medium term, the mission also suggested that it would be preferable to maintain a substantial fiscal reserve, given the importance of the reserves for the credibility of the exchange rate system, as well as the heavy dependence of the revenue system on relatively volatile land-related revenues.

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[9]The Basic Law requires that the "budget [be kept] commensurate with the growth rate of [the SAR's] gross domestic product." The Law does not discriminate between capital and recurrent expenditure, but it is interpreted to apply strictly only to recurrent spending. Given the lumpy nature of investment projects, capital outlays are kept in line with GDP on average, rather than on a year-to-year basis.

[10]The fiscal impulse is an estimate of the change in the fiscal deficit excluding asset transactions (chiefly revenues from sales of land), and provides a measure of the impact of fiscal policy on domestic demand.

24. **The mission suggested that demographic trends also argued in favor of maintaining large reserves.**[11] The significant increase in the old-age dependency ratio expected early in the next century would raise the burden on social safety nets, given that the current system provides essentially free medical care to Hong Kong residents and extensive income support to the low-income elderly. The Mandatory Provident Fund (MPF)—which will begin operations by the year 2000—would not significantly reduce the demands on the health care system and social safety nets by the elderly population.[12]

25. **The authorities stressed that they were committed to the fiscal framework embodied in the Basic Law, and they recognized the need for fiscal restraint in the present environment**. In particular, since the FY 1998 budget would be the first since the handover, it would be important to impress the market with the authorities' continued commitment to fiscal prudence and expenditure restraint. However, a surplus of the size estimated by the staff for FY 1998 would be difficult to sustain politically, and it would be difficult to resist pressures for at least modest tax cuts.

26. **The authorities agreed that significant fiscal reserves would help bolster confidence in the period ahead, but had not yet reached a decision on the level of reserves that would be desirable from a longer-term perspective**. They noted that, in Hong Kong's circumstances, fiscal reserves could not be used to pre-fund future spending obligations, including those that might arise from an aging population, since the Basic Law was interpreted as constraining spending as a share of GDP. Thus, the question would be whether or not the burden on the social safety nets from demographic pressures would displace spending in other areas. They also agreed that the low rate of return on reserves—well below nominal GDP growth—was an important issue, since it required large primary surpluses to maintain reserves as a share of GDP. These issues would be addressed as part of the review of the strategic objectives of the fiscal reserves that was now underway.

E. Structural and Other Issues

27. The authorities recently announced an ambitious program to alleviate the chronic shortage of low-cost **housing**. The program calls for an increase in the annual production of apartments to 85,000 units beginning in 1999—compared with recent average annual production of around 50,000 units—and an increase in the rate of home ownership from around 50 percent presently to 70 percent in the next ten years. Measures to achieve these objectives included: (i) increased supply of land for residential development; (ii) increased construction of housing for subsidized sale; (iii) expanded subsidy programs for home

[11]See the background papers for a discussion.

[12]The Mandatory Provident Fund (MPF) system will require employees to deposit 5 percent of their salaries (matched by an employer contribution) to an eligible defined contribution pension plan. Contributors would be eligible to withdraw funds in a lump sum at age 65.

ownership; and (iv) new programs for the purchase of public rental units by low-income families.

28. The mission noted that public intervention in the housing market was substantial. Roughly half the population already was housed in public rental housing, or received some sort of rental or mortgage assistance, and the government's housing program envisaged that the majority of new housing units built during the next seven years would be developed by the public sector. Studies also had shown that government housing subsidies were poorly targeted, and concerns have been raised that subsidies have contributed to high property prices. As a result, the mission suggested a greater emphasis be placed on targeting subsidies to low-income households and reducing government intervention in the housing market. The authorities responded that the government's objective of increasing the rate of home ownership recognized the need to reduce overall government involvement in the housing market over the longer term. Nonetheless, the priority in the nearer term was to promote a rapid increase in housing supply, even if this meant a substantial government participation in housing development and a measured approach to stricter means testing.

29. Regarding **industrial policies**, the government has recently announced measures to reduce the burden of government regulation, promote tourism and the entertainment industry, provide loan guarantees for small- and medium-sized enterprises, and support research and development. The authorities stressed that these initiatives did not represent a drift toward a more activist industrial policy, and were simply geared toward fostering competitiveness and high value-added economic activity in Hong Kong. For the same reasons, the authorities had announced important initiatives aimed at improving the quality of **education**, including measures to increase the share of children attending whole-day primary schools to 60 percent by the year 2002, improve the skills of primary school teachers, and increase standards for English-language instruction.

30. The authorities were of the view that the lack of a comprehensive framework for **competition policy** had not led to anti-competitive practices or increased business costs in the nontraded services sector. Indeed, Hong Kong was typically rated as one of the most competitive economies in the world. In their view, a legislated competition policy would be overly rigid and bureaucratic and, instead, a high level Competition Policy Advisory Group was to be established to address evidence of oligopolistic behavior on a case-by-case basis.

31. In the area of **trade policy**, the authorities expressed concern that textile quotas were being phased out relatively slowly, which posed a risk that industrial countries would not be able to meet their commitment to eliminate quotas by 2005. They also noted the SAR's objection to relating trade liberalization to nontrade-related issues such as labor standards; these issues were best left to other fora, such as the International Labor Organization. More generally, Hong Kong was in favor of a new round of multilateral trade negotiations, since there seemed too many issues outstanding to be dealt with separately.

32. The authorities noted the considerable progress that had been made in the area of **data dissemination**, including Hong Kong SAR's subscription to the Special Data Dissemination Standard (SDDS), and observed that further improvements were expected during the coming year. The mission acknowledged the important strides already made, but encouraged more rapid progress in a number of areas. The mission expressed particular concern with the lack of timely external current and capital account data, which hampers analysis of external developments (Annex II).

III. STAFF APPRAISAL

33. **In many respects, developments in Hong Kong SAR during the past year have generally been favorable**. The economy has recovered from the slowdown of 1994–95, inflation and the trade imbalance have been contained, the fiscal situation has strengthened, and foreign exchange reserves are ample. Concerns about the continuation of the existing economic and legal frameworks following the handover of sovereignty have waned, and the monetary authorities have successfully resisted the recent attacks on the exchange rate link.

34. **Nonetheless, the regional crisis has significantly clouded short-term prospects for the SAR**. The economic fundamentals, including the historical flexibility of factor markets, suggest that the impact of the crisis on Hong Kong could be relatively modest and short lived. However, the prospects for the real economy and financial markets depend importantly on the depth and duration of the present crisis in the region. The economic and financial market turmoil in Southeast Asia has not yet shown signs of abating, and the magnitude of the regional slowdown and the rise in domestic interest rates leaves Hong Kong at risk of substantial slowdown in activity. At the same time, the SAR's financial markets are open and relatively liquid, and depreciations within the region have resulted in a substantial loss of competitiveness, which means that Hong Kong is particularly vulnerable to further speculative attacks. In these circumstances, the critical policy challenges will be to maintain confidence in the authorities' commitment to a rules-based and noninterventionist policy framework, to ensure that financial and other policies remain supportive of the economy's historical resilience and flexibility, and to maintain the strength of regulatory oversight over the financial system.

35. **The staff continues to endorse the authorities' commitment to the linked exchange rate system**. The system has provided an anchor for economic stability since 1983, and is supported by substantial foreign exchange reserves, a large fiscal surplus, and flexible factor markets. The link also plays a critical part in maintaining confidence in Hong Kong's role as an international financial center, to a significant degree because it demonstrates the continued commitment to free market policies. In the staff's view, the potential disadvantages of a fixed exchange rate are outweighed by the assurance it provides of an independent monetary policy under the "one country, two systems" approach. Since the risk of further adverse shifts in market sentiment remains significant, monetary conditions will probably need to remain tight for a period of time. However, higher interest rates would facilitate a desirable

unwinding of the asset price inflation, rapid credit growth, and labor market tightness that emerged during the past year. These adjustments will have the important benefit of helping to ensure the continued competitiveness of the Hong Kong economy.

36. **Recent financial market turmoil is likely to place the domestic banking sector under pressure, and profitability is likely to be eroded if interest rates stay high.** Nonetheless, the strength of the prudential and regulatory oversight of the financial sector, as well as the strong capital position and profitability of the domestically incorporated banks, should help the system weather the regional crisis. Further steps to enhance disclosure of banks' problem loans, more specific guidelines for provisioning and income recognition, and improvements in the financial disclosure by foreign and mainland banks and nonbanks, could help reduce market uncertainty and limit risks of unwarranted contagion. There also is a need to ensure stricter adherence to existing prudential guidelines on bank exposure to the property sector. The development of a market for mortgage-backed securities will allow banks to enhance their liquidity and risk management, but it will be important to ensure that the creation of the Mortgage Corporation does not result in a significant liability for the public sector.

37. **The staff strongly endorses the commitment to prudent fiscal policies.** Given the exceptionally strong fiscal outturn in FY 1997, there will undoubtedly be pressures to relax fiscal policies in the FY 1998 budget—the first budget following the handover. The staff would not recommend the introduction of substantial expansionary measures. In view of the recent turmoil in financial markets, and the need to allow demand pressures to unwind, this would not be a propitious moment to signal a shift away from the tradition of significant surpluses. Indeed, given the importance that large fiscal reserves play in maintaining confidence in the authorities' policy framework, including the exchange rate link, it would be appropriate to maintain a substantial fiscal reserve over the medium term. A large reserve would also provide assurances that resources will be available to meet the substantial fiscal burden that is expected to arise from population aging.

38. While the authorities' emphasis on rationalizing its **housing policies** is appropriate, public sector intervention in the housing market is large, and roughly half the population lives in public housing or receives some form of housing assistance. In the staff's view, an emphasis needs to be placed on reducing overall government involvement in the housing market, particularly by increasing the supply of land for private sector development and by more strictly targeting subsidies to the truly needy.

39. Notwithstanding the near-term risks, Hong Kong's **medium-term economic prospects** appear favorable. Productivity is high, and Hong Kong is in a unique position to benefit from the growing demand by the mainland for financial, business, and trade-related services. However, it will be important to resist pressures to adopt programs aimed at promoting specific industries or sectors, since these could impair the flexibility of goods and labor markets, and their ability to adjust to changing economic circumstances. Improvements

in the competitive environment within the services sector, including through further deregulation, would be the most effective means of reducing business costs.

40. The authorities' recent efforts to improve the timeliness and accuracy of **economic data** for Hong Kong SAR, and their subscription to the Special Data Dissemination Standard, are commendable. However, further progress is needed in this area, especially with regard to the timely provision of external current and capital account data.

41. The staff recommends that the **next Article IV consultation discussions** take place in accordance with the standard 12-month cycle.

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators

Nominal GDP (1996): US$154 billion
Population (mid-1997): 6.5 million
GDP per capita (1996): US$24,500

	1994	1995	1996	Latest 1997	Staff Projections 1997	Staff Projections 1998
Real GDP (percent change)	5.4	3.9	4.9	6.3 1/	5.3	3.8
Real domestic demand	11.8	7.1	3.4	8.7 1/	8.0	4.0
Private consumption	6.7	1.6	4.8	6.8 1/	5.2	2.8
Gross fixed capital formation	15.7	10.4	12.2	17.5 1/	13.6	4.7
Foreign balance (contribution)	-5.9	-3.3	1.4	-3.1 1/	-2.9	-0.5
Saving-investment balance (percent of GDP) 2/	1.9	-3.0	-1.7	-2.3 1/	-2.5	-1.7
Gross domestic saving	33.1	30.4	30.6	31.2 1/	31.1	31.4
Gross domestic investment	31.9	34.8	32.3	33.5 1/	33.6	33.1
Inflation (percent change)						
Consumer prices	8.1	8.7	6.0	5.8 3/	6.0	5.0
GDP deflator	6.9	2.6	5.5	6.9 1/	6.5	4.8
Employment (percent change)	2.6	1.1	3.5	4.0 4/	...	...
Unemployment rate (percent)	1.9	3.2	2.8	2.2 5/	...	...
Real wages	1.3	-1.1	0.4	0.3 6/	...	...
Government budget (percent of GDP) 7/						
Revenue	17.3	16.7	17.5	...	19.7	19.0
Expenditure	16.0	17.0	15.3	...	15.9	17.1
Consolidated budget balance	1.3	-0.3	2.2	...	3.8	2.0
Reserves at March 31 8/	14.9	13.7	14.5	...	32.1	32.2
Money and credit (percent change, end-period)						
Narrow money (M1)	-1.2	2.8	14.2	6.6 9/	...	...
Broad money (M3)	13.6	13.6	10.6	12.0 9/	...	...
Loans for use in Hong Kong	17.1	11.1	17.0	30.7 10/	...	...
Interest rates (percent, end-period)						
Best lending rate	8.5	8.8	8.5	9.8 11/	...	...
Three-month HIBOR	6.3	5.9	5.5	10.0 11/	...	...
Merchandise trade (percent change)						
Export volume	10.4	12.0	4.8	5.0 4/	5.0	5.5
Domestic exports	-2.3	2.0	-8.4	1.0 4/	2.0	0.5
Reexports	13.8	14.3	7.5	5.7 4/	5.6	6.3
Import volume	14.0	13.8	4.3	6.8 4/	6.3	5.9
Export value	11.8	14.9	4.0	3.0 12/	3.4	6.2
Import value	16.6	19.2	3.0	5.0 12/	4.1	6.2
Terms of trade	-0.9	-2.1	0.6	0.1 4/	0.5	0.4
External balances (in billions of US$)						
Merchandise trade balance	-10.9	-19.6	-18.3	-16.5 13/	-20.5	-21.8
In percent of GDP	-8.4	-14.1	-11.9	-12.2 14/	-11.8	-11.6
Goods and nonfactor services balance	1.6	-6.0	-2.6	-5.0 14/	-4.3	-3.2
In percent of GDP	1.2	-4.3	-1.7	-2.3 14/	-2.5	-1.7
Foreign exchange reserves (in billions of U.S. dollars, end of period)	49.3	55.4	63.8	96.5 15/	...	...
In months of retained imports	9.9	9.1	10.7	15.5 15/	...	...
Exchange rate						
Linked rate (fixed)				HK$7.80/US$1		
Market rate (HK$/US$1, period average)	7.728	7.736	7.734	7.743 16/	...	...
Real effective exchange rate (period average, 1990=100)	130.1	128.6	136.2	147.2 17/	...	...

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

1/ First half of 1997 over first half of 1996; saving and investment ratios are averaged over second half 1996–first half 1997.
2/ Foreign component of saving included for 1994–95 only.
3/ January–November 1997 (average of 12-month changes).
4/ January–September 1997 over January–September 1996.
5/ January-September.
6/ March 1997 over March 1996.
7/ Fiscal year begins April 1.
8/ Fiscal reserves at end-FY1997 include the projected HK$205 billion balance in the Land Fund (15.3 percent of GDP).
9/ October 1997 over October 1996.
10/ September 1997 over September 1996.
11/ November 1997.
12/ January-October 1997 (average of 12-month changes).
13/ September 1997.
14/ June 1997; ratios to GDP are for the last four quarters.
15/ November 1997. Includes US$17.4 billion Land Fund assets.
16/ January–November 1997.
17/ January–October 1997.

Table 2. Hong Kong SAR: Gross Domestic Product by Expenditure Component at Constant (1990) Market Prices, 1992–97

(Percentage change)

	1992	1993	1994	1995	1996	1997 Jan.-June 1/
Consumption	8.3	6.9	6.4	1.9	4.7	6.6
Private	7.7	7.5	6.7	1.6	4.8	6.8
Government	13.2	2.2	3.9	4.4	4.3	5.3
Gross fixed capital formation	9.2	3.7	15.7	10.4	12.2	17.5
Private	9.7	-0.7	15.5	8.8	11.5	21.5
Government	5.2	39.3	17.1	19.4	15.9	-1.4
Final domestic demand	8.6	5.9	9.1	4.5	7.2	10.3
Private	8.3	5.1	9.2	3.7	6.9	13.5
Government	10.9	12.4	8.4	9.9	9.0	2.4
Total domestic demand	9.2	4.9	11.8	7.1	3.4	8.7
Exports of goods and nonfactor services	18.3	12.7	9.8	11.0	4.9	4.9
Exports of goods	19.8	13.5	10.4	12.0	4.8	5.2
Domestic exports	0.2	-4.5	-2.3	2.0	-8.4	-1.9
Reexports	28.3	19.6	13.8	14.3	7.5	6.4
Exports of nonfactor services	10.6	8.0	6.5	4.8	5.8	3.3
Imports of goods and nonfactor services	20.8	12.0	13.5	12.7	4.1	6.3
Imports of goods	22.2	12.7	14.0	13.8	4.3	6.7
Imports of nonfactor services	9.7	5.8	8.8	2.0	1.9	2.1
Gross domestic product	6.3	6.1	5.4	3.9	4.9	6.3
Memorandum items:						
Contribution to growth:						
From total domestic demand	8.7	4.7	11.3	7.2	3.5	9.3
Of which: From change in stocks	0.7	-1.0	2.6	2.8	-3.6	-1.3
From net exports of goods and nonfactor services	-2.5	1.4	-5.9	-3.3	1.4	-3.1

Sources: Census and Statistics Department, *Quarterly Report of GDP Estimates, Second Quarter 1997.*

1/ Percentage changes calculated over January–June 1996.

Table 3. Hong Kong SAR: Consolidated Government Account, FY 1993–FY 1997 1/

	1993/94	1994/95	1995/96	1996/97		1997/98	
				Budget	Actual	Budget	Staff Proj.
				(In billions of Hong Kong dollars)			
General Revenue Account							
Revenue	143.9	151.1	153.2	162.6	173.9	177.9	183.9
Expenditure	98.5	108.2	123.3	142.1	138.5	159.4	164.4
Current	93.2	106.0	120.3	137.9	134.7	154.4	159.4
Capital	5.3	2.2	3.0	4.2	3.8	5.0	5.0
Surplus before transfers	45.4	42.9	29.9	20.5	35.4	18.5	19.5
Transfers to funds	22.5	39.1	32.5	15.1	13.4	4.3	...
Balance after transfers	22.9	3.8	-2.6	5.4	22.0	14.2	...
Consolidated Account Funds 2/							
Revenue 3/	22.7	23.9	26.8	33.1	34.5	56.9	80.4
Capital expenditure 4/	47.7	53.6	59.8	52.0	44.2	43.7	48.9
Surplus before transfers	-25.0	-29.7	-33.0	-18.9	-9.7	13.2	31.5
Transfers from General Revenue Account	22.5	39.1	32.5	15.1	13.4	4.3	...
Balance after transfers	-2.5	9.4	-0.5	-3.8	3.7	17.5	...
Total Consolidated Account							
Revenue	166.6	175.0	180.0	195.7	208.4	234.8	264.3
Expenditure	146.2	161.8	183.1	194.1	182.7	203.1	213.3
Current	93.2	106.0	120.3	137.9	134.7	154.4	159.4
Capital	53.0	55.8	62.8	56.2	48.0	48.7	54.9
Surplus (+)/Deficit (-)	20.4	13.2	-3.1	1.6	25.7	31.7	51.0
Fiscal reserves balance, end of fiscal year 5/	140.2	151.0	147.9	150.2	173.6	194.7	224.6
				(In percent of GDP)			
Total Consolidated Account							
Revenue	18.6	17.3	16.7	15.5	17.5	17.3	19.7
Expenditure	16.3	16.0	17.0	15.3	15.3	15.0	15.9
Current	10.4	10.5	11.2	10.9	11.3	11.4	11.9
Capital	5.9	5.5	5.8	4.4	4.0	3.6	4.0
Surplus (+)/Deficit (-)	2.3	1.3	-0.3	0.1	2.2	2.3	3.8
Fiscal reserves balance, end of fiscal year 5/	15.6	14.9	13.7	11.9	14.5	14.4	16.8
				(Percentage change)			
Total Consolidated Account							
Revenue	25.5	5.0	2.9	8.7	15.8	12.7	26.8
Expenditure	29.0	10.6	13.2	6.0	-0.2	11.2	16.7
Current	14.2	13.7	13.5	14.6	12.0	14.6	18.3
Capital	67.2	5.3	12.5	-10.5	-23.6	1.5	12.3
Fiscal reserves balance, end of fiscal year 5/	15.9	7.7	-2.1	1.5	17.4	12.2	29.4

Sources: Data provided by the Government Secretariat, Finance Bureau; and staff projections.

1/ The fiscal year begins April 1.

2/ Consists of the Capital Works Reserve Fund; Capital Investment Fund and Loan Fund beginning in 1990/91; Disaster Relief Fund beginning in 1993/94; and Civil Service Reserve Fund beginning in 1994/95.

3/ Includes revenue from land sales.

4/ Includes direct financing of airport-related projects as well as Government equity injections into the Airport Authority and the Mass Transit Railway Corporation.

5/ Excluding the Land Fund.

Table 4. Hong Kong SAR: Medium-Range Fiscal Forecast, FY 1996–FY 2001 1/

	1996/97 Actual	1997/98 Budget	1997/98	1998/99	1999/2000	2000/01
			Staff Projections			
	(In billions of Hong Kong dollars)					
Revenue	208.4	234.8	264.3	277.5	301.3	334.5
General Revenue Account	173.9	177.9	183.9	200.6	224.8	251.2
Consolidated Account Funds	34.5	56.9	80.4	76.9	76.5	83.3
Of which: Capital Works Reserve Fund 2/	...	49.4	...	40.0	46.9	49.4
Expenditure	182.7	203.1	213.3	248.6	280.3	320.8
General Revenue Account	138.5	159.4	164.4	181.6	206.5	235.5
Consolidated Account Funds	44.2	43.7	48.9	67.0	73.8	85.3
Of which: Capital Works Reserve Fund 3/	...	35.7	32.5	40.8	48.0	54.9
Capital Investment Fund 4/	...	0.8	5.6	16.9	16.0	18.1
Surplus (+)/Deficit (-)	25.7	31.7	51.0	28.9	21.0	13.7
Fiscal reserves balance, end of fiscal year 5/	173.6	374.9	429.1	469.5	502.6	529.3
Balance in the Land Fund of the HKSAR 6/	...	197.0	...	...	...	...
	(In percent of GDP) 7/					
Revenue	17.5	17.3	19.7	19.0	18.9	19.2
Of which: Land sales 8/	2.6	3.8	5.4	4.5	4.3	4.3
Expenditure	15.3	15.0	15.9	17.1	17.6	18.4
Surplus (+)/Deficit (-)	2.2	2.3	3.8	2.0	1.3	0.8
Fiscal reserves balance, end of fiscal year 5/	14.5	27.7	32.1	32.2	31.5	30.4
Balance in the Land Fund of the HKSAR 6/	...	14.5	...	...	...	...

Sources: Government Secretariat, Finance Bureau; *The 1997/98 Budget*; and staff estimates.

1/ Fiscal year beginning April 1.

2/ Includes mainly revenue from land sales. From July 1, 1997 onward, land revenues which previously accrued to the Land Fund will be included in the HKSAR budget.

3/ Includes financing of airport-related projects.

4/ Includes Government equity injections into the Airport Authority and Mass Transit Railway Corporation.

5/ Fiscal reserves at the end of FY 1997/98 include the balance in the Land Fund (HK$197 billion as of July 1, 1997), which reverted to the HKSAR on July 1, 1997.

6/ Balance shown is as of July 1, 1997.

7/ Calculated with respect to calendar year GDP.

8/ Staff estimates.

Hong Kong SAR—Fund Relations

I. Membership status:

As a Special Administrative Region of the People's Republic of China, Hong Kong SAR is not a member of the Fund. However, annual consultation discussions have been held with the Hong Kong authorities since October 1990, and the staff also holds discussions with the authorities in connection with the staff's International Capital Markets reports. STA has provided Hong Kong with technical assistance in the area of balance of payments statistics and Hong Kong officials have attended INS courses on balance of payments and monetary statistics, and financial programming. The Hong Kong Monetary Authority is a participant in the New Arrangements to Borrow, in an amount of SDR 340 million.

II. Exchange Rate Arrangements:

The Hong Kong dollar has been linked to the U.S. dollar under a currency board arrangement since October 1983 at a rate of HK$7.8/US$1. The market rate fluctuates around the linked rate, usually within a margin of less than 1 percent. There are no restrictions on current or capital transactions in Hong Kong SAR, and the Hong Kong dollar is freely convertible.

Hong Kong SAR—Statistical Issues

Hong Kong SAR provides statistics to the Fund on a timely basis for surveillance and publication in *International Financial Statistics*, and has subscribed to the SDDS. However, there are a number of data deficiencies, including:

- Data on current transfers are not compiled.
- Data on the capital account, and portfolio and other investment are not compiled. Only partial data on direct investment are available.
- Domestic and foreign assets and liabilities of the banking system are not classified by residency principle. Fully disaggregated data are not available on the banking system's domestic assets and liabilities in accordance with the Fund's methodology.
- Production-based GDP estimates at constant prices are not compiled.
- GFS data are not reported to STA.

These data deficiencies hamper analysis of the external financial position and competitiveness of services industries. To address this concern, the authorities have taken several initiatives in the past two years:

- An annual survey of external factor income flows was launched in 1994. Data for external factor income flows and GNP estimates are now available for 1993–95.
- A research project to compile balance of payments estimates for 1993–95 was started in 1996. STA provided technical assistance to the project.
- The authorities have developed a plan and secured the necessary policy and funding support to launch a full-scale balance of payments survey. The balance of payments statement would become available in stages between end–1998 and end–1999.

Hong Kong SAR

Survey of Reporting of Main Statistical Indicators

As of end–November 1997

	Exchange rates	Inter-national reserves	Reserve/ base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index	Exports/ Imports	Current account balance 1/	Overall government balance 2/	GDP/GNP
Date of latest observation	Nov. 29	Oct. 31	Oct. 1997	Sep. 30	Oct. 1997	Nov. 29	Oct. 1997	Oct. 1997	Oct. 1997	FY 1996	Q2 1997
Date received	Nov. 29	Nov. 27	Nov. 28	Nov. 10	Nov. 28	Nov. 29	Nov. 21	Nov. 27	Nov. 27	March 1997	Nov. 3
Frequency of data	D	M	M	M	M	D	M	M	M	A, Q	Q
Frequency of reporting	D	M	M	M	M	D	M	M	M	A, Q	Q
Frequency of publication	D	M	M	M	M	D	M	M	M	A, Q	Q
Source of data	C, N	N	N	N	N	C, N	N	N	N	N	N
Mode of reporting	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M
Confidentiality	C	C	C	C	C	C	C	C	C	C	C

1/ Merchandise trade balance. Balance on goods and non-factor services reported quarterly, with the same lag as GDP data. Full current account data are not compiled.

2/ Fiscal year beginning April 1.