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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/9

3:30 p.m., January 23, 1991

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	Z. Iqbal, Temporary
	L. E. N. Fernando
	D. Powell, Temporary
Dai Q.	Zhang Z.
	J. M. Abbott, Temporary
	B. Szombati, Temporary
	G. H. Spencer
	B. Bossone, Temporary
	T. S. Allouba, Temporary
	A. Gronn, Temporary
B. Goos	
	C. D. Cuong, Temporary
	G. Bindley-Taylor, Temporary
	J.-L. Menda, Temporary
	M. A. Hammoudi, Temporary
	L. J. Mwananshiku
D. Peretz	
G. A. Posthumus	
	K. Kpetigo, Temporary
	M. Galán, Temporary
A. Végh	
K. Yamazaki	N. Tabata

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

Also Present

Asian Department: K. Saito, Deputy Director; M. J. Fetherston, J. E. Leimone, B. J. Smith. European Department: H. O. Schmitt, S. M. Thakur. Exchange and Trade Relations Department: T. Leddy, Deputy Director. Legal Department: P. L. Francotte, R. B. Leckow. Bureau of Statistics: Q. M. Hafiz. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisor to Executive Director: H.-J. Scheid. Assistants to Executive Directors: Chen M., B. R. Fuleihan, O. A. Himana, K. Ichikawa, C. J. Jarvis, M. E. F. Jones, W. Laux, R. Meron, M. Mrakovcic, J.-P. Schoder, Shao Z., S. von Stenglin, Wang J.

1. UNITED KINGDOM - HONG KONG - 1990 ARTICLE IV CONSULTATION DISCUSSIONS

The Executive Directors continued from the previous meeting (EBM/91/8, 1/23/91) their consideration of the staff report for the 1990 Article IV consultation discussions with respect to Hong Kong (SM/90/233, 12/19/90; and Cor. 1, 1/17/90). They also had before them a background paper on recent economic developments in Hong Kong (SM/91/2, 1/4/91).

Ms. Powell recalled that Mr. Peretz had remarked that if the tourist industry or other sectors of the services industry were to become uncompetitive, wages in that sector would subsequently adjust and pressures on the labor market would ease. She did not disagree with that idea, although the adjustment might take some time and could involve a shrinking of the tourist industry. However, such an outcome seemed much less likely in the public sector, which, while small compared with the public sector of other countries, still was the largest employer in Hong Kong and was likely to expand in response to an increased demand for social and other public services. Rising expenditures on education, for example, were probably necessary to ensure a continued upgrading of qualifications and skills of the labor force. If wages in the traded goods sector continued to reflect large productivity gains, there would have to be adjustments, like those in public sector wages in 1990. Those conclusions suggested that public expenditure, as proportion of GDP, could increase--even apart from the large planned infrastructure projects--which underscored the desirability of widening the tax base. Finally, she welcomed the first consultation discussions with Hong Kong and supported the request to conduct full consultations in the future on an annual basis.

The staff representative from the European Department said that he agreed with the comments that Mr. Peretz had made at the previous meeting. Directors were clearly concerned about the implications for inflation that flowed from the linked exchange rate system. The current rate of inflation--about 10 percent--seemed to be close to its peak level. The recession was thus far over a year old, but it had not yet led to an easing of labor cost pressures. Competitiveness in many industries was clearly under strain at present. Wage growth, which had reached 20 percent, had been receding for a number of quarters, and the staff had no doubt that, as the recession continued into the coming months, there would be a considerable easing of labor cost pressures and, in due course, of inflation as a whole. Hence, as Mr. Peretz had suggested, with the cyclical slowdown the inflationary problem in Hong Kong was not likely to get out of hand.

Nevertheless, the staff representative went on, as long as Hong Kong continued to enjoy relatively strong productivity growth in manufacturing relative to other industries, some excess of inflation over and above that in other industrial countries seemed difficult to avoid while the linked exchange rate was in place. Of course, that problem was not unique to Hong Kong--for example, it had been a persistent feature of Japanese experience in the 1960s, when rapid growth in manufacturing had led consumer prices in

Japan to increase to a rather high level. That inflation had been a part of the adjustment process; it was part of the mechanism by which wealth was spread throughout the economy under a fixed exchange rate system. But clearly that development was not also without cost: it distorted resource allocation, might discourage savings, and would hurt industries such as tourism, as was already clearly evident in Hong Kong. What had been an inexpensive tourist haven a number of years previously had become an expensive one at present, and the upward price pressures in that sector were likely to continue. At the same time, while one should not ignore the costs, one should also avoid overestimating them.

During the consultation discussions the staff had been aware of the problems stemming from inflation and had searched as best it could in the economy for evidence of distortions caused by the inflation, the staff representative continued. The one piece of evidence that the staff had noted consistently was in the property market, and particularly the heavy reliance on investment in buildings and property development as sources of wealth creation and investment in Hong Kong. There was little evidence of other distortions caused by the inflation. For example, the low negative real interest rates might well have been expected to hurt savings, but gross savings in Hong Kong were estimated to be in excess of 30 percent of GDP. While the staff would therefore not go so far as to say that the inflation had not created distortions, the staff would caution against overestimating the extent of the problem.

The linked exchange rate system admittedly had a cost, the staff representative from the Asian Department remarked, and the authorities would certainly agree with that conclusion. However, that cost should be weighed against the benefits, which, in the view of the authorities and the staff, had proved to be substantial.

Mr. Bossone made the following statement:

> I will focus my remarks on one critical issue, inflation, which has so animated the discussion thus far. However, let me clarify at the outset that the brevity of my comments, which will be restricted to a single critical aspect of Hong Kong's economy, should not convey the wrong impression to the authorities. Indeed, I would like to stress the full appreciation of this chair for the success achieved by Hong Kong in its remarkably rapid progress toward economic development, for the wisdom of the authorities' long-term development strategy, and for the valuable example they have set for all countries on how to prosper through freedom of trade and enterprise. This chair welcomes the starting of the process of regular consultations between the Hong Kong authorities and the Fund.
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> As regards Hong Kong's most urgent problems, which might very likely produce medium-term complications, this chair--like

others--is concerned about the current level of inflation and the prospects for price increases in the near future. What concerns us most is that, as one speaker has noted this morning, it seems that both the staff and the authorities have a sort of "fatalistic" approach to the problem. The result is that the underlying policy framework does not address the problem with the needed attention. Many factors contribute to keeping inflation high: (i) economic growth is sustained by consumption while investment appears feeble and might stay so for a number of years; (ii) conditions in the labor market continue to be tight while the stance of the authorities on relieving labor shortages through imports of skilled labor is rather restrictive; (iii) the uniformity of sectoral wage increases, vis-à-vis the ongoing shift of the economy's production structure to sectors with lower productivity growth, adds to the inflationary pressure; (iv) the medium-term budgetary plans may well turn out to be expansionary, as the income growth projections used to estimate revenue may be overoptimistic; and (v) a heavy concentration of public capital spending is expected to take place in the years ahead while no clear signals of revenue-raising measures appear in sight.

All this not only suggests that the current inflation is likely to persist but also threatens that its trend might well deteriorate. Fears of deterioration are even reinforced when one considers the traditional reluctance of the Government to use fiscal policy as a demand-management tool. The staff has this morning underscored that inflation in Hong Kong is a sectoral, rather than a general, economy-wide problem. This might be so for the time being, but the intersectoral linkages of the economy, particularly in the case of the inflation-prone sectors identified by the staff, would sooner or later transmit a cost push to other sectors, affecting competitiveness in the export industry.

This chair joins others in believing that the authorities should act much more drastically in the area of inflation. To this purpose, following a specific announced commitment by the authorities to reduce inflation, a sudden change in the fiscal policy attitude, for instance, could be desirable. It would be immediately credible and would attain quick results, especially because it would diverge radically from the traditional policy pattern pursued so far. Some temporary forms of direct taxation and ways to broaden the tax base might do the job fairly well, thus avoiding the inflationary effects of indirect taxes. From the point of view of efficiency, I certainly agree with both the authorities and the staff that a broader-based indirect tax should eventually be introduced, but I would discourage the authorities from choosing the present time for such an operation.

Looking also at other possible policy options, this chair believes that there is scope for improvements in the exchange rate policy. Having considered the opinions debated earlier, this chair remains convinced that a nominal appreciation of the Hong Kong currency vis-à-vis the U.S. dollar would have the overall benefit of lowering inflation and, above all, of inducing discipline in the private sector. Coupled with a tax maneuver along the lines I have sketched out, this should not jeopardize credibility, as the staff has warned this morning, but instead would indeed reinforce it. I would welcome staff comments on this option.

This chair urges the authorities to upgrade their statistical information system for balance of payments data. As part of the international community and with a view to playing an increasingly active role in international cooperation, the authorities should make every effort to improve the availability, transparency, and timeliness of statistics.

Finally, this chair supports the authorities' request for annual consultations.

Ms. Szombati said that Hong Kong's economic performance continued to be impressive. With rapid GDP growth--averaging 2 percent a year--for the past 25 years, Hong Kong was one of the dynamic newly industrialized economies (NIEs) that had emerged during the 1980s. In addition, it had become one of the major financial and trade centers of Asia. The Government's policy of "positive nonintervention" provided a stimulating economic environment for both domestic entrepreneurs and international investors with a free exchange and trading system, a fixed exchange rate, open capital markets, and low taxation. Hong Kong's excellent performance doubtless had much to do with the ability of its strong private economy, operating under conditions of minimal governmental regulation, to adapt rapidly to external changes and take full advantage of its strategic geographic situation. However, that flexibility and adaptability had a price: in the absence of corrective monetary or fiscal measures to ward off trouble or moderate the effects of external shocks, adjustment would sooner or later become unavoidable; and in the absence of policies for alleviating its rigors, the adjustment was likely to be very painful when it did take place.

However vividly Hong Kong's economic performance illustrated the effectiveness of free-market mechanisms, Ms. Szombati said, it must be regarded as an anomaly in the current highly interdependent world economy. Many nations coordinated their domestic policies through cooperative arrangements, and very few countries were politically or historically positioned to create a similar free environment for economic agents.

Hong Kong's failure to collect data on its capital account and international reserves was disappointing, Ms. Szombati said. Such a failing hardly seemed consistent with the role Hong Kong played in international finance, and she would like to see the Government make a greater effort to correct it.

Mr. Galán commented that his chair welcomed the Article IV consultation discussions for the territory of Hong Kong and supported Mr. Peretz's proposal to hold future discussions on the annual consultation cycle.

It was difficult and challenging to find a policy recommendation for a country with such an impressive record of economic performance, Mr. Galán continued. Hong Kong had grown at a rate of 8 percent per year for the past 25 years, and it had the ability, with its labor and enterprise skills, to adapt rapidly to changes in the international market environment; in addition, there were no exchange restrictions on current or capital transactions, and the country had been a remarkable example of a free trade policy. The Government had successfully focused on maintaining a favorable economic environment for private financial sector development. Nevertheless, to fully appreciate, understand, and transmit Hong Kong's impressive record, he welcomed the authorities' consideration of the recommendation to fill important gaps in the balance of payments statistics and to verify whether or not the compilation of the data would be feasible.

With respect to the discussion of inflationary pressures and their relation to the exchange rate policy in Hong Kong, he still harbored doubts about how much of the inflation was domestically generated and how much was imported, especially as the U.S. inflation rate had almost doubled in the past five years, Mr. Galán said. Staff comments on that matter would be helpful. He wondered whether the staff felt that the rise in inflation had been affecting the flow of capital in Hong Kong and what the expectations were for that flow in the near future.

Mr. Abbott made the following statement:

Hong Kong is now a substantial economy with an annual GDP of $70 billion. It is a marvelous example of extraordinarily successful externally oriented economic development. Over the years it has shown exceptional ingenuity and adaptability in adjusting to external disturbances. The prospective 1997 transfer of authority from the United Kingdom to China will be a landmark step, expanding the integrative opportunities of Hong Kong but also testing the economic management skills of all concerned.

I believe that it is timely for the Fund to have begun Article IV consultations with Hong Kong. I would like to thank the Managing Director for his foresight and initiative in launching these consultations. I would also like to express my appreciation both to the U.K. and the Hong Kong authorities for their assistance and cooperation in this work. The staff is to be commended for an excellent report providing welcome perspective on economic developments in Hong Kong and clear analysis of the policy tools the Hong Kong authorities have developed to manage their very open economy. I also welcome Mr. Dai's statement reconfirming support for the one country/two system approach to development and his authorities' commitment to the continued capitalistic development of Hong Kong.

If there is any doubt that trade can be the handmaiden of growth, that doubt should be dispelled by a reading of these reports on Hong Kong. As an occasional visitor to Hong Kong, and as a shopper in the United States, I was well aware of the extent to which Hong Kong relied on trade. But, in line with Mr. Landau's remarks, I was struck by the extent to which Hong Kong has been able, repeatedly, to exploit emerging trade opportunities to achieve progressively higher levels of development and higher standards of living for its population. The gains from the increased integration of the Hong Kong economy with the economy of Southern China is the most recent example of this process. Increasing specialization in higher value-added activities has been possible because trade opportunities were available and utilized. Furthermore, the rapid economic progress in southern China is testimony that the gains from trade have been mutual. With growing affluence, whole new sectors, such as tourism, transport, and finance, have come into prominence. The adaptability that is characteristic of the Hong Kong economy allowed these new sectors to emerge and flourish.

"Positive nonintervention" is a policy that appears to have served the economy well. While government expenditure is maintained at a low level of GDP, some of the social indicators reported are impressive. Life expectancy is very high, medical expenses are largely provided for, and education is heavily supported. The Government is deeply involved in the housing sector. The current governmental support for major public projects points to the "positive" side of "positive nonintervention." I highlight these indicators of public sector involvement because it is somewhat jolting for a regular reader of staff reports to read that Hong Kong is an economy with no government debt, that it has run budgetary surpluses for five successive years, and that it has a contingency reserve equivalent to 15 percent of GDP. I would be interested in any observations the staff would care to make as to the quality of public services in Hong Kong.

The staff report and background paper provide very useful explanations of developments in Hong Kong's banking and financial markets and helpful analysis of new techniques of monetary control. The staff notes that the dominant objective of monetary policy is to maintain the exchange link to the U.S. dollar, so that there is little latitude for separate internal monetary objectives. The staff also observes that, despite the cyclical downturn since 1989, inflation has not settled back to the extent hoped. I gather that it is the staff's view that there is considerable scope for the prices of nontraded goods to run ahead of traded goods prices, so that overall inflation could persist at 10 percent for some time. In an economy as open as that of Hong Kong, I would have expected a rather tighter relation between traded and nontraded goods prices under a pegged exchange rate regime. I would be interested in any additional thoughts the staff has on the security of the monetary anchor under the linked exchange rate system operated by Hong Kong.

In the reports it is clearly explained that missing information on factor services, transfers, and capital flows makes it impossible to construct current account and capital account balances. Nonetheless, page 38 of the background to the staff says that judgmental inferences about private capital movements are possible, and that it appears there was a shift toward significant private capital outflows in 1989. Could the staff comment further on whether it believes that these outflows represent capital flight or cyclical accommodation of the slowdown in domestic activity?

The reports reviewed here today mark an important step forward in our understanding of trade and financial trends in the Hong Kong region. Gaps remain, and I would encourage the Hong Kong authorities to continue to work closely with the staff to improve both the quality and the availability of the fundamental statistics. As the date for transfer of authority from the United Kingdom to the People's Republic of China draws closer, I am sure that the Board will wish to be as fully informed as possible of any monetary or payments implications of that transfer. I support Mr. Peretz's recommendation that Article IV consultations be conducted on an annual rather than a bicyclical schedule. I am delighted that this dialogue with the Hong Kong authorities has begun and I would again like to complement all involved in making these consultations possible.

Mr. Gronn commented that the Hong Kong economy had performed impressively, and, in line with the thrust of the staff appraisal, he would particularly underline the importance of sticking to the fixed exchange rate regime for reasons of confidence. It was equally essential to address the issue of widening of the tax base in order to maintain over time a sound fiscal balance while at the same time allowing low tax rates to benefit the economy.

He wished to make two specific comments, Mr. Gronn said. First, on the problem of inflation, the staff had reported that the inflation rate in Hong Kong was likely to remain above the rate in partner countries. In view of the policies pursued by the authorities, including maintaining a fixed exchange rate pegged to the U.S. dollar and not wanting to use fiscal policies for demand-management purposes, it seemed that the authorities needed to rely on other means to reduce inflation. He had listened with interest to the discussion of alternative pegs and the possibility of currency appreciation to counter inflation. For its part, the staff had suggested timely integration of labor to avert labor shortages. A third possibility would be, at least in principle, to introduce incomes policies. Given the authorities' adherence to nonintervention, and even though he understood that the wage formation in the labor market was, as Mr. Peretz had mentioned, very flexible to changing circumstances, he wished to ask the staff if incomes policy would play a constructive role in dampening the inflationary tendencies of the Hong Kong economy.

Second, he had noted with interest the statement by Mr. Peretz that the authorities looked forward to a continuing and lasting relationship between the Fund and Hong Kong. As such a relationship could contribute to the confidence in the future of the Hong Kong economy, Mr. Gronn remarked, he certainly hoped that such a relationship could be established. But he also took it then for granted that Hong Kong would start complying with the Fund's request to collect and provide adequate information on the balance of payments. Finally, like other speakers, he could go along with the proposal by Mr. Peretz to place Hong Kong on the annual consultation cycle.

Mr. Goos made the following statement:

I welcome this first Article IV consultation with Hong Kong and the intention to repeat such consultation discussions on a regular basis in the future. This intention is consistent with the role of Hong Kong as a newly industrialized economy and its significant role as a major trading partner and international financial center.

I fully agree with Mr. Peretz that, for an open economy with such characteristics, a framework of financial stability is essential; and I think that this applies not just to the framework itself but, more importantly, to the achievement of financial stability. However, performance on that score looks rather worrisome. Moreover, inflation--according to the paper--is expected to persistently exceed inflation in the major industrial countries.

Considering the adverse effects of inflation in general on financial stability in particular under a fixed exchange rate regime, I was quite surprised by the complacent attitude to this problem shown by the authorities and the staff. I am concerned that the strategy of just sweating out the inflationary pressures accumulated during the previous boom might undermine national savings as well as confidence in the stability of Hong Kong's economy and erode the external competitiveness of important economic sectors, including notably tourism.

It is indicated in the report that the government sector is believed to be too small to use fiscal policy as a demand-management instrument, and that this would also be inconsistent with the authorities' policy of "positive nonintervention." This may be true to some extent; however, at the same time, it is rather clear that the rapid reduction in the fiscal surplus by 4 percent of GDP since 1988 must have had a significant expansionary effect on the economy, thereby exacerbating inflationary pressures. By the same token, I feel that the authorities should make every effort to strengthen the fiscal position, be it by revenue measures or enlisting private capital for the financing of the substantial infrastructural projects planned for the coming years.

The concern about inflation and financial stability is underlined by the strong expansion of M3, exceeding persistently the rate of nominal GDP growth. Quite to my surprise, this aspect has not been addressed in the paper, and I would therefore be grateful for the staff's comments. I recognize, of course, that the room for manoeuvre for monetary policy is severely circumscribed by the fixed exchange rate policy and the importance attached to this policy in maintaining confidence in Hong Kong's economy. However, I wonder whether achievement of that objective really necessitates an absolutely fixed link, or whether it would not allow for the possibility of occasional exchange rate revaluations. It were made clear that the Hong Kong dollar would only be allowed to appreciate against the U.S. dollar--which would be tantamount to the announcement of a hard currency option--confidence would probably be strengthened compared to the present strategy.

On that assumption, a discrete revaluation of the Hong Kong dollar could dampen the inflationary pressures emanating from the manufacturing sector and at the same time widen substantially the scope for an effective monetary policy. Maybe the staff would care to comment.

Finally, I feel that confidence could greatly benefit if the authorities formulated a medium-term strategy for Hong Kong's economic and financial development. Ideally, such a strategy should be explicitly endorsed by the Chinese authorities to remove any doubt about their intentions after 1997.

Such a confidence approach could help contain the outflow of skilled labor and of capital as well as the relocation of private enterprises abroad. In this context, the recently announced decision of the Hong Kong and Shanghai Bank to leave Hong Kong is a worrisome point in case, especially because that Bank, as I understand it, has been issuing some 80 percent of the banknotes. Perhaps the staff could comment on the possible repercussions of that intended move on Hong Kong's money supply and the effectiveness of monetary policy in general.

I support the staff appraisal in the expectation that the authorities will release all of the information that is normally required for a comprehensive assessment of economic and financial developments. I also support placing Hong Kong on the annual consultation cycle.

The staff representative from the Asian Department said that the staff had attempted, in the absence of complete balance of payments statistics, to make some inferences about capital flows from available information on government accounts and on transactions in goods and nonfactor services. While it was not possible to indicate with any degree of confidence the absolute sign and direction of flows, it certainly appeared that there had been a shift in direction toward net capital outflows in 1989, and there was some evidence that that position had continued subsequently. The staff would not wish to try to say whether the outflows were capital flight or the result of the cyclical slowdown. There had been speculation in the press that capital flight had occurred, and that inflows of capital associated with new investment had slowed.

It was very difficult to see a role for incomes policy in Hong Kong, the staff representative said. Wages were freely market determined in Hong Kong, which was one of the few places in the world where wages went down as well as up in response to market conditions. In addition, unionization was very fragmented. Hence, the structures required for an incomes policy to be effective did not exist in Hong Kong; nor were the social conditions favorable for an incomes policy, which would not be greeted with favor by either the Government or the population at large.

There was some question whether Hong Kong's favorable experience could be repeated in other countries, the staff representative said. Of course, Hong Kong's economic success was traceable in part to the implementation of good policies, but it had to be recognized also that Hong Kong was a very special society. Hong Kong had been forced by circumstances to adopt its current policy approach, and the flexible economy that resulted from the country's isolated position and its need to continuously adapt to the changing world situation. Hong Kong had not had the possibility to develop policies to protect its people from unexpected adverse developments; the people of Hong Kong had had to adapt to survive, and, over time, that attitude had become deeply imbedded in the people's attitude to life. It would be difficult to impose that sort of ethic in other economies in the way that it had been forced in Hong Kong. One aspect of that reality was that the quality of the public services provided in Hong Kong was uneven. Some public services were expensive, such as public housing, which was a great success story in Hong Kong. Several decades ago, Hong Kong had faced an influx of refugees who had to be placed in clearly deficient housing. An extensive public housing program had subsequently brought adequate housing within the reach of most people. But beyond that, public services, in the general sense of those services in Western economies, were not extensively available in Hong Kong. A question for the future was whether, in the wake of the growing prosperity in Hong Kong, the population would expect better and more extensive public services than were currently available.

The question of Hong Kong's possible future development as an international financial center was a difficult one, the staff representative from the Asian Department said. The authorities had taken a number of steps to strengthen the functioning of the futures markets after they had experienced difficulties in 1987. Those steps included the strengthening of the management of the market, the introduction of a guaranteeing function, and surveillance of transactions. More recently, the cost of futures transactions had been reduced. The staff was not in a position to say where those steps would place Hong Kong's financial markets in a competitive sense.

Mr. Peretz said that, as he understood it, the relocation of the Hong Kong and Shanghai Bank involved only the legal residence of the head office of the worldwide Hong Kong and Shanghai Banking Corporation group. The head office of the Hong Kong and Shanghai Bank would remain in Hong Kong.

Mr. Spencer made the following statement:

I enjoyed reading the staff papers on Hong Kong and I welcome the opportunity to review an economy that has had such a strong influence--at least relative to its size--on the thinking of economic policymakers. As far as I can tell, that influence has always been to positively reinforce beliefs in the dynamism and robustness of a free-market capitalist system.

The report tells us of course that all is not perfect with the Hong Kong economy. But what a refreshingly different set of problems to confront!

My comments on Hong Kong are in the three key areas of monetary policy, labor markets, and fiscal policy.

First, in considering monetary policy, the staff report and other speakers have observed that, in such an open economy, monetary conditions are closely determined by the authorities' commitment to maintaining the exchange rate link with the U.S. dollar. This link has provided a very visible element of stability amidst the volatile and somewhat rumor-prone Hong Kong financial markets.

However, there must be real doubts as to whether the dollar peg has provided an efficient mechanism for achieving either price stability or external adjustment. The staff acknowledges that the real exchange rate has been more volatile under the peg than under the previous float.

But it is perhaps more important to note that real exchange rate movements have often tended to aggravate rather than alleviate external imbalances. In particular, while the strong growth and balance of payments performance over 1986-88 clearly warranted a real exchange rate appreciation, Chart 8 shows how the fall of the U.S. dollar brought about a real depreciation in the Hong Kong dollar of something like 17 percent.

This real depreciation exacerbated already strong rates of monetary growth, and took inflation from 3 percent in 1986 to double digits by 1989. Furthermore, with the external position remaining strongly positive, continuing high rates of inflation have been required through 1989-90 just to return the real exchange rate to its 1986 level.

This adjustment process--with relatively high inflation rates--seems likely to persist for some time yet. Thus, the fixed exchange rate arrangement does not appear to have been very successful, either in facilitating external adjustment, or in holding inflation to the U.S. level.

Notwithstanding these comments, however, I agree with the staff and previous speakers that a return to some sort of float would not be a sensible move in the current delicate political environment. But perhaps there is scope to consider upward adjustments in the peg at times when strong domestic inflationary pressures persist, as Mr. Landau suggested.

Alternatively, the problem of third-currency movements against the U.S. dollar might be reduced by using a trade-weighted basket peg rather than the U.S. dollar link, particularly in light of Hong Kong's steadily reducing share of trade with the United States. I would be interested to hear from staff whether they would see any merit in an exchange arrangement less rigidly tied to the fortunes of the U.S. dollar.

The shortages of labor in recent years obviously represent a serious economic bottleneck. If high rates of growth are to continue over 1991 and 1992, then the Hong Kong Government will clearly need to do more to encourage labor force growth than the rather tentative recent steps described in the background paper on recent economic developments in Hong Kong.

If labor market policies are insufficient to attract the necessary skilled and semi-skilled workers to support rapid growth, then other policies--including the public investment program in particular--should be restrained accordingly.

Moving on to the interesting area of fiscal policy in Hong Kong, the central issue here would appear to be the intention of the Government to spend much of its large financial reserve on a major expansion of airport, port, and related facilities over the next ten years.

There are clearly several aspects to this strategy that warrant consideration. The political aspect is obviously an important one, given the significant long-term effects of the investment projects, and this must be resolved between the People's Republic of China (PRC) and the Hong Kong authorities.

From an economic perspective, there are both macroeconomic and financing issues to consider. On the first count, we agree with the staff and Mr. Peretz that fiscal policy should not in general be driven by stabilization objectives. However, with budget expenditures up by 67 percent in the past two years, and planned further increases in public investment, we would agree with the staff that stabilization considerations cannot presently be ignored.

In particular, the authorities must consider carefully the stress that any large fiscal impulse will place on already stretched labor market and infrastructure resources. The potentially heavy demands on capital markets may also lead to financial crowding out if investors are deterred during periods of political uncertainty.

The risk of overstretching both real and financial resources suggests that the authorities should try to stick closely to their target of avoiding further increases in expenditure relative to GDP. However, the prospects for achieving this goal by moderating current expenditures seem limited owing to, first, the increasing public demand for social services and environmental protection measures, and, second, the difficulty in insulating public sector real wages from the upward trend in private real wages.

Certainly the staff appears to have some doubts whether the fiscal objective can be achieved in the absence of some paring back of the investment program. I would be pleased to hear from the staff whether this is indeed its view.

Turning briefly to the financing of the public investment program, on the face of it, the staff's suggestion that the Hong Kong Government should gear itself up seems perfectly sensible, particularly given the absence of existing government debt. However, with the approach of 1997 likely to put an increasing risk premium on Hong Kong resident debt, it would seem an inopportune time to be accessing the bond markets. If it is decided to issue government, or government-guaranteed debt, it would obviously help to ease the situation if the investment and borrowing strategy were to receive implicit approval from the PRC authorities.

If, on the other hand, financing is to come mainly from private partners and a rundown in government reserves, then we must ask what is a reasonable minimum level of reserves for Hong Kong over this period, i.e., what level of reserves will be necessary to protect the fixed exchange rate link under most foreseeable circumstances? I would be interested to hear whether the staff or the Hong Kong authorities have any views on this matter.

The important area of taxation has already been discussed by other Directors. I would just add my support to the recommendation that the tax system be reviewed with the aim of rebalancing and broadening the revenue base while minimizing any additional intrusion into economic activity. I am pleased to hear from Mr. Peretz that the Hong Kong authorities are already looking in this direction.

On one final point, I would just like to put in a word against the interest rate cartel that has for so long been an incongruous feature of an otherwise fairly competitive financial system. Based on the traditional power of the large Hong Kong banks, the restrictions on nonbank deposit rates clearly represent a bias against domestic deposit taking--in favor of other, more risky investment channels, such as equities and high-yielding foreign dollar deposits. While new financial instruments have been devised to help get around the interest rate restrictions, the distortion seems likely to have added to the already volatile nature of the Hong Kong financial markets. I would be interested to hear whether the staff sees any useful purpose in continuing the cartel arrangement.

In concluding, I would like to commend the authorities for their very successful policy of "positive nonintervention," and I wish them every success in maintaining their excellent economic record during the coming transition period.

The staff representative from the Asian Department said that, while the issue of exchange rate overshooting might well exist in theory, the extraordinary flexibility of Hong Kong's economy had kept such overshooting from actually occurring. The adjustment of entrepreneurs in Hong Kong to changing circumstances had been very rapid, as was reflected in the balance of payments; the growth in trade had varied considerably from year to year, but the balance on goods and nonfactor services that could be measured had remained remarkably steady. Compared with most other economies, the adjustment in the external accounts to changing circumstances in Hong Kong had taken place with extraordinary rapidity. The authorities had a considerable record of fiscal achievement over many years and had built up large reserves against possible future needs. In the past two years, there had been some reduction of previously large fiscal surpluses, but the accounts were still in surplus. The authorities were aware of the problems facing the budget, and they had a medium-term fiscal framework in which they were analyzing the problems. The authorities seemed very confident that they could stay within their own medium-term guidelines, which were based on 5 percent real economic growth per year. The staff had felt that that figure was an ambitious target, but given that basic assumption, they felt confident that they could meet their goal of keeping spending growth from exceeding the rate of economic growth; in other words, the size of the government would not grow beyond its present level of about 15 percent of GDP. The authorities did admit that, during the peak years of spending they planned for infrastructure projects, there would be some overshooting, or a hump, in public spending, but they expected that, by the end of the five-year period, spending would come back below the trend line; taking the period as a whole they would remain within their spending guideline. The staff endorsed the authorities' confidence that, with the authorities' record of achievement and their plans for restraint, there was no reason to be greatly concerned that the fiscal position would get out of hand in the coming period.

Mr. Posthumus said that he had supported the authorities' fiscal policy but had reservations about monetary policy and certainly about the high rate of inflation. However, the staff's comments were convincing. Governments in countries with market economies generally tried to undertake considerable steering and correcting of their economies; the authorities in Hong Kong did not do so, and their approach seemed to have worked well.

Mr. Peretz said that he wished to respond to Mr. Spencer's comments on monetary expansion. Thus far, the discussion on monetary policy had centered on the relationship between confidence and the exchange rate link and the question whether another nominal anchor could be used in a country like Hong Kong. He doubted whether any measure of money supply would provide an anchor in Hong Kong, as considerable domestic balances were held offshore by nonresidents and there was considerable switching between currencies. Therefore, in searching for a nominal anchor, the authorities probably could not do better than the present exchange rate link.

Hong Kong's great economic success was due to the implementation of many of the policies that the Fund traditionally recommended, Mr. Peretz remarked. For many years, the authorities had maintained a firm fiscal policy, and the budget was still in surplus. In addition, they had also maintained a sound framework for monetary policy, a low degree of government intervention in the economy, and, above all, a reliance on the working of free and flexible markets to provide the basis for continuing growth. In recent years, there had been a shift in Hong Kong from a manufacturing-based economy to a service-based economy and, above all, to becoming one of the world's major financial centers. The staff report showed how the shift away from manufacturing had led to huge growth in manufacturing employment on the Chinese mainland, which was welcome to all the parties concerned and was a good example of how free trade and free movement of factors could benefit all countries.

Hong Kong currently faced a 1997 deadline for the transfer of authority to China, Mr. Peretz continued. However, the prospect of that transfer should not pose any great difficulties, and, in that connection, he welcomed Mr. Dai's statement confirming his authorities' commitment to maintaining confidence in Hong Kong as a market-based economy, which would continue the same kind of economy after 1997. That commitment was entirely consistent with everything the Chinese authorities had said all along, and he welcomed it as a confirmation. While the transfer of authority should not be a source of great difficulty, people obviously were thinking about the situation, which clearly underscored the importance of maintaining confidence. The issue of confidence was particularly important given the amount of financial business carried out in Hong Kong; for any financial center, confidence above all was important. Accordingly, many of Hong Kong's economic policies had to be designed to help bolster confidence and provide a framework that would help retain that confidence over the coming years. It was appropriate to see the exchange rate link, and the developing monetary control arrangements that went along with it, in the context of the crucial need to maintain confidence.

He agreed with Mr. Goos's comments on the benefits of following a medium-term economic strategy, Mr. Peretz said. The main element of the medium-term strategy for Hong Kong was the maintenance of the exchange rate link. In times of uncertainty, it was especially important for the authorities to maintain a transparent and credible monetary policy framework.

The vulnerability of the tax base was a slightly different aspect of the same sort of concern, Mr. Peretz went on. The authorities were carefully considering the need to broaden and reduce the vulnerability of the tax base.

There were substantial advantages to the exchange rate link as an important source of stability and as a guarantee in the long run against accelerating inflation, Mr. Peretz said. The rate of inflation was likely to fall in the coming period. There were costs, of course, to that kind of exchange rate arrangement, as had been recognized by the staff in its report and Mr. Dai in his statement. But in the authorities' view, the benefits greatly outweighed the costs, particularly given the very flexible nature of the economy and the huge and very efficient markets in both labor and goods. Hence, the costs of such a link were probably less in Hong Kong than they might be in some other countries, and he welcomed Mr. Posthumus's support of the authorities' approach, founded perhaps on that thought. One message of the present discussion might be that, while there was some concern about the inflation in Hong Kong, the Board was generally supportive of the authorities' medium-term framework in which monetary policy was carried out.

The room for an active fiscal policy was even more limited in Hong Kong than in many other countries, for the reasons that were well explained in the staff report and which he had mentioned in his opening statement, Mr. Peretz said. Nevertheless, monetary policy needed to be supported by a prudent fiscal policy, and the authorities intended to continue to do so; their intention was to hold public expenditure growth close to GDP growth. There would be year-to-year deviations, but that was the medium-term objective. The intention was that fiscal revenues should cover current spending and at least half of capital spending. The authorities were looking for ways to widen the tax base, which would help to enhance the robustness of the tax base.

He welcomed Mr. Dai's remarks on general Chinese support for the airport project, Mr. Peretz said. Anyone who had ever flown into Kai Tak Airport would recognize the need for a new airport in Hong Kong. The latest project cost estimate he had was about HK$79 billion, spread over 15 years, excluding the railway link and the port, and between 40 percent and 55 percent of the cost was to be met by the private sector. The financing of the project had been planned, and would of course continue to be planned, very carefully and would be contained within the overall fiscal policy framework that he had described.

As to Mr. Spencer's question about the optimum level of reserves after 1997, it was clear that the main instrument for protecting the exchange rate in Hong Kong was adjustments in interest rates rather than reserves, although Mr. Abbott had usefully noted the level of cumulative savings compared with previous years, Mr. Peretz remarked. Not all the relevant data were published, but the available data suggested a minimum of HK$100 billion in savings, a large amount and well in excess of the total cost of the airport project; and Hong Kong had no public debt.

His authorities welcomed the Article IV consultation discussions, which in their view were very valuable, Mr. Peretz said. They valued the staff's advice and were broadly following it. To judge from the current discussion, the Board, as well as the Hong Kong authorities, would find it useful to have a further discussion in a year's time, and he hoped that Hong Kong would be placed on the annual consultation cycle.

The Chairman made the following summing up:

Executive Directors, noting that these were the first Article IV consultation discussions with respect to Hong Kong, expressed their satisfaction with the initiation of this procedure and their admiration for Hong Kong's economic achievements. A record of success had been built on the foundation of a liberal policy framework favorable to enterprise, international trade, and capital flows. As a result, the economy had developed a high degree of flexibility, which was conducive to rapid adjustment to shifts in the world economic environment.

Directors noted that the economy slowed in late 1988, and that the slowdown persisted through 1990. While the downturn reflected in part the pressures on resources generated by the previous three years of rapid growth, it had broadened as demand in China and in overseas markets weakened. A recovery in growth, Directors observed, seemed likely to await a strengthening of exports. Despite the continuation of lower growth, the labor market had remained generally tight, in part because of higher emigration, and inflation remained at about 10 percent.

Inflation was explained in part as a consequence of the much larger productivity growth in manufacturing, compared with services, a larger differential than in other countries, which enabled producers to accommodate large wage increases. With monetary policy directed towards maintaining the fixed link with the U.S. dollar, its effectiveness at least in the short run in containing inflation in the non-traded sector was constrained. In light of this constraint, Directors encouraged the authorities to consider actions in other areas to bring down inflation. Imports of labor or the further transfer of labor-intensive activities from Hong Kong to China, and steps to strengthen labor training could be helpful. Continued adherence to the authorities' guidelines on fiscal policy could also play a helpful role.

Directors agreed with the authorities that the policy of linking the Hong Kong dollar to the U.S. dollar was central to efforts to sustain confidence in the economy and financial system during the years leading up to the transfer of authority over Hong Kong to China in 1997. They also agreed that the link had proved to be an effective anchor for monetary policy. Nevertheless, they noted the costs associated with the linked exchange rate system, especially low or negative real interest rates that could distort resource allocation and discourage saving, and its contribution to inflation at rates above those in the industrial countries. They noted, however, that saving remained high, and that present inflationary pressures could be expected to ease somewhat as the present cyclical slowdown has its full effect. While some

Directors explored the possibility offered by alternative monetary arrangements to mitigate these difficulties, it was generally accepted that some temporary excess of inflation was at present an integral element of the adjustment process.

Directors praised the authorities for their record of prudent fiscal management, although noting the recent reduction in budget surpluses and the very rapid increases in budget outlays in 1989 and 1990, which may have contributed to inflationary pressures. While the fiscal outlook remained generally favorable, Directors cautioned that fiscal prospects would be affected were growth to be lower than projected and by any overruns in expenditures associated with the program of investment in infrastructure planned for the coming decade. They therefore strongly endorsed the authorities' efforts toward expenditure control. They also encouraged the authorities to consider changes in the tax system to make it less narrowly based. In this connection, they suggested that consideration be given to the introduction of a broad-based indirect tax. Directors also encouraged the authorities to fill in the major gaps that exist in balance of payments statistics, and to release more information on asset holdings of the Exchange Fund, which include international reserves.

Directors welcomed Hong Kong's firm commitment to free trade, open capital markets, and an exchange system free of restrictions. They noted that this policy approach had been instrumental in the development of dynamic externally oriented industries and Hong Kong's emergence as a major financial center. Directors noted with interest that rapidly expanding economic ties with China had become, in a medium-term perspective, an important source of economic growth and a vehicle for structural change. Directors were of the opinion that the further expansion of these ties and permanent efforts at confidence building, in conjunction with cooperation between the Hong Kong and Chinese authorities, would serve as a firm basis for Hong Kong's continued growth and prosperity extending beyond the transfer of authority over Hong Kong to China in 1997.

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

Mr. Goos said that he understood that the Chairman wished to be cautious in discussing exchange rate policy in the summing up and would not wish to state explicitly that the authorities should revalue the Hong Kong dollar. However, the staff or management should convey to the authorities in a more direct manner the firmer views on that matter that were held by a number of Directors.

The Chairman commented that it seemed best not to be too explicit in discussing exchange rate policy in the summing up. He would discuss the exchange rate in his private contacts with the authorities in the future.

APPROVED: September 30, 1991

JOSEPH W. LANG, JR.
Acting Secretary