INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/16
FOR IMMEDIATE RELEASE
February 13, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with the People's Republic of China—Hong Kong Special Administrative Region

On January 23, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the People's Republic of China—Hong Kong Special Administrative Region.[1]

Background

Hong Kong SAR's real GDP grew by about 7¼ percent (year-on-year) in the first three quarters of 2005, from 8¼ percent in 2004, boosted, in part, by strong Mainland-related exports. The economic expansion that has been sustained for nine consecutive quarters has strengthened the macroeconomic outlook for Hong Kong SAR. The continued robust growth owes much to the favorable external environment, with judicious macroeconomic policies, continued structural reforms, and the confidence building effects of the Closer Economic Partnership Arrangement (CEPA) with the Mainland making significant contributions. Importantly, job creation has steadily gathered strength, which has brought down the unemployment rate quite significantly, although for low-skilled workers it remains relatively high. Reflecting the buoyant activity, inflation has picked up mildly, but remains well contained. Asset prices, which have rebounded sharply since mid-2003, now appear to be stabilizing.

The authorities have continued to take advantage of high growth to further strengthen the fiscal position. The outturn for the FY2004/05 deficit (excluding issuance of bonds and notes)

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

at ¼ percent of GDP—was substantially better than the projected 5 percent of GDP. Buoyant tax revenues (profits and income tax), higher-than-expected land sales and investment income, along with continued expenditure restraint (including civil service wage cuts) were the main contributors to the better performance. Fiscal reserves were equivalent to about 23 percent of GDP (at end-FY2004/05), but remained below its pre-crisis level of 34 percent of GDP. The FY2005/06 budget targets a deficit of about ¾ percent of GDP. Based on current economic trends and reflecting the government's unstinted restraint on spending, the staff projects that the budget could return to balance in the current fiscal year, significantly ahead of schedule.

Looking ahead, staff expects economic activity to moderate in the near term with real GDP growth projected to about 5½ percent in 2006 with some easing of external demand. The risks to this outlook are broadly balanced. Despite this moderation in activity, inflation should rise modestly as rents pick up and the labor market tightens. Given the general openness of the economy and the strong linkages with the Mainland, Hong Kong SAR's growth prospects will continue to depend crucially on external conditions and developments in the Mainland. If global demand weakens significantly, Hong Kong SAR's current driver of growth—net exports—could be threatened. On the upside, consumption and investment growth could be higher, reflecting higher asset prices, stronger household balance sheets, and sizeable increases in corporate profits.

Sustaining strong growth over the medium term will also depend crucially on effectively meeting the challenges of integration with the Mainland. The continued success of Hong Kong as an international financial center hinges upon its ability to assist in the Mainland's financial intermediation. Hong Kong is well positioned to play a significant role in this process in view of its sophisticated financial infrastructure, although progress in this area depends crucially upon the pace of financial liberalization in the Mainland. Cooperation and coordination with the Mainland's financial authorities, which have advanced well, will therefore become increasingly important.

Executive Board Assessment

Executive Directors commended the Hong Kong SAR authorities on their skillful macroeconomic management in the face of a series of external shocks over the last few years. Along with improved external conditions and continued structural reforms, macroeconomic policies have helped to sustain the economic expansion—for nine consecutive quarters—while inflation is moderate and the external sector remains strong.

Looking ahead, Directors noted that sustaining growth over the medium term will require that the challenges of economic integration with the Mainland be met effectively. In particular, Hong Kong SAR will need to remain competitive by maintaining its traditional strengths—namely, flexible product and factor markets and sound macroeconomic policies—as well as by seeking out new areas of growth, including an increased role in Mainland financial intermediation.

Directors commended the authorities on the continued improvement in the fiscal position. They noted that expenditure restraint, supported by robust economic activity, is likely to return the budget to balance this fiscal year, well ahead of schedule.

With the government's current fiscal target nearly achieved, Directors were encouraged by the authorities' increased focus on longer-term issues. Hong Kong SAR's rapidly aging population is likely to exert substantial pressure on public finances, especially through rising health care costs. Accordingly, the government's attention to health care reform is timely. Directors observed that, in formulating a longer-term fiscal strategy, consideration should also be given to the appropriate level of fiscal reserves. Directors stressed the importance of broadening Hong Kong SAR's tax base to stabilize the volatily of its revenues. In this regard, they welcomed the authorities' plans to press ahead with public consultation on the feasibility of a low-rate goods and services tax, which should be broadly based and implemented with minimal exemptions. Directors noted that low-income families adversely affected by the tax could be assisted through targeted transfers.

Directors commended the Hong Kong Monetary Authority on its management of the Linked Exchange Rate System and supported the authorities' commitment to the arrangement. They noted that the May 2005 refinements to the currency board had reduced uncertainties that had led to speculation, and further strengthened the system. Directors observed that adjustment to large or prolonged shocks will need to rely on the flexibility of Hong Kong SAR's real exchange rate. This will depend on the efficiency of its domestic markets, as reflected in changes in interest rates, wages, and asset and product prices.

Directors welcomed the initiatives undertaken to strengthen Hong Kong SAR's financial market infrastructure and supervisory systems. In particular, they welcomed the progress toward the introduction of a deposit protection scheme, the preparation for the implementation of Basel II by banks, and the establishment of a Financial Reporting Council. They also welcomed the expanded scope for transactions in renminbi in Hong Kong SAR. Directors considered that the growing size and sophistication of Hong Kong SAR's financial markets and instruments will contribute to maintaining Hong Kong's vibrancy as a financial center, while also requiring continued close surveillance to ensure that markets remain efficient and orderly. In this context, Directors welcomed the close cooperation with the financial authorities on the Mainland. Directors were encouraged by the significant steps taken towards the implementation of the anti-money laundering and combating the financing of terrorism (AML/CFT) framework and looked forward to continued progress in this area.

Directors supported the authorities' strategy to reduce unemployment among low-skilled workers through training programs and job placement assistance. Directors noted the recent call for a debate on the appropriateness of introducing a statutory minimum wage and standard working hours, while emphasizing the importance of maintaining the flexibility of Hong Kong SAR's markets that has served to underpin the economy's resilience to external shocks. In this regard, Directors also welcomed the establishment of a committee to review existing domestic competition policy and the possible role of a general competition law.

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

	2002	2003	2004	2005	2006
				Proj.	
Real GDP (percent change)	1.8	3.1	8.2	7.0	5.5
Real domestic demand (contribution)	-0.7	0.1	4.5	1.8	2.0
Foreign balance (contribution)	2.5	3.1	3.7	5.2	3.5
Inflation (percent change)					
Consumer prices	-3.0	-2.6	-0.4	1.2	1.5
GDP deflator	-3.5	-6.4	-3.3	-0.5	1.3
Employment (percent change)	-0.6	-0.4	2.8	3.8	3.0
Unemployment rate (percent)	7.3	7.9	6.8	5.4	3.8
Real wages	1.3	0.2	-1.2	...	...
Government budget (percent of GDP) 1/					
Revenue	13.9	16.8	20.4	18.6	17.9
Expenditure	18.7	20.1	18.8	18.6	17.8
Consolidated budget balance	-4.8	-3.3	-0.3	0.0	0.1
External balances (in billions of US$)					
Merchandise trade balance	-5.1	-5.8	-9.3	-4.5	-0.8
(In percent of GDP)	-3.1	-3.6	-5.6	-2.6	-0.4
Current account balance	12.4	16.5	16.4	17.8	19.2
(In percent of GDP)	7.6	10.4	9.6	10.2	10.3
Foreign exchange reserves					
Foreign exchange reserves (in billions of US$, end of period)	111.9	118.4	123.6	123.8	124.8
(In percent of GDP)	68.4	74.5	74.4	70.8	66.8

Sources: Data provided by the Hong Kong SAR authorities; and IMF staff estimates and projections.
1/ Fiscal year begins April 1.