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# IMF Concludes 2006 Article IV Consultation Discussions with the People's Republic of China—Hong Kong Special Administrative Region

On December 15, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions with the People's Republic of China—Hong Kong Special Administrative Region.[1]

## Background

Hong Kong SAR has recovered strongly from a series of shocks in recent years and, as expected, the pace of growth is now moderating. Growth was 6.8 percent (year-on-year) in the first three quarters of 2006, somewhat slower than the 7.3 percent recorded in 2005. The continued brisk pace of growth, and its pick-up in the third quarter relative to the second quarter, was due to stronger Mainland-related exports of goods and financial services, and continued strong domestic demand. Household and corporate balance sheets remain robust. Significantly, job creation has continued to improve across all sectors and skill levels, bringing the unemployment rate to its lowest level in more than five years, and inflation is modest.

On the policy front, this fiscal year's budget continues to take advantage of the strong economy to strengthen the fiscal position. Last fiscal year, revenue growth and

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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. This PIN summarizes the views of the Executive Board as expressed during the December 15, 2006 Executive Board discussion based on the staff report.

expenditure restraint helped achieve the first budget surplus (of around 1 percent of GDP) since the Asian crisis. On current economic and spending trends, this year's target surplus of ½ percent of GDP is likely to be modestly over performed. In addition, the refinements made by the authorities to the Linked Exchange Rate System in May 2005 have dampened renminbi-related speculative pressures by effectively limiting currency movements against the U.S. dollar to a narrow band.

Looking ahead, staff expects growth to moderate to around 5½ percent in 2007. Inflation is expected to firm modestly with the tightening labor market and as rents adjust to previous increases in property prices. Although the external position should remain strong, the current account surplus is expected to narrow with maturing external demand. The main near-term risks to this outlook are a sharper slowdown in global demand (particularly in the United States) and a rise in protectionist sentiments against China.

Over the medium term, much will depend on how well the evolving financial integration with the Mainland is managed and leveraged, and competitive pressures from other regional financial centers withstood. Although fundraising by Chinese entities reached new heights in 2006, the extent of financial integration with the Mainland is still small relative to its potential. Increasing Hong Kong SAR's role in the direct intermediation of the Mainland's domestic savings will be key for the continued success of its financial center. Consequently, continued cooperation and coordination with the Mainland's financial authorities, which have advanced well, remain crucial.

**Executive Board Assessment**

Executive Directors welcomed the Hong Kong SAR economy's sustained expansion, now in its fourteenth consecutive quarter, which they attributed to the authorities' skillful macroeconomic management, the flexibility of Hong Kong SAR's markets, and the economy's highly developed financial infrastructure. Looking ahead, Directors noted that, while growth is likely to moderate, it will remain strong over the medium term if financial integration with the Mainland is further deepened and managed well.

Directors commended the authorities on making use of the current strong economy to strengthen the fiscal position and address the longer-term fiscal challenges of revenue volatility and age-related spending pressures. They welcomed the growing public recognition of the need to broaden the tax base, and public discussion of ways to do it. In this context, several Directors noted that a low-rated and broad-based goods and services tax would be an efficient way to broaden the tax base, if targeted compensation is provided to alleviate the resulting burden on low-income households. Directors also suggested that the authorities consider seeking other ways to stabilize investment income through arrangements with the Exchange Fund.

Directors reiterated their support for the authorities' commitment to the Linked Exchange Rate System, and noted that the refinements undertaken in May 2005 appear to have fortified the system against short-term shocks. Adjustment to longer-lasting shocks would, however, continue to rely on the demonstrated flexibility of Hong Kong SAR's domestic markets and its strong institutions. At the same time, Directors noted that some non-price competitiveness issues warrant close attention, and therefore welcomed the envisaged competition policy law that would add to the economy's traditional strengths. Directors cautioned, however, that the design of labor market regulation needs to ensure that the balance between market flexibility and adequate worker protection is maintained.

Directors noted that financial integration with the Mainland would be a key driver of future economic prospects. They encouraged continued coordination between the authorities and their Mainland counterparts on ways to use Hong Kong SAR's advanced financial platform to improve financial intermediation in the Mainland, noting that such coordination would be of benefit to both economies.

Directors concurred with the authorities that enhancing financial sector supervision is critical to safeguarding the competitiveness of the financial center. In this regard, they welcomed progress on cross-border regulatory supervision, preparations for Basel II adoption, and plans to broaden AML/CFT enforcement.

**People's Republic of China, Hong Kong Special Administrative Region: Selected Economic and Financial Indicators 1/**

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| | | | | Proj. | |
| ***Real GDP*** (percent change) | 3.2 | 8.6 | 7.3 | 6.8 | 5.4 |
| Real domestic demand (contribution) | 0.1 | 4.7 | 1.7 | 4.4 | 5.0 |
| Foreign balance (contribution) | 3.1 | 3.9 | 5.6 | 2.5 | 0.4 |
| ***Inflation*** (percent change) | | | | | |
| Consumer prices | -2.6 | -0.4 | 1.0 | 2.0 | 2.2 |
| GDP deflator | -6.3 | -3.6 | -0.2 | -0.1 | 0.9 |
| ***Employment*** (percent change) | -0.4 | 2.8 | 2.3 | 2.9 | 2.2 |
| Unemployment rate (percent, period average) | 7.9 | 6.8 | 5.6 | 4.8 | 4.4 |
| Real wages | 0.2 | -1.2 | -0.4 | … | … |
| ***Government budget*** (percent of GDP) 2/ | | | | | |
| Revenue | 16.8 | 18.4 | 17.9 | 17.7 | 17.5 |
| Expenditure | 20.1 | 18.8 | 16.9 | 17.2 | 16.8 |
| Consolidated budget balance | -3.3 | -0.3 | 1.0 | 0.6 | 0.7 |
| ***External balances*** (in billions of US$) | | | | | |
| Merchandise trade balance | -5.8 | -9.3 | -7.6 | -10.1 | -15.8 |
| (In percent of GDP) | -3.6 | -5.6 | -4.3 | -5.3 | -7.8 |
| Current account | 16.5 | 15.7 | 20.3 | 20.7 | 20.4 |
| (In percent of GDP) | 10.4 | 9.5 | 11.4 | 10.9 | 10.1 |
| ***Foreign exchange reserves*** 3/ | | | | | |
| (In billions of US$, end of period) | 118.4 | 123.6 | 124.3 | 128.2 | 128.7 |
| (In percent of GDP) | 74.7 | 74.5 | 69.9 | 67.6 | 63.8 |

Sources: Data provided by the Hong Kong SAR authorities; and IMF staff estimates and projections.
1/ Data as at December 15, 2006.
2/ Authorities' FY2006/07 Budget estimates.
3/ Includes Land Fund assets from 1997 (US$17.5 billion at end-1997).