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## **IMF Executive Board Concludes 2007 Article IV Consultation Discussions with the People's Republic of China—Hong Kong SAR**

On January 18, 2008, 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 (SAR).<sup>1</sup>

### **Background**

Hong Kong SAR grew strongly—around 7½ percent annually—during 2004 to 2006. This performance reflects Hong Kong SAR's successful transformation from its manufacturing presence to a services hub over past decades. Recently, growth has been driven by domestic demand, with private construction beginning to recover after a decade-long decline. Unemployment is at its lowest in almost a decade, while inflation is moderate. Strong import demand has widened the merchandise trade deficit, and narrowed the current account surplus.

Since refinements to the Linked Exchange Rate System in May 2005, the regime has operated smoothly with the Hong Kong dollar moving within its trading band during this period. In late October, however, a combination of factors—including U.S. interest rate cuts and temporarily tight domestic liquidity in Hong Kong SAR—led the Hong Kong dollar to appreciate to the strong side of the trading band. As required by the Linked Exchange Rate System, the Hong Kong Monetary Authority intervened to keep the Hong Kong dollar within the band. Since the last intervention at end-October, and as liquidity conditions eased, the Hong Kong dollar again

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<sup>1</sup> 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.

returned to floating well within its trading band. On the fiscal front, the anticipated budget surplus of 1.7 percent of GDP is likely to be exceeded given current trends in revenue and expenditure restraint.

Looking ahead, growth is expected to moderate to below 5 percent in 2008. Rising incomes should keep domestic demand strong while widening the trade deficit and reducing the current account surplus. The labor market would likely tighten further which, together with rising rents and further renminbi appreciation, should increase inflation modestly. The biggest risk is a more-than-expected deterioration in external demand especially in the United States and Europe, and further potential international financial turbulence.

Over the medium term, much will depend on how well financial integration with the Mainland is deepened. Trade integration with the Mainland was completed long ago and, reflecting the successful transformation of Hong Kong SAR over the past decade, services and financial integration with the Mainland is now poised to deepen. Proposals for increased equity market integration are under consideration, renminbi bond issuance in Hong Kong SAR has commenced, and local banks are expanding their Mainland presence. The benefits from this integration are clear, but it also bears associated risks, although these should be limited as long as China's growth is sustained. Nonetheless, close cross-market and cross-border regulatory co-ordination will remain crucial to safeguarding Hong Kong SAR's financial stability.

### **Executive Board Assessment**

Executive Directors welcomed Hong Kong SAR's sustained strong economic growth and deepening integration with the Mainland. They noted that the impressive developments of recent years owed much to the flexibility of Hong Kong SAR's markets—which has enabled the adjustment to external shocks—as well as to the authorities' skillful macroeconomic management. Looking ahead, Directors considered that, while growth is likely to moderate in the near term, medium-term growth prospects will be strong if market flexibility is safeguarded and the SAR's role in Mainland intermediation is deepened.

Directors reiterated their support for the authorities' commitment to the Linked Exchange Rate System, and also noted that the current real value of the Hong Kong dollar is in line with fundamentals. The Hong Kong dollar has moved within its trading band since the band was created in May 2005, at times withstanding significant speculative pressure. Nonetheless, Directors noted that frictions in the money market—that may cause episodic anomalies between the exchange rate and interest rates—should be addressed. In this regard, they welcomed the recent initiatives to improve liquidity management in the financial system.

Directors emphasized that Hong Kong SAR's traditional strengths—flexible markets and sound governance—should be safeguarded and strengthened. In this context, they welcomed the proposed general competition law, and stressed the importance of striking an appropriate balance between low-income worker protection and wage flexibility. On wage protection, some Directors noted that alternative measures such as expanding in-work benefits for low income

workers could be preferable to introducing a minimum wage, given the crucial role market flexibility has played in Hong Kong SAR's adjustment to past shocks. Directors also welcomed the recent initiatives to improve Hong Kong SAR's already strong governance and supervisory regimes.

Directors noted that Hong Kong SAR's prospects depend on how well the financial center expands its role in Mainland intermediation, and welcomed the authorities' proactive steps in this direction. In light of the deepening of financial integration, Directors welcomed the expansion of cross-border regulatory cooperation. Nonetheless, they noted that diversifying into new financial products and geographical markets would also benefit the financial sector and expand Hong Kong SAR's business base.

Directors noted that the current fiscal stance is appropriate, and welcomed the recent initiative to stabilize investment income and reduce revenue volatility. However, they encouraged the authorities to address potential future aging-related spending pressures, and to broaden the tax base.

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**People's Republic of China, Hong Kong Special Administrative Region:  
Selected Economic and Financial Indicators, 2004–2008**

	2004	2005	2006	2007	2008
Real GDP (percent change)	8.5	7.1	6.8	6.0	4.6
Real domestic demand (contribution)	4.7	1.5	5.1	6.1	5.1
Foreign balance (contribution)	3.5	5.6	1.7	0.0	-0.5
Saving and investment (percent of GDP)					
Gross national saving	31.3	31.9	32.1	33.0	31.9
Gross domestic investment	21.8	20.6	21.4	22.3	23.3
Inflation (percent change)					
Consumer prices	-0.4	1.0	2.0	2.2	3.7
GDP deflator	-3.5	-0.1	-0.1	2.0	2.3
Employment (percent change)	2.5	2.0	2.1	1.7	1.0
Unemployment rate (percent)	6.8	5.6	4.8	4.1	4.0
Government budget (percent of GDP) 1/					
Revenue	18.4	17.9	19.5	18.4	18.9
Expenditure	18.8	16.9	15.4	15.1	15.8
Consolidated budget balance	-0.3	1.0	4.0	3.3	2.9
Reserves at March 31	22.9	22.5	25.0	27.3	27.1
Money and credit (percent change, end-period)					
Narrow money (M1)	17.2	-10.3	13.1	...	...
Broad money (M3)	8.6	5.2	15.5	...	...
Loans for use in Hong Kong SAR 2/	4.9	7.7	2.3	...	...
Interest rates (percent, end-period)					
Best lending rate	5.0	7.8	7.8	...	...
Three-month HIBOR	0.3	4.2	3.8	...	...
Merchandise trade (percent change)					
Export volume	14.9	10.4	9.3	6.2	5.9
Domestic exports	2.2	6.1	3.0	5.0	2.8
Re-exports	15.8	10.7	9.7	6.3	6.1
Import volume	13.7	8.0	9.2	7.3	7.2
Export value	15.9	11.1	9.6	15.0	8.4
Import value	17.0	10.1	11.5	16.8	10.2
External balances (in billions of US\$)					
Merchandise trade balance	-9.3	-7.6	-14.0	-21.7	-30.0
In percent of GDP	-5.6	-4.3	-7.4	-10.6	-13.7
Current account balance	15.7	20.2	20.2	21.8	18.9
In percent of GDP	9.5	11.4	10.6	10.7	8.7
Foreign exchange reserves 2/					
In billions of U.S. dollars, end of period	123.6	124.3	133.2	153.7	160.5
In months of retained imports	21.1	19.8	18.6	17.4	15.8

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

1/ Fiscal year.

2/ Figures exclude trade financing.