INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 09/130
FOR IMMEDIATE RELEASE
December 2, 2009

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

IMF Executive Board Concludes 2009 Article IV Consultation Discussions with People's Republic of China—Hong Kong Special Administrative Region

On November 23, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions with People's Republic of China—Hong Kong Special Administrative Region (SAR).[1]

Background

Hong Kong SAR's economy was severely affected by the global financial crisis (through both trade and financial channels) but a recovery is now underway, fueled by growth on the Mainland, supportive policies, and accommodative monetary conditions imported from the United States. Despite the steepness of the downturn in early 2009, job losses have been relatively modest and unemployment now stands at 5.2 percent (in seasonally adjusted terms, August to October). Headline inflation has declined due to lower food inflation and the direct effects of fiscal measures (such as the reductions in rates and public housing rent). Weak services exports and income flows have narrowed the current account surplus to around 11½ percent of GDP in the first half of 2009. Nevertheless, significant capital inflows have led to an increase in official reserves to around US$223 billion by end-August.

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

In February, the government announced an expansionary budget with a deficit of HK$39.9 billion. In May, the budget was supplemented with a further HK$16.8 billion (1 percent of GDP) fiscal package. The government has also provided loan guarantees to help alleviate the tightening of credit conditions experienced by small- and medium-sized companies, particularly in late 2008. These loan guarantee schemes secured more than 240,000 jobs. The combined discretionary policy stimulus taken since 2008-09 (excluding the additional commitment of about HK$107.4 billion under the various loan guarantee schemes) amounts to over 5 percent of GDP.

The Hong Kong financial system has withstood the downturn well. Banks were generally not exposed to the securitized products at the center of the crisis in the U.S., had good internal risk management systems, were highly liquid, and had low loan-to-deposit ratios. Average capital adequacy ratios were 16½ percent at end-June with around three-fourths of that being in the form of Tier 1 capital. Banking system profitability has declined due to higher provisioning and tighter interest margins and the economic slowdown has worsened credit quality, particularly on lending to small- and medium-sized enterprises. Nevertheless, nonperforming loans remain at low levels (classified loans were 1½ percent of the total in June).

Executive Board Assessment

The Executive Directors observed that Hong Kong SAR had been severely affected by the global financial crisis, resulting in a sharp economic contraction in early 2009. The swift, broad-based policy efforts taken by the authorities, particularly a sizeable fiscal stimulus package, coupled with accommodative monetary conditions, have facilitated a rapid turnaround. Growth is expected to strengthen steadily and unemployment to decline in the coming months. Nevertheless, the outlook is subject to downside risks, including a weaker-than-expected recovery in Hong Kong SAR's major trading partners.

Directors noted that strong capital inflows and the resultant large liquidity overhang in the financial system could potentially lead to rapid credit growth, fueling asset markets and creating macroeconomic volatility. They welcomed the authorities' contingency strategy to pre-empt asset price bubbles, as well as ongoing efforts to increase the availability of land. Strict enforcement of the existing regulatory regime would be essential, while countervailing prudential measures could play a role in mitigating the credit-asset price cycle. Directors emphasized that, when liquidity conditions and pressures on the currency eventually reverse, clear communication of policy actions by the monetary authorities will be important.

Directors generally considered that the Linked Exchange Rate System remains appropriate for Hong Kong SAR as an anchor for monetary and financial stability, and noted the staff assessment that the real effective exchange rate of the Hong Kong dollar continues to be broadly in line with economic fundamentals. Given the importance of maintaining price flexibility to facilitate real exchange rate adjustment to external shocks, Directors urged caution in setting a statutory minimum wage, taking into account the need to protect low-income workers while also minimizing labor market distortion.

Directors welcomed the robustness of the Hong Kong banking system, the result of banks' careful risk management and the authorities' vigilant, prudent regulation and enforcement. Hong Kong SAR, in coordination with Singapore and Malaysia, is well advanced in planning an exit from the blanket deposit guarantee, which has been instrumental in restoring confidence since its introduction in October 2008. Directors supported the proposal to increase the deposit protection limit in line with the coverage in other jurisdictions.

Noting that the recovery is still fragile, Directors endorsed plans to maintain fiscal support in the upcoming 2010/11 budget, including spending on key infrastructure projects and social programs. They encouraged further steps to improve fiscal reporting and strengthen medium-term expenditure planning. Directors commended the authorities for their commitment to health care reform, which aims at reducing the burden on public finances while safeguarding the existing commitment to support those most in need of public health care services. They considered it prudent to phase in supplementary sources of financing at an early stage.

Directors highlighted the urgency of upgrading the quality and expanding the range of services provided by Hong Kong SAR, in view of the shift in the Mainland's growth strategy away from exports to domestic consumption. Potential areas include tourism and leisure, health care, and higher education. Directors also encouraged the authorities to continue to explore ways to develop Hong Kong SAR into an offshore renminbi business center.

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 2006–10 [1/]

	2006	2007	2008	2009	2010
				Staff Proj.	
Real GDP (percent change)	7.0	6.4	2.4	-2.0	5.0
Contribution					
Domestic demand	5.3	6.9	0.7	-0.7	4.6
Private consumption	3.5	5.0	0.9	-0.3	3.1
Government consumption	0.0	0.2	0.1	0.6	0.6
Gross fixed capital formation	1.5	0.7	-0.1	-1.0	0.9
Inventories	0.2	0.9	-0.2	0.0	0.0
Net exports	1.7	-0.6	1.6	-1.3	0.4
Inflation (percent change)					
Consumer prices	2.0	2.0	4.3	-1.0	0.5
GDP deflator	-0.3	2.9	1.4	-0.6	2.0
Employment (percent change)	2.1	2.2	1.5	-0.2	1.8
Unemployment rate (percent, period average)	4.8	4.0	3.5	5.1	4.8
Real wages	-0.3	0.5	0.5	…	…
Government budget (percent of GDP)					
Revenue	19.5	22.2	18.9	17.8	16.0
Expenditure	15.4	14.5	18.6	18.7	17.4
Consolidated budget balance	4.1	7.7	0.2	-0.9	-1.4
Fiscal reserves as of March 31	25.0	30.5	29.5	29.2	25.8
Money and credit (percent change, end-period)					
Narrow money (M1)	13.1	25.4	4.7	...	...
Broad money (M3)	15.5	20.6	2.6	...	...
Loans for use in Hong Kong SAR	2.3	15.2	11.0	...	...
Interest rates (percent, end-period)					
Best lending rate	7.8	6.8	5.0	...	...
Three-month HIBOR	3.8	3.3	0.9	...	...
Asset prices					
Hang Seng stock index (end of period, 1964=100)	19,965	27,813	14,387	...	...
Hang Seng stock index (percent change)	34.2	39.3	-48.3	...	...
Residential property prices (end of period, percent change)	4.1	25.7	-11.1	...	...
Merchandise trade (percent change)					
Export volume	9.3	7.0	1.9	-11.4	3.2
Import volume	9.2	8.8	1.8	-10.5	2.7
External balances (percent of GDP)					
Merchandise trade balance	-7.4	-9.5	-10.7	-11.0	-9.5
Domestic exports	9.4	7.3	6.1	3.1	2.8
Re-exports	157.8	159.8	163.5	149.7	149.9
Imports	174.6	176.6	180.3	163.8	162.2
Current account	12.1	12.3	14.2	11.2	11.9

Foreign exchange reserves 2/					
In billions of U.S. dollars, end-of-period	133.2	152.7	182.5	233.4	236.8
In months of retained imports	18.6	19.5	22.1	32.6	32.3
In percent of broad money (M3)	20.3	19.4	22.6	...	...
Exchange rate					
Linked rate (fixed)			HK$7.80/US$1		
Market rate (HK$/US$1, period average)	7.768	7.801	7.787	...	...
Real effective rate (period average, 2000=100) 3/	78.8	74.6	72.0	...	...

Sources: CEIC Database; and staff estimates and projections.

1/ Unless otherwise stated, all growth rates are for year-on-year.
2/ Includes Land Fund assets.
3/ IMF staff estimates.