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IMF Executive Board Concludes 2010 Article IV Consultation with Hong Kong Special Administrative Region

On November 22, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Hong Kong Special Administrative Region (SAR).¹

Background

Hong Kong SAR's economy is recovering briskly with all demand components resuming a strong growth trajectory. Growth is likely to reach 6¾ percent this year and moderate to 5–5½ percent in 2011. Net exports have been buoyed by vigorous growth in the Mainland and the ongoing global recovery. Investment has benefited from the implementation of various multi-year public infrastructure projects and private investment in machinery and equipment has picked up. At the same time, consumption bounced back as labor markets improved and confidence returned. Inflation, meanwhile, has rebounded from the lows seen in 2009, driven by higher costs for utilities and certain services (such as education, tourism, and transportation). In the coming months, higher property prices will increasingly feed through into the housing component of the consumer price index. These price pressures will become increasingly visible in the coming months with inflation expected to reach around 5 percent by end-2011.

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>.

Hong Kong banks have withstood well the financial market volatility of the past year. Despite the compression of net interest margins, profits have risen due to higher fee, trading, and investment income. Capital levels are well in excess of regulatory requirements, average loan-to-deposit ratios are low, and liquidity ratios are very high. Interbank interest rates in Hong Kong SAR remain close to zero, mirroring developments in U.S. dollar interest rates. The monetary base expanded rapidly over the past few years as money flowed into Hong Kong SAR and pushed the Hong Kong dollar to the strong side of its trading band, though since early this year the Hong Kong dollar has moved to the interior of the band. Banks, meanwhile, gradually boosted lending and loans for use in Hong Kong SAR have increased 21 percent over a year ago with around half of new loans going to the property sector.

Residential property prices in Hong Kong SAR have grown at a rate that exceeded most regional comparators. Property price rises that were initially concentrated in the luxury end of the market subsequently filtered down into the mass market. For the more expensive segments of the market, prices are now 10 percent above the nominal levels reached in 1997 while, for the mass market, prices are fast approaching their historical peaks. The authorities, however, have taken a series of steps to stabilize the property market and safeguard financial stability. These include macro-prudential measures such as a tightening of loan-to-value and debt service ratio rules, steps to dissuade speculation (such as increase in transaction taxes), efforts to increase land supply, and reforms to strengthen consumer protection.

In the 2010/11 Budget, the government continued with temporary stimulus measures—including waiving two months' rent for public housing tenants, providing additional social assistance and old age allowances, and reducing or waiving taxes and fees—and forecasted a deficit of 1½ percent of GDP. However, revenue performance in the first part of this fiscal year has been buoyant—with strong tax performance and substantially higher land-related revenues.

Executive Board Assessment

Executive Directors noted that growth is recovering strongly due, in large part, to the authorities' prompt policy response in the aftermath of the global financial crisis. They considered that the recovery has been broad-based and that economic growth will remain robust, while inflation could rise, fueled by the closing of the output gap, rising housing rents, and spillovers from the highly accommodative monetary policy in advanced economies.

Against this backdrop, Directors supported a countercyclical fiscal stance for the 2011/12 budget, which would entail discontinuing the temporary support measures implemented during the global crisis. At the same time, Directors supported the

continuation of the multi-year plans for infrastructure spending, which are an integral part of Hong Kong SAR's strategy to increase integration with the Mainland.

Directors considered that the forces behind the recent rapid increase in property prices—relatively tight supply conditions, abundant liquidity, and strong demand from Mainland residents and financial sector professionals—are likely to persist in the near term. They agreed that the authorities' graduated policy response has been appropriate, which has enabled them to be better prepared now than in past cycles to deal with housing price pressures and safeguard financial stability. Directors welcomed the further property sector measures announced by the authorities on November 19 to mitigate the amplitude of prices and curb speculation as well as the authorities' commitment to consider additional measures should high rates of property price inflation persist.

Directors agreed that Hong Kong SAR's financial system has been managed prudently and is well regulated and supervised. They also considered the banking system to be in a strong position as indicated by low non-performing loan ratios, healthy levels of capital, and high liquidity. They noted that macroprudential measures have helped dampen the amplitude of the asset price cycle and will help ensure financial stability in the event the cycle reverses.

Directors considered that the linked exchange rate system is an anchor of monetary and financial stability and merits continued support. They noted that Hong Kong SAR's great strength is the flexibility and adaptability of its economy, which has been well demonstrated during past crises. Directors highlighted, however, the need to preserve labor market flexibility by ensuring that the statutory minimum wage is introduced carefully and evaluated after some experience has been garnered with its use.

Directors saw the significant potential for Hong Kong SAR to leverage its unique position as an international financial center with strong links to the Mainland by continuing to work with the Mainland authorities to foster the development of an offshore renminbi market. They welcomed further efforts to facilitate greater real and financial sector linkages with the Mainland.

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Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 2007–11 1/

	2007	2008	2009	2010	2011
				Staff Proj.	
Real GDP (percent change)	6.4	2.2	-2.8	6.7	5.2
Contribution					
Domestic demand	7.0	1.4	0.8	5.4	4.5
Private consumption	5.1	1.4	-0.2	3.4	2.8
Government consumption	0.3	0.2	0.2	0.2	0.2
Gross fixed capital formation	0.7	0.2	-0.4	1.7	1.5
Inventories	1.0	-0.3	1.2	0.0	0.0
Net exports	-0.7	0.7	-3.6	1.3	0.7
Inflation (percent change)					
Consumer prices	2.0	4.3	0.5	2.7	5.0
GDP deflator	2.9	1.5	0.2	1.5	4.9
Employment (percent change)	2.2	1.2	-1.5	3.8	2.1
Unemployment rate (percent, period average)	4.0	3.5	5.2	4.0	3.5
Real wages	0.7	0.7	-1.3	...	...
Government budget (percent of GDP)					
Revenue	22.2	18.9	19.5	22.0	21.6
Expenditure	14.5	18.6	17.7	18.6	18.9
Consolidated budget balance	7.7	0.2	1.8	3.5	2.7
Fiscal reserves as of March 31	30.5	29.5	31.9	32.9	31.9
Money and credit (percent change, end-period)					
Narrow money (M1)	25.4	4.7	39.6	...	...
Broad money (M3)	20.6	2.6	5.2	...	...
Loans for use in Hong Kong SAR	15.2	11.0	-1.0	...	...
Interest rates (percent, end-period)					
Best lending rate	6.8	5.0	5.0	...	...
Three-month HIBOR	3.3	0.9	0.1	...	...
Asset prices					
Hang Seng stock index (end of period, 1964=100)	27,813	14,387	21,873	...	...
Hang Seng stock index (percent change)	39.3	-48.3	52.0	...	...
Residential property prices (end of period, percent change)	25.7	-11.1	28.5	...	...
Merchandise trade (percent change)					
Export volume	7.0	1.9	-12.7	18.5	7.9
Import volume	8.8	1.8	-9.5	18.8	7.6
External balances (percent of GDP)					
Merchandise trade balance	-9.5	-10.7	-12.8	-15.5	-14.6
Domestic exports	7.3	6.1	4.7	4.5	4.1
Re-exports	159.8	163.7	148.2	169.5	169.2
Imports	176.6	180.5	165.6	189.6	187.9
Current account	12.3	13.6	8.7	8.3	9.1
Foreign exchange reserves 2/					
In billions of U.S. dollars, end-of-period	152.7	182.5	255.8	257.3	259.3
In months of retained imports	19.5	22.1	34.6	27.0	25.4
In percent of broad money (M3)	19.4	22.6	29.9	...	...
Exchange rate					
Linked rate (fixed)					
Market rate (HK\$/US\$1, period average)	7.801	7.787	7.752	...	...
Real effective rate (period average, 2000=100) 3/	74.1	70.1	71.7	...	...

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.