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IMF Executive Board Concludes 2012 Article IV Consultation Discussions with People's Republic of China—Hong Kong Special Administrative Region

On January 9, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions with Hong Kong Special Administrative Region (SAR), and considered and endorsed the staff appraisal without a meeting.¹

Background

Real GDP growth in Hong Kong SAR is projected to slow to 1¼ percent in 2012, pulled down by the weak external environment. However, domestic demand has been resilient, buoyed by a healthy labor market and supportive fiscal policy. Fiscal measures include waiving rates, reductions of public housing rent, tax relief to households, and increases in social spending. Consumer price pressures have eased, in line with the cooling economy.

After a short respite in late-2011, the rapid run-up in property prices has resumed. Prices increased by 23 percent in the first ten months of 2012 and have doubled from their 2008 trough. The rise in mass market prices has been particularly pronounced of late and the rental market is following a similar trend. The loan-to-value ratio for mortgages has remained at around 55 percent.

Overall bank credit growth, a key concern in recent years, has decelerated significantly in line with slowing economic activity and tighter macro-prudential policy. Hong Kong SAR's banking system asset quality and profitability has proven resilient to the recent turmoil in the global economy. Although IPO activity has been slow, the equity market has recently rebounded, and corporate bond issuance has been strong.

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.

Financial integration with the Mainland has continued. Over the past few years, Hong Kong SAR's banking system claims on Mainland borrowers have grown significantly and accounted for 28 percent of Hong Kong SAR banks' total external claims as of end-June 2012. After growing rapidly through late 2011, the share of renminbi deposits has stabilized at around 9 percent of total system deposits.

Executive Board Assessment

In concluding the Article IV consultation with Hong Kong SAR, Executive Directors endorsed staff's appraisal as follows:

Hong Kong SAR is weathering the global economic storms fairly well. Weakening external demand is dragging down growth, but the domestic economy is proving resilient buoyed by supportive fiscal policy and continued strength in construction and tourism-related sectors. Unemployment remains low. Inflation has declined on the heels of the slowing economy and easing of food price pressures in the Mainland. Looking forward, growth is expected to recover in line with the improved global economy while inflation is forecast to remain within a comfortable range. Nonetheless, as a small and highly open economy, Hong Kong SAR remains susceptible to external shocks and would strongly feel the effects of a worsening of the euro area crisis, the U.S fiscal cliff, or a hard-landing in the Mainland.

The absence of an independent monetary policy means that fiscal policy is the main tool for demand management. Overall, Hong Kong SAR's fiscal policy has been effective in reducing output volatility thanks to the active use of discretionary policies. That includes 2012, with fiscal policy providing timely support to help counter the impact from slowing external demand. Next year's budget should continue to be supportive of demand and, in the event of an external shock, fiscal policy should be deployed to provide further stimulus and protect low-income and vulnerable households. To prevent an erosion of fiscal discipline, it would be critical to ensure that policies are applied symmetrically through the business cycle, with stimulus being withdrawn as the economy recovers. Hong Kong SAR's history of fiscal prudence, which has built fiscal reserves to over 30 percent of GDP, provides an important backbone to the economy.

While the probability of a correction large enough to generate major macroeconomic and financial consequences is fairly low in the near term, the property sector is the main source of domestic economic risk. Policies on a variety of fronts are needed to contain macroeconomic and financial risks from the housing market. The authorities have taken appropriate macro-prudential measures to help safeguard the banking system. These measures should continue to be fine-tuned in line with evolving risks and, if needed, additional measures could be deployed. Macro-prudential measures should, however, remain focused on safeguarding financial stability, while other policies—such as fiscal measures—can best be used to address broader concerns about demand-supply imbalances and affordability. Improving affordability ultimately hinges on a sufficient provision of new housing. Therefore, the government's efforts to ensure a steady and adequate supply going forward, including through public housing, are welcome, although the impact may be limited in the short run given planning and construction lags.

Hong Kong SAR's banking system remains well capitalized, putting it in a good place to start implementing Basel III standards in 2013. The authorities have moved proactively to contain risks in the financial system. The slowdown in credit growth is welcome, as are the targeted measures to contain risks in real estate lending and efforts to closely monitor and supervise Mainland exposures. The HKMA should continue to assess evolving risks and, as needed, could deploy additional macro-prudential measures, tighten underwriting standards, and ask banks to increase buffers. As a financial center, Hong Kong SAR would feel the impact of a global financial shock. Bank distress elsewhere in the world could spill over into Hong Kong SAR, with shocks emanating in the United States or the Mainland having the largest potential impact. Hong Kong SAR's existing liquidity facilities and deposit protection scheme should prove sufficient to maintain financial stability, but, in an extreme shock, additional measures could be considered in conjunction with other jurisdictions. The ongoing opening of the Mainland's capital account and expanded international use of renminbi provide further opportunities for Hong Kong SAR to strengthen its position as an international financial center. The FSAP scheduled for next year will afford an opportunity to explore financial sector issues in greater depth.

The Linked Exchange Rate System (LERS) is a transparent, credible, and effective exchange rate regime and warrants continued support as the best arrangement for Hong Kong SAR. Hong Kong SAR has an economic system that adjusts to the changing environment through movements in nominal wages and prices. The preconditions to sustain such a system—including a strong fiscal position, robust and proactive financial oversight, and flexible labor, product, and asset markets—are in place. Hong Kong SAR's economic flexibility facilitates a quick and effective adjustment of the real exchange rate so as to avoid sizable or persistent misalignments. The Hong Kong dollar and external position are assessed to be broadly in line with fundamentals.

Fostering inclusive growth is an ongoing concern. Hong Kong SAR's economic flexibility and reliance on free-market principles are sources of economic strength and resilience which, however, can also result in income inequality given the importance of skill-based wage premiums. Moreover, the high and rising cost of housing is straining the budget of many lower- and middle-income families. The authorities have implemented an array of measures—including the statutory minimum wage and planned increases in public housing—geared toward improving the living standards of lower-income households. Weight should continue to be placed on policies to reinforce the existing social welfare programs and provide support and opportunities to lower-income households.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 2006–13 1/

	2006	2007	2008	2009	2010	2011	Staff projections	
							2012	2013
Real GDP (percent change)	7.0	6.5	2.1	-2.5	6.8	4.9	1.2	3.0
Contribution								
Domestic demand	5.3	7.0	1.3	0.8	6.6	5.7	3.1	3.3
Private consumption	3.5	5.0	1.1	0.5	3.9	5.1	1.8	2.2
Government consumption	0.1	0.3	0.2	0.2	0.3	0.2	0.2	0.2
Gross fixed capital formation	1.5	0.7	0.3	-0.7	1.5	1.6	1.1	0.9
Inventories	0.2	1.0	-0.3	0.9	0.9	-1.2	0.0	0.0
Net exports	1.7	-0.5	0.8	-3.3	0.2	-0.8	-1.8	-0.3
Inflation (percent change)								
Consumer prices	2.0	2.0	4.3	0.5	2.4	5.3	3.8	3.5
GDP deflator	-0.5	3.1	1.3	-0.4	0.3	3.8	3.5	3.1
Employment (percent change)	1.9	2.2	0.9	-1.2	0.2	2.9	1.0	1.1
Unemployment rate (percent, period average)	4.8	4.0	3.5	5.3	4.3	3.4	3.4	3.3
Real wages	-0.1	0.7	0.7	-1.5	-0.4	2.7	...	...
Government budget (percent of calendar year GDP)								
Revenue	19.2	21.7	18.5	19.2	21.2	22.6	20.4	20.8
Expenditure 2/	15.1	14.2	18.3	17.4	17.0	18.8	20.1	19.0
Consolidated budget balance	3.9	7.5	0.1	1.6	4.2	3.8	0.2	1.7
Fiscal reserves as of March 31	24.6	29.9	29.0	31.4	33.5	34.6	33.2	33.0
Money and credit (percent change, end-period)								
Narrow money (M1)	13.1	25.4	4.7	39.6	12.8	10.8	...	...
Broad money (M3)	15.5	20.6	2.6	5.2	8.0	12.9	...	...
Loans for use in Hong Kong SAR (not including trade financing)	2.3	15.2	11.0	-2.1	20.9	12.6	...	...
Interest rates (percent, end-period)								
Best lending rate	7.8	6.8	5.0	5.0	5.0	5.0	...	...
Three-month HIBOR	3.8	3.3	0.9	0.1	0.3	0.3	...	...
Asset prices								
Hang Seng stock index (end of period, 1964=100)	19,965	27,813	14,387	21,873	23,035	18,434	...	...
Hang Seng stock index (percent change)	34.2	39.3	-48.3	52.0	5.3	-20.0	...	...
Residential property prices (end of period, percent change)	4.1	25.7	-11.1	28.5	21.0	11.1	...	...
Merchandise trade (percent change)								
Export volume	9.3	7.0	1.9	-12.7	17.3	3.4	-3.3	6.7
Import volume	9.2	8.8	1.8	-9.5	18.1	4.7	-1.3	6.6
External balances (percent of GDP)								
Merchandise trade balance 3/	16.0	12.7	11.4	5.9	1.0	-3.7	-6.4	-6.0
Domestic exports 4/	9.2	7.1	6.0	4.6	4.6	4.6	3.8	3.6
Re-exports 4/	154.9	156.4	160.6	145.7	167.6	171.7	157.7	158.1
Imports 4/	171.4	172.8	177.1	162.9	191.0	198.9	185.5	185.4
Current account 3/	12.7	13.0	15.0	9.5	6.6	6.5	4.1	4.0
Foreign exchange reserves 5/								
In billions of U.S. dollars, end-of-period	133.2	152.7	182.5	255.8	268.7	285.4	281.9	283.6
In months of retained imports	18.6	19.5	22.0	34.6	28.7	25.9	25.3	24.2
In percent of broad money (M3)	20.4	19.4	22.5	29.9	29.2	27.4	...	...
Exchange rate								
Linked rate (fixed)				HK\$7.80/US\$1				
Market rate (HK\$/US\$1, period average)	7.768	7.801	7.787	7.752	7.769	7.784	...	...
Real effective rate (period average, 2000=100) 6/	99.0	93.9	88.9	91.0	88.7	85.7	...	...

Sources: CEIC Database; and staff estimates.

1/ Unless otherwise stated, all growth rates are for year-on-year.

2/ In 2006-07, 2008-09, and 2009-10 fiscal years, expenditure excludes bond repayments.

3/ Balance of Payments BPM6 basis.

4/ National Accounts SNA 08 basis.

5/ Includes Land Fund assets.

6/ IMF staff estimates.