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IMF Executive Board Concludes 2015 Article IV Consultation Discussions with People's Republic of China—Hong Kong Special Administrative Region

On January 11, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions¹ with Hong Kong Special Administrative Region (SAR).

Hong Kong SAR's growth is expected at 2¼ percent in 2015, with domestic demand acting as the principal source of momentum. Growth is likely to pick up modestly to 2½ percent in 2016, with a smaller drag from external demand reinforcing resilient domestic demand. Inflation has declined and is expected to remain below 3 percent in 2015/16 on softer commodity prices. The current account has dropped to around 2½ percent of GDP, but is projected to improve to around 3½ percent over the medium term as the global economy recovers.

The economy has operated with low interest rates for seven years and is now likely to see rates increase with the Fed liftoff. Generally favorable spillovers from Mainland China thus far may also turn more challenging going forward with the ongoing transition to slower, but more sustainable, growth in the Mainland. The domestic property sector has experienced a renewed run-up in prices since mid-2014, but there are some signs evident now of a pause in momentum.

Considering the fiscal and financial buffers in place in Hong Kong SAR, these risks are likely to have limited impact on the economy and financial system provided the increase in interest rates is gradual (and in line with the path envisaged in the U.S. Federal Reserve's FOMC median forecasts for the Federal Funds rate), and Mainland China's growth slows in orderly fashion.

Nevertheless, if growth slows more than expected in early 2016, fiscal policy will need to provide additional support in the February budget with an emphasis on expanded relief measures for vulnerable households, small businesses, and accelerated urban renewal and infrastructure spending where possible.

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.

While property prices are showing some early signs of leveling off, the propensity for further increases remains because of the underlying shortfall in supply. Sustained efforts to ensure that the targets of the 2014 Long-Term Housing Strategy are met will be important for managing public expectations regarding supply and affordability.

Hong Kong SAR has a strong track record of filling regulatory and data gaps, and assessing systemic risks in the financial system. Essential infrastructure support for healthy market development has been provided, for instance in offshore RMB services. The resilience of the economy and financial system was displayed during the past summer when markets functioned in orderly fashion even as volatility in equity and currency markets increased substantially after the correction in the Mainland indices. Further strengthening aspects of the defenses will require completing the process underway for enacting legislation on a comprehensive recovery and resolution framework; continuing to strengthen the oversight regime for securities markets, broker dealers and asset managers as their business model evolves with new channels connecting Hong Kong SAR and Mainland markets; and fully implementing a risk-based capital regime for insurance companies.

Executive Board Assessment²

Executive Directors commended the authorities for their sound policy management which has supported steady growth of the economy and its resilience, and low unemployment despite elevated global financial market volatility. Directors agreed that Hong Kong SAR's small open economy faces multiple challenges related to the Fed liftoff, structural change in Mainland China, and the domestic property sector. However, the strong fiscal and financial buffers will help mitigate potential negative impacts arising from these risks. Directors welcomed the authorities' commitment to stay vigilant and implement a prudent mix of policies to secure healthy growth in the medium term.

Directors observed that fiscal policy should strike a balance between supporting the economy in the near term and addressing the future needs of an aging population and a shrinking workforce. They encouraged proactive use of the fiscal space to cushion the economy if economic activity weakens significantly in early 2016, by expanding relief measures for vulnerable households and small businesses, and accelerating urban renewal and infrastructure spending where possible. They commended the recent progress in a number of areas to address the long-term fiscal challenges, including the planned Low-Income Working Family Allowance Scheme to incentivize labor force participation and the Future Fund to raise investment returns of the fiscal reserves.

² 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>.

Directors agreed that restoring demand-supply balance in housing markets should continue to be a policy priority. They encouraged the authorities to implement the 2014 Long-Term Housing Strategy effectively to ensure that additional housing supply targets are met and that public expectations about supply and affordability improve in a durable manner. Directors agreed that adjustments to stamp duties could be considered if there is a sustained decline in transaction volumes with the potential to generate adverse spillovers to the broader economy. Property-related macroprudential measures should also continue to remain in place and any adjustments should be made based on evolving financial stability risks and not in response to aggregate demand developments. They recommended monitoring the level of floating rate mortgages.

Directors noted that Hong Kong SAR has a strong track record of filling regulatory and data gaps, assessing systemic risks, and strengthening financial institutions' loss absorption buffers in a preemptive manner. They encouraged the authorities to complete the legislation on a comprehensive recovery and resolution framework, to continue to strengthen the oversight regime for securities markets, broker dealers, and asset managers as their business model evolves with new channels connecting Hong Kong SAR and Mainland markets, and to fully implement a risk-based capital regime for insurance companies.

Directors agreed that the Linked Exchange Rate System remains the best arrangement for Hong Kong SAR and serves as an anchor of stability for this small open economy with a globally integrated financial services industry.

Hong Kong SAR: Selected Economic and Financial Indicators, 2010–16

	2010	2011	2012	2013	2014	Proj.	
						2015	2016
Real GDP (percent change)	6.8	4.8	1.7	3.1	2.5	2.2	2.5
Contribution							
Domestic demand	6.7	6.0	3.7	3.9	2.8	1.4	2.3
Private consumption	3.8	5.2	2.6	3.0	2.1	3.1	2.0
Government consumption	0.3	0.2	0.3	0.3	0.3	0.3	0.3
Gross fixed capital formation	1.7	2.2	1.6	0.6	0.0	-0.9	-0.3
Inventories	0.9	-1.7	-0.8	0.0	0.5	-1.0	0.3
Net exports	0.2	-1.3	-2.0	-0.9	-0.3	0.8	0.2
Inflation (percent change)							
Consumer prices	2.4	5.3	4.1	4.3	4.4	2.7	2.9
GDP deflator	0.3	3.9	3.5	1.9	2.9	3.7	2.3
Employment (percent change)	0.2	2.9	2.4	1.8	0.6	0.7	0.7
Unemployment rate (percent, period average)	4.3	3.4	3.3	3.4	3.3	3.2	3.1
Real wages (percent change)	-0.4	2.7	1.6	0.1	-2.4	...	...
Government budget (percent of fiscal year GDP)							
Revenue	21.2	22.6	21.7	21.3	21.2	22.0	22.1
Expenditure	17.0	18.8	18.5	20.3	17.6	18.5	19.4
Consolidated budget balance	4.2	3.8	3.2	1.0	3.7	3.5	2.7
Fiscal reserves as of March 31	33.5	34.6	36.0	35.3	36.7	38.3	39.2
Money and credit (percent change, end-period)							
Narrow money (M1)	12.8	10.8	22.2	9.7	13.1	...	...
Broad money (M3)	8.0	12.9	11.0	12.4	9.6	...	...
Loans for use in Hong Kong SAR (not including trade financing)	20.9	12.5	7.0	10.6	13.5	...	...
Interest rates (percent, end-period)							
Best lending rate	5.0	5.0	5.0	5.0	5.0	...	...
Three-month HIBOR	0.3	0.5	0.3	0.3	0.3	...	...
Asset prices							
Hang Seng stock index (end of period, 1964=100)	23,035	18,434	22,657	23,306	23,605	...	...
Hang Seng stock index (percent change)	5.3	-20.0	22.9	2.9	1.3	...	...
Residential property prices (end of period, percent change)	21.0	11.1	25.7	7.7	13.5	...	...
Merchandise trade (percent change)							
Export volume	17.3	3.5	1.9	6.5	0.8	-2.6	0.2
Domestic exports	-0.1	-0.6	10.1	-1.6	2.3	-0.9	0.2
Re-exports	17.9	3.6	1.7	6.8	0.8	-2.7	0.2
Import volume	18.1	4.7	3.0	7.2	0.9	-3.4	-0.6
Current account balance (percent of GDP) 1/	7.0	5.6	1.6	1.5	1.9	2.5	2.7
Foreign exchange reserves 1/							
In billions of U.S. dollars, end-of-period	257.1	269.9	300.5	311.1	328.5	...	...
In months of retained imports	27.5	24.6	26.5	26.3	26.3	...	...
In percent of broad money (M3)	27.9	26.0	26.0	23.9	23.1	...	...
Exchange rate							
Linked rate (fixed)							
Market rate (HK\$/US\$, period average)	7.769	7.783	7.755	7.756	7.754	...	...
Real effective rate (period average, 2010=100)	100.0	96.6	98.7	102.2	105.7	...	...

Sources: CEIC; and IMF staff estimates.

1/ Data published using the Balance of Payments Statistics Manual 6 (BPM6) format.