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People's Republic of China–Hong Kong SAR: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of People's Republic of China–Hong Kong SAR on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with People's Republic of China–Hong Kong SAR, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of People's Republic of China–Hong Kong SAR; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports allows for the deletion of market sensitive information.

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PEOPLE'S REPUBLIC OF CHINA—HONG KONG SPECIAL ADMINISTRATIVE REGION

Staff Report for the 1999 Article IV Consultation Discussions

Prepared by the Staff Representatives for the Consultation Discussions Held in 1999 in Respect of the Hong Kong Special Administrative Region[1]

Approved by Wanda Tseng and Ishan Kapur

January 31, 2000

- Consultation discussions were held in the Hong Kong Special Administrative Region of the People's Republic of China during November 10–22, 1999.
- The staff team comprised Messrs. Robinson (Head), Aziz, Nishigaki and Breuer (all APD), and Sturm (RES). Mr. Wei Benhua, Executive Director, and Mr. Zhang Fengming, Alternate Executive Director, each attended a number of the discussions.
- The mission met with Financial Secretary Sir Donald Tsang, Chief Executive of the Hong Kong Monetary Authority (HKMA) Joseph Yam, as well as a range of government officials, banking, corporate, and trade union representatives, and academics.
- The principal authors of this report are Messrs. Robinson and Aziz.

[1]The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

Contents

I. Background and Recent Developments

1. **During the first six years of the 1990s, Hong Kong SAR continued to achieve sustained high growth in an environment of rapid structural change.** The period was characterized by impressive rates of resource utilization and efficiency gains; a rapid shift in the structure of the economy toward services as manufacturing industry relocated to the Mainland of China; and the development of a thriving international financial center (Box 1). Given the linked exchange rate, the relatively rapid productivity growth in the tradeables sector led to higher inflation (to achieve the required real appreciation). This was accompanied by a rapid run up in asset prices; while partly due to economic fundamentals, a substantial price bubble also emerged (Box 2).

2. **Given the openness of the economy, the Asian crisis hit the economy hard, despite Hong Kong SAR's generally strong fundamentals.** External demand fell sharply, and the depreciation of the yen and the crisis-country currencies led to a sharp real appreciation in the Hong Kong dollar (Chart 1). Driven by rising risk premia, real interest rates rose markedly, and asset prices dropped very sharply. As confidence ebbed, market pressures intensified, culminating in a major attack on the foreign exchange and stock markets in August 1998. Fearing erosion of domestic confidence in the economy, and concerned that markets were being manipulated through the so-called "double play,"[2] the authorities took the unorthodox step of intervening in the stock markets; they also implemented a variety of measures to strengthen the currency board, improve transparency and increase the cost of speculation in financial markets.[3] Aided by an improvement in the external environment, this succeeded in calming markets, which recovered somewhat during the remainder of the year.

3. **At the conclusion of last year's consultation discussions, Executive Directors observed that while the Asian crisis had seriously affected the Hong Kong SAR economy, adjustment was proceeding rapidly, reflecting the underlying flexibility of the economy.** They strongly supported the authorities' commitment to maintaining the linked exchange rate supported by active use of fiscal policy and job creation and retraining

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[2]Under the "double play," speculators shorted the foreign exchange and stock markets simultaneously. They hoped to profit from their short foreign exchange position and, by forcing interest rates up to support the exchange rate, to push the stock market down and profit from their short stock market position.

[3]These included the introduction of a rediscount facility; formalizing the undertaking to convert Hong Kong dollar clearing balances to U.S. dollars at a fixed exchange rate of US$1=HK$7.75 (to be gradually shifted to the linked rate of US$1=HK$7.8 by August 2000—for further details see footnote 11); tighter enforcement of rules on short selling and settlement of trades; higher margin requirements in the futures market; enhanced market supervision and disclosure; and increased penalties for illegal activities.

Box 1. Hong Kong SAR: Developments in Financial Markets

Over the past 20 years, Hong Kong SAR has developed into a major international financial center. As of end–December 1999, 285 financial institutions were operating in Hong Kong SAR, including 76 of the world's 100 largest banks. The main markets are:

- **Foreign exchange and derivative trading.** Daily turnover averages $79 billion (Chart A), the sixth largest in the world; nearly half is in the US$/yen and US$/HK$ markets. The top ten players account for half of total trading (the top 30 for over three-quarters).

- **International banking.** At end–November 1999, external assets of Hong Kong SAR-based banks total $482 billion, with 39 percent of lending to Japan, 7 percent to the Mainland of China, and 10 percent each to the United Kingdom and Singapore.

- **Stock market.** At end–November 1999, market capitalization was $540 billion, the 10th largest in the world; about 5 percent was accounted for by Mainland or Mainland-related firms. About 30 percent of turnover is due to regional and global investors.

- **Other markets.** There are small but growing domestic debt and futures and options exchanges, and a large gold bullion market. Hong Kong SAR is also a regional center for portfolio management and insurance.

The Asian crisis, combined with events in Japan and the Mainland of China, has had a significant effect on financial sector activity. In particular:

- **International banking activity has sharply declined**, with external assets of authorized institutions dropping by 19 percent since 1997. This was mostly due to consolidation of the Japanese banking industry; from the second half of 1998 the growing financial problems in the Mainland's financial institutions and enterprises also contributed (but on a much smaller scale).

- **The stock market fell very sharply through August 1998, with new issues slowing to a trickle.** This reflected the worsening economic situation in Hong Kong SAR, but also concerns about the Mainland economy, and withdrawals by foreign investors to meet losses in other markets. Since that time, the market has recovered sharply, driven mainly by the reflux of capital to the region, and even reached pre-crisis peaks in December 1999.

- **Domestic debt issues remained strong in 1998**, due mainly to supranational borrowers. While the latter have since declined, new issues in the first nine months of 1999 have nevertheless risen very sharply, mainly due to the decline in nominal interest rates.

Looking to the future, Hong Kong SAR will face growing competition from other financial centers, both inside and outside the region. To ensure that Hong Kong SAR remains in the premier league of financial centers, the Financial Secretary announced a series of measures in the 1999 budget to strengthen the securities and futures markets. These include:

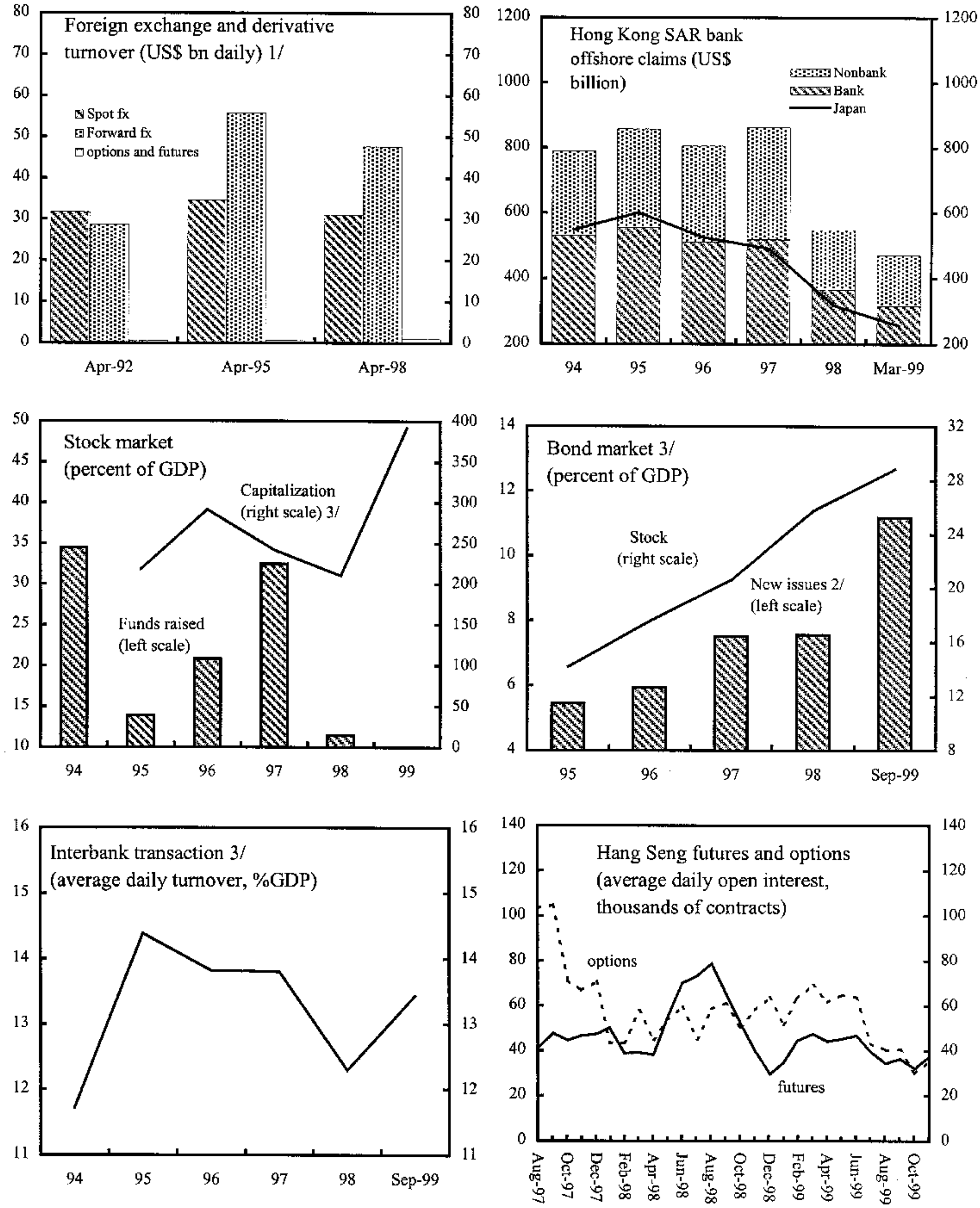
- **Consolidation and ultimately listing the various exchanges and their clearing houses**, to separate ownership from trading rights and enhance competition.

- **Comprehensive reform of the regulation of securities and futures markets.**

- **Consolidation and integration of clearing services.**

- **In addition, the Growth Enterprise Market was set up in November 1999**, specializing in small- and medium-size Mainland-based science and technology-related companies.

Chart A. Hong Kong SAR: Indicators of Financial Market Activity



Source: Hong Kong Monetary Authority, Monthly Statistical Bulletin.

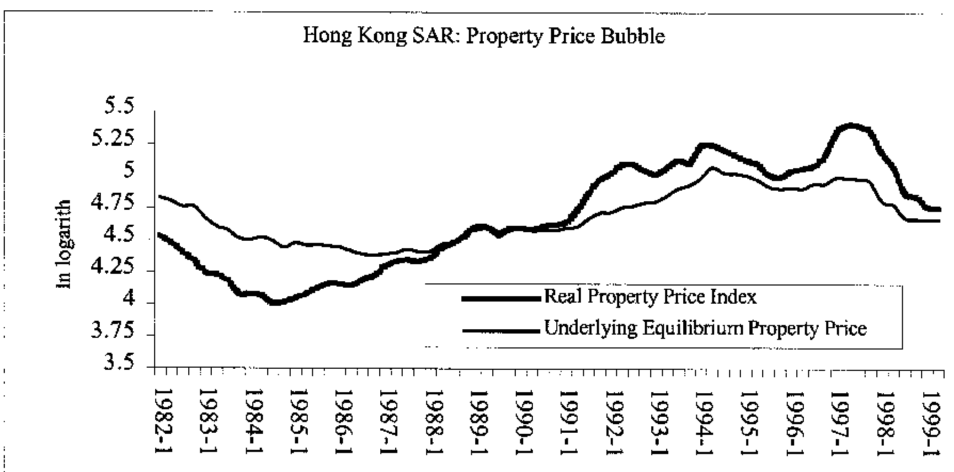
1/ BIS Triennial Survey.
2/ Exclude Exchange Fund note, which are very small.
3/ 1999 data is calculated with prorated GDP.

Box 2. Have Property Prices in Hong Kong SAR Bottomed out?

The property sector plays a crucial role in Hong Kong SAR on account of its relative size, interlinkages with key macroeconomic variables, and as a determinant of competitiveness and of banking sector and stock market performance. From the early 1990s, the property sector has experienced a sustained boom (with a short correction during 1994–95). The staff's econometric work on residential property prices[1] suggests that while a significant part was due to fundamentals—in particular sustained negative real interest rates, rising income, and the appreciation of the real effective exchange rate—a speculative bubble of some 40–45 percent emerged by mid–1997, induced in part by an increasingly positive assessment of the transfer of sovereignty to China.

Following the onset of the Asian crisis, the property price bubble burst, and prices dropped very sharply. In response, the government suspended land sales, and removed a number of anti-speculative measures that had been introduced earlier. By end–1998, residential property prices were 40 percent below their mid–1997 peak, but have since stabilized. The staff's calculations suggest that residential prices may now have returned broadly to equilibrium (broadly consistent with anecdotal evidence). Office and retail property prices, however, have continued to decline, reflecting substantial overcapacity, and are now 50 percent below their pre-crisis level.

Hong Kong SAR's experience during the 1990s raises the question whether—perhaps because of the oligopolistic structure of the property market, or because of the possibility of sustained periods of negative real interest rates under the linked exchange rate system—it may be particularly prone to property market bubbles. The staff's analysis suggests that while bubbles have emerged in the past,[2] their size and duration is comparable with those in metropolitan U.S. cities, suggesting that such structural factors may not in fact be of importance.[3]

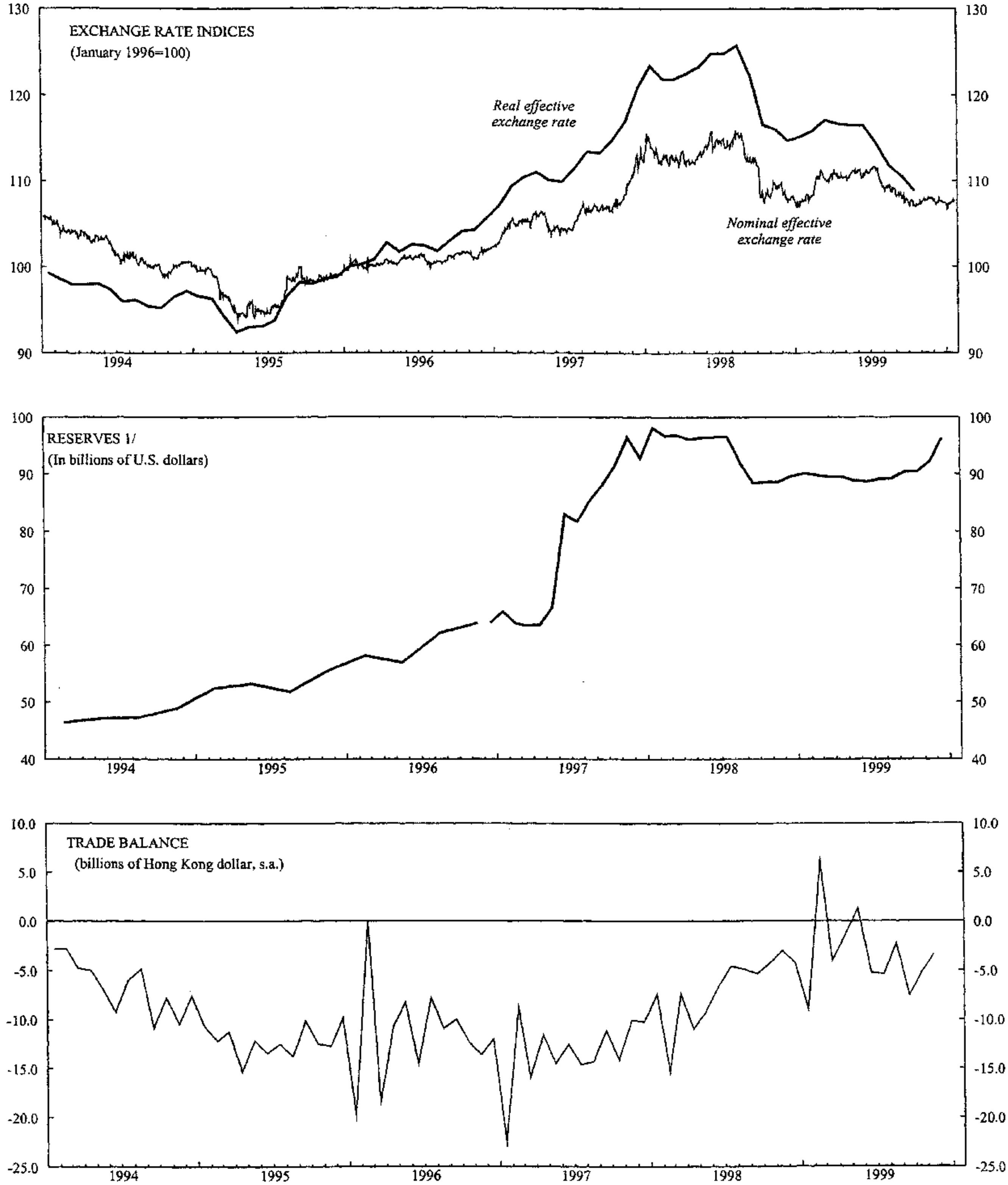


[1]See Sanjay Kalra, Dubravko Mihaljek, and Christoph Duenwald, "Property Prices and Speculative Bubbles: Evidence from Hong Kong SAR," IMF Working Paper 00/2.

[2]Also, price-average cost margins in real estate are extremely procyclical (Box 8).

[3]Michael Enright, Edith Scott, and David Dodwell, *The Hong Kong Advantage*, Oxford University Press, (1997), also found that the very high property costs in Hong Kong SAR were due to land scarcity and the government's ability to influence land supply, rather than oligopolistic behavior of property developers.

Chart 1
Hong Kong SAR
EXTERNAL INDICATORS, 1982-99



Source: Hong Kong Monetary Authority; IMF: Information Notice System and staff estimates..

1/ Reserves include foreign currency assets of the Land Fund from July, 1997.

programs to mitigate the adverse impact on growth and employment, set in the context of a medium-term framework to restore budget balance, as required under the Basic Law. While appreciating the reasons for the stock market intervention, they noted that this raised concerns about the role of government in the securities market and potential conflict of interest, and urged the authorities to move quickly to dispose of their equity holdings in an orderly manner.

4. **In the event, GDP fell by over 5 percent in 1998 (Table 1), as private consumption and investment dropped sharply in response to the fall in asset prices, declining external demand, high interest rates, and the uncertain business outlook.** The decline in domestic demand (Chart 2) was compounded by a sharp fall in exports of goods, tourism, and financial services as regional demand weakened. However, this was more than offset by an even larger reduction in imports, so that net exports of goods and nonfactor services shifted from a deficit of 3¼ percent of GDP in 1997 to a surplus of ¾ percent of GDP in 1998. Reserves fell by US$3 billion to US$89½ billion (17½ months of retained imports), suggesting modest net capital outflows during the year.[4]

5. **Over the past year, adjustment has generally continued as anticipated under the linked exchange rate arrangement**. Following the fall in asset prices, consumer prices—after some lag—have deflated rapidly, declining by over 4 percent in the 12 months ending in November 1999. Together with the appreciation of the yen and crisis-country currencies, this has erased the appreciation of the real effective exchange rate in the first year of the crisis (Chart 1). The staff's calculations suggest that the exchange rate is now close to equilibrium, implying that the downward price adjustment could be nearing completion (consistent with that, seasonally adjusted CPI deflation has slowed significantly in recent months).[5]

6. **In the labor market, adjustment in larger enterprises has taken place primarily through employment shedding**; while nominal payroll per worker has slowed—and turned negative on a seasonally adjusted basis in the first half of 1999—it appears that real earnings have continued to rise (Box 3). However, the reduction in employment in larger enterprises has been more than offset by rising employment in the public sector, the informal sector and on the Mainland, so that total employment has continued to increase. Nevertheless, with the labor force continuing to grow strongly, unemployment has risen from 2¼ percent before the crisis to 6 percent by end–1999.

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[4]Current and capital account data are at present available only on an annual basis and with a considerable lag; balance of payments is not directly comparable with trade data (which are on a national accounts basis). The authorities plan to begin publishing quarterly data in early 2000.

[5]Based on a simple model relating the real effective exchange rate to the economic structure, terms of trade, foreign inflation rate, and public investment (see SM/98/12, 1/12/98, for details).

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 1994-2000

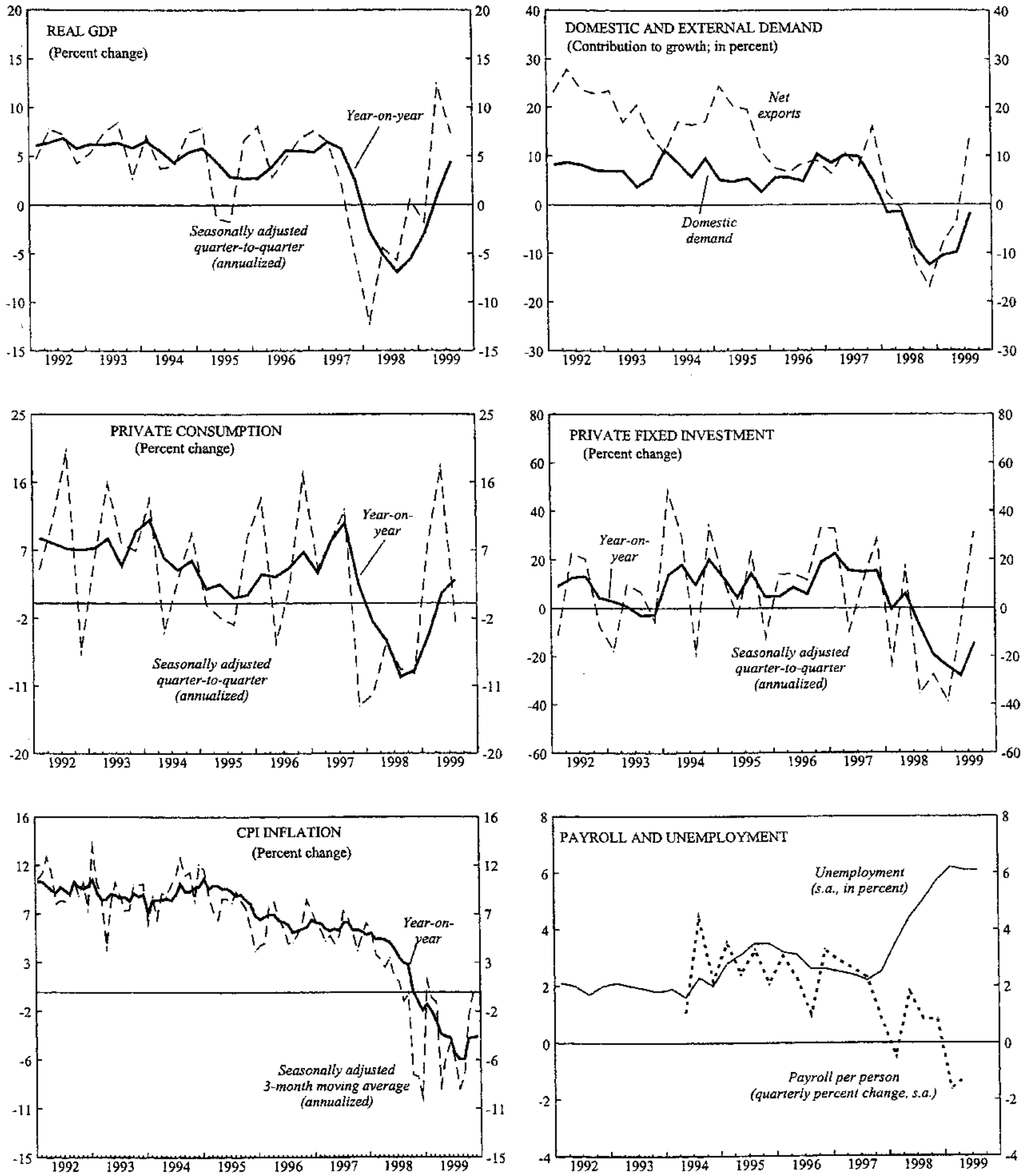
Nominal GDP (1998):	US$164 billion
Population (mid-1999):	6.8 million
GDP per capita (1998):	US$24,477

						1999						Staff Projection	
	1994	1995	1996	1997	1998	Q1	Q2	Q3	Q4	Latest		1999	2000
Real GDP (percent change)	5.4	3.9	4.5	5.0	-5.1	-3.0	1.1	4.5	...	...		2.0	4.3
Real domestic demand	11.8	7.1	2.5	8.2	-8.9	-12.7	-10.6	0.1	...	...		-2.1	5.4
Private consumption	6.7	1.6	4.7	6.2	-6.7	-4.4	1.3	3.0	...	...		1.5	4.3
Gross fixed capital formation	15.7	10.7	10.8	12.7	-6.4	-21.2	-26.1	-10.8	...	...		-14.0	4.0
Foreign balance (contribution)	-5.9	-3.3	1.9	-3.4	4.3	10.7	12.7	4.3	...	...		4.1	-1.0
Saving and investment (percent of GDP)													
Gross domestic saving	33.1	30.5	30.7	31.1	30.2	26.6	28.0	32.6	...	...		29.5	29.1
Gross domestic investment	31.9	34.8	32.1	34.6	29.7	25.1	24.9	25.9	...	...		26.7	27.0
Saving-investment balance	1.2	-4.3	-1.4	-3.4	0.5	1.4	3.1	6.7	...	...		2.8	2.1
Inflation (percent change)													
Consumer prices	8.8	9.0	6.3	5.8	2.8	-1.8	-4.0	-5.9	-4.1	-4.0	7/	-4.0	0.0
GDP deflator	6.9	2.5	5.9	5.9	0.9	-3.6	-5.4	-6.3	...	...		-5.0	-0.9
Employment (percent change)	2.6	1.1	3.5	4.6	1.8	1.9	1.8	1.6	...			1.7	2.6
Unemployment rate (percent)	1.9	3.2	2.8	2.2	4.7	6.2	6.1	6.1	...	6.0	7/	6.1	5.0
Real wages	1.3	-1.0	0.4	1.0	0.1	2.6	3.8	4.4	...	...		...	...
Government budget (percent of GDP)													
Revenue	17.3	16.7	17.5	21.2	17.0 1/	...	...	...	...	...		17.6	19.0
Expenditure	16.0	17.0	15.3	14.7	18.9 1/	...	...	...	...	...		19.2	19.2
Consolidated budget balance	1.3	-0.3	2.2	6.6	-1.8 1/	...	...	...	...	...		-1.5	-0.2
Reserves at March 31	14.9	13.7	14.6	34.5	34.3 1/	...	...	...	...	...		33.8	32.5
Money and credit (percent change, end-period)													
Narrow money (M1)	-1.2	2.8	14.2	-4.3	-5.0	-0.9	6.9	9.1	...	4.4	6/	...	...
Broad money (M3)	13.6	14.2	10.5	8.2	10.5	8.6	10.0	7.3	...	7.8	6/	...	...
Loans for use in Hong Kong SAR	17.0	11.1	17.1	24.4	-3.8	-5.2	-8.4	-8.1	...	-7.4	6/	...	...
Interest rates (percent, end-period)													
Best lending rate	8.5	8.8	8.5	9.5	9.0	8.8	8.3	8.5	8.5	8.5	8/	8.5	...
Three-month HIBOR	6.3	5.9	5.5	9.1	5.8	5.6	5.7	5.7	5.9	5.7	8/	5.9	...
Merchandise trade (percent change)													
Export volume	10.4	12.0	4.8	6.1	-4.3	-4.8	-2.0	8.1	...	8.8	2/, 5/	2.6	8.7
Domestic exports	-2.3	2.0	-8.4	2.2	-7.9	-9.0	-12.6	-7.8	...	-8.1	2/, 5/	-9.0	8.5
Reexports	13.8	14.3	7.5	6.8	-3.7	-4.1	-0.3	10.8	...	11.5	2/, 5/	4.5	8.7
Import volume	14.0	13.7	4.3	7.2	-7.2	-10.2	-7.9	6.9	...	7.1	2/, 5/	0.5	9.4
Export value	11.8	14.9	4.0	4.2	-7.4	-9.0	-5.9	4.4	10.4	10.4	2/, 7/	1.9	10.2
Import value	16.6	19.3	3.0	5.2	-11.5	-13.8	-11.3	4.4	11.2	11.2	2/, 7/	0.2	11.1
Terms of trade	-0.9	-2.1	0.6	0.7	1.5	...	...	...	...	...		-0.4	-0.2
External balances (in billions of US$)													
Merchandise trade balance	-10.4	-19.0	-17.8	-21.1	-10.9	-1.7	-1.6	-0.8	...	0.0	6/	-8.2	-10.6
In percent of GDP	-8.4	-14.1	-11.9	-12.3	-6.7	...	...	...	...	...		-5.1	-6.5
Goods and nonfactor services balance	2.1	-5.5	-1.6	-5.3	1.4	...	...	...	...	...		5.0	4.0
In percent of GDP	1.6	-3.9	-1.0	-3.1	0.8	...	...	...	...	...		3.2	2.4
Foreign exchange reserves 3/													
In billions of U.S. dollars, end of period	48.9	55.4	63.8	92.8	89.6	89.5	88.6	90.4	96.3	96.3	7/	96.3	...
In months of retained imports	9.9	9.1	10.7	14.7	17.5	...	...	...	...	...		...	...
Exchange rate													
Linked rate (fixed)					HK$7.80/US$1								
Market rate (HK$/US$1, period average)	7.728	7.736	7.734	7.742	7.745	7.748	7.751	7.761	7.770	7.778	8/	7.758	...
Real effective rate (period average, 1990=100)	129.3	127.5	136.3	149.5	161.6	154.4	155.0	149.2	...	144.8	5/	...	...

Sources: Data provided by the Hong Kong SAR authorities; and staff estimates and projections. Staff projections are consistent with the WEO submission of December 10, 1999.

1/ Estimate for the fiscal year 1998.
2/ Current month and previous two months compared with the same period of previous year.
3/ Includes Land Fund assets from 1997 (US$17.5 billion at end-1997).
4/ September 1999.
5/ October 1999.
6/ November 1999.
7/ December 1999.
8/ January 2000.

Chart 2
Hong Kong SAR
OUTPUT AND PRICES, 1992-99



Sources: Hong Kong Monthly Digest of Statistics, Hong Kong Census and Statistics Department; and staff estimates.

Box 3. The Labor Market in Hong Kong SAR

Hong Kong SAR's labor market has traditionally been highly flexible. Over the past two decades, labor market developments have been characterized by rapid growth of both employment and labor productivity, a low unemployment rate, and a substantial shift in the sectoral composition of employment from manufacturing to services as low skill industries migrated to the Mainland. Labor market legislation focuses on work place safety, preventing unfair dismissal (e.g., in case of sickness or pregnancy) and redundancy pay in case of termination of long-term employment. There is no public unemployment insurance scheme (although means-tested support is provided to the needy under the CSSA), or minimum wage legislation (except for some foreign workers). Unionization is limited, and collective bargaining is not obligatory and rare in practice.

During the Asian crisis, unemployment—which previously averaged 2–3 percent—has jumped sharply to 6¼ percent, the highest level for over two decades. Surprisingly, however, total employment—as measured in the General Household Survey (GHS)—has actually risen, despite the substantial decline in real GDP; however, the labor force has increased even faster, mainly due to a positive net migration balance and a slight increase in the participation rate. A comparison with other data sources—especially the Survey of Employment and Vacancies (SEV), which covers a more limited sample—suggests that registered private enterprises reduced staff by almost 9 percent during the recession, focusing on lower-skilled employees. However, this was offset by rising employment in the public sector, the "informal sector" (non-registered business, including self employment), and Hong Kong SAR residents working in the Mainland (which are all included in the GHS).

Table. Recent Labor Market Developments
(1,000 persons, unless indicated otherwise)

	1996	1997	1998	1999	
				Q1	Q2
Labor force	3,094	3,216	3,359	3,440	3,475
Employment:	3,008	3,145	3,201	3,226	3,263
Registered enterprises (SEV)	2,372	2,292	2,126	2,216	2,225
Other	636	853	1,075	1,010	1,038
Unemployment	86.1	71.3	157.6	213.3	211.4
(Percent, s.a.)	2.8	2.2	4.7	6.2	6.1
Underemployment 1/	51.7	37.9	85.5	104.4	99.8
(Percent)	1.7	1.2	2.5	3.0	2.9

Sources: Census and Statistics Department, *Monthly Digest of Statistics*, October 1999; Quarterly Report on General Household Survey, various issues Annual Digest of Statistics, 1999.

1/ Persons employed less than 35 hours per week, looking for more work.

Nominal payroll per person (which is available only for enterprises covered by the SEV) stabilized in mid–1998, and began to fall in early 1999 (Chart 2); however, with consumer prices falling, real payroll per person has continued to rise. The payroll statistics are likely to understate the degree of pay adjustment taking place, because redundancies have been concentrated among lower-paid workers (resulting in an increase in measured average payroll per person, with no rise in labor cost for remaining employees); this may have biased payroll per person data upward by more than 2 percent during 1998. Also, there have been wage cuts in a substantial percentage of enterprises; the Q1 1999 payroll survey suggests 40 percent of companies reduced payroll per capita on a year-on-year basis; 15 percent held the level constant. Nevertheless, a number of the mission's interlocutors saw some downward nominal wage rigidity in some parts of the economy, which may adversely affect the speed with which unemployment will decline in the recovery.[1]

[1]The existence of some downward wage rigidity despite a highly unregulated labor market is consistent with the predictions of "efficiency wage" theory, based on the positive relationship between labor productivity and the real wage. Under these conditions the firm may not reduce wages in response to negative real shocks, because there may be a more than offsetting reduction in labor productivity.

7. **With adjustment well underway, and activity in the region strengthening, clear signs of recovery emerged in the first half of 1999**. Initially these were seen in financial and asset markets, including through a sharp rise in equity prices driven by foreign capital inflows; a marked decline in the risk premium; and firming up of residential property prices (although office property prices and rentals still remain weak). During the second half of the year, property prices have remained broadly stable, but equity prices continued to rise very rapidly,[6] and by end–1999 the Hang Seng index had exceeded its mid–1997 peak (Chart 3). In the first week of January, prompted by a sell-off in U.S. markets, the Hang Seng index fell by some 9 percent, and is presently around its November 1999 level.

8. **From the second quarter of 1999 onward, the recovery spread to the real economy**. GDP rose very sharply in the second and third quarters (Chart 2), and is projected at 2 percent for 1999 as a whole, well in excess of earlier expectations. The pickup has been primarily driven by a rebound in consumption in response to rising wealth and consumer confidence; rising reexport trade with the Mainland; and latterly higher public investment in housing and infrastructure projects. However, private investment has declined sharply, reflecting corporates' efforts to reduce gearing ratios; continued caution by banks, and high short term real interest rates. Correspondingly, import growth remained very subdued, and net exports of goods and services are projected to have increased by a further 2½ percent of GDP to 3¼ percent of GDP, the highest level since the early 1990s.

9. **Fiscal policy has been substantially eased as activity slowed.** For FY 1998 (April to March), the budget balance deteriorated by 8½ percent of GDP to a deficit of 1¾ percent of GDP; excluding asset-related transactions, whose impact on demand is limited, this implied a fiscal impulse of 3½ percent of GDP (Table 2). For FY1999, the budget envisaged a deficit of 3 percent of GDP set within a clear framework of a return to balance in the medium term. However, given relatively encouraging land revenues, the appreciation in value of the Exchange Fund's equity holdings to date, and the traditional underspending on current expenditures, the staff estimates that the deficit may be only 1½ percent of GDP (since this improvement is due to higher asset-related revenues, there is no *underlying* tightening of the fiscal position). The outturn for the first six months of the current financial year is broadly in line with this projection.

10. **On the monetary side, while M1 and M2 growth have picked up since mid–1998, loans and advances have continued to fall in both nominal and real terms** (Chart 4),[7]

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[6]The rise in equity prices owed much to the strength of the four largest stocks (accounting for over 50 percent of the index) who have substantial business interests outside Hong Kong SAR and have benefited from the global reratings of bank and telecommunications sectors.

[7]Since data on foreign assets and liabilities on a residency basis is not available, Hong Kong SAR does not publish a monetary survey. However, it appears that the difference between the growth of broad money and credit aggregates primarily reflects lower foreign borrowing.

Chart 3

Hong Kong SAR

FINANCIAL INDICATORS, 1995-99

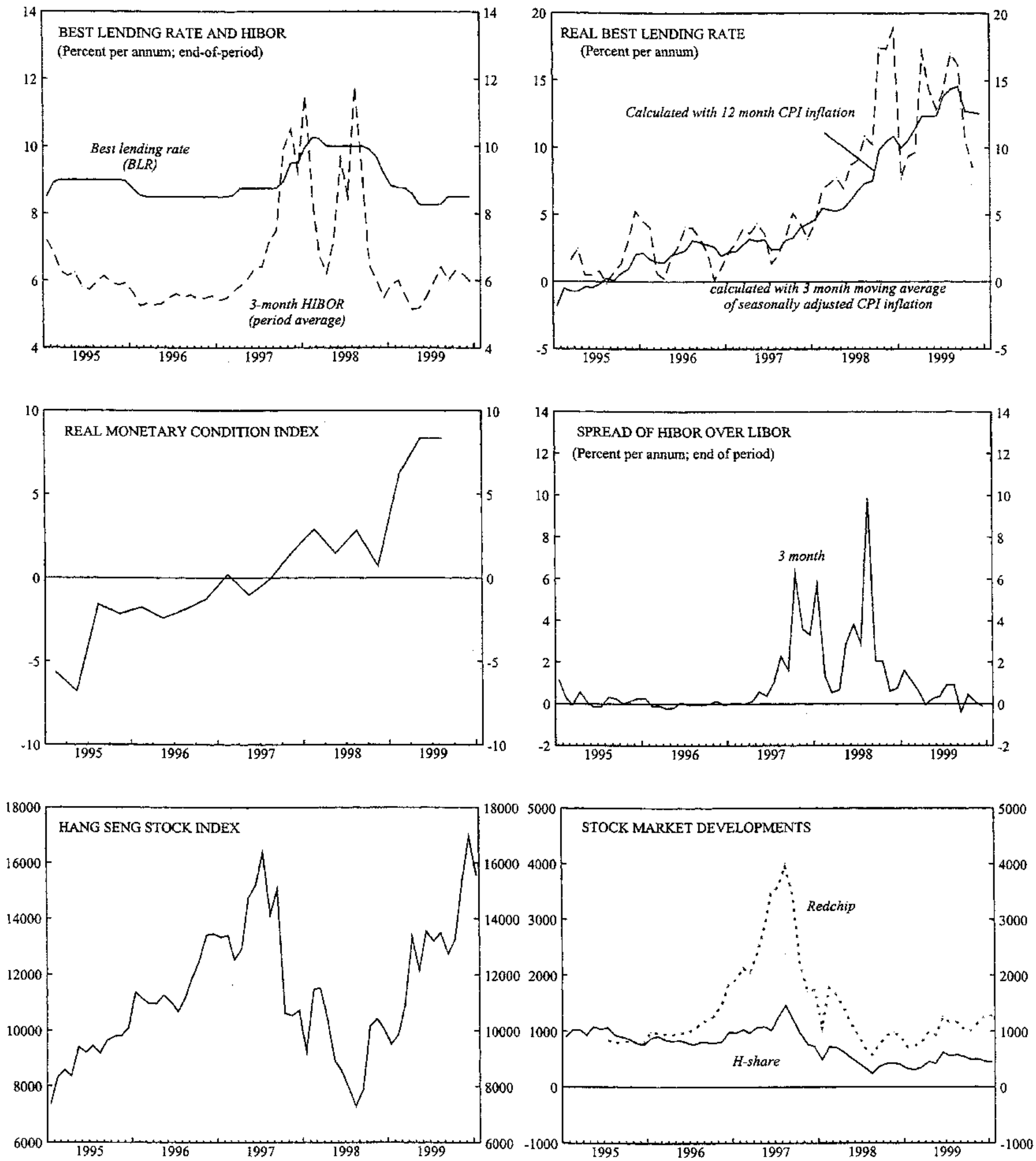


Table 2. Hong Kong SAR: Consolidated Government Account, FY 1996–FY 2002

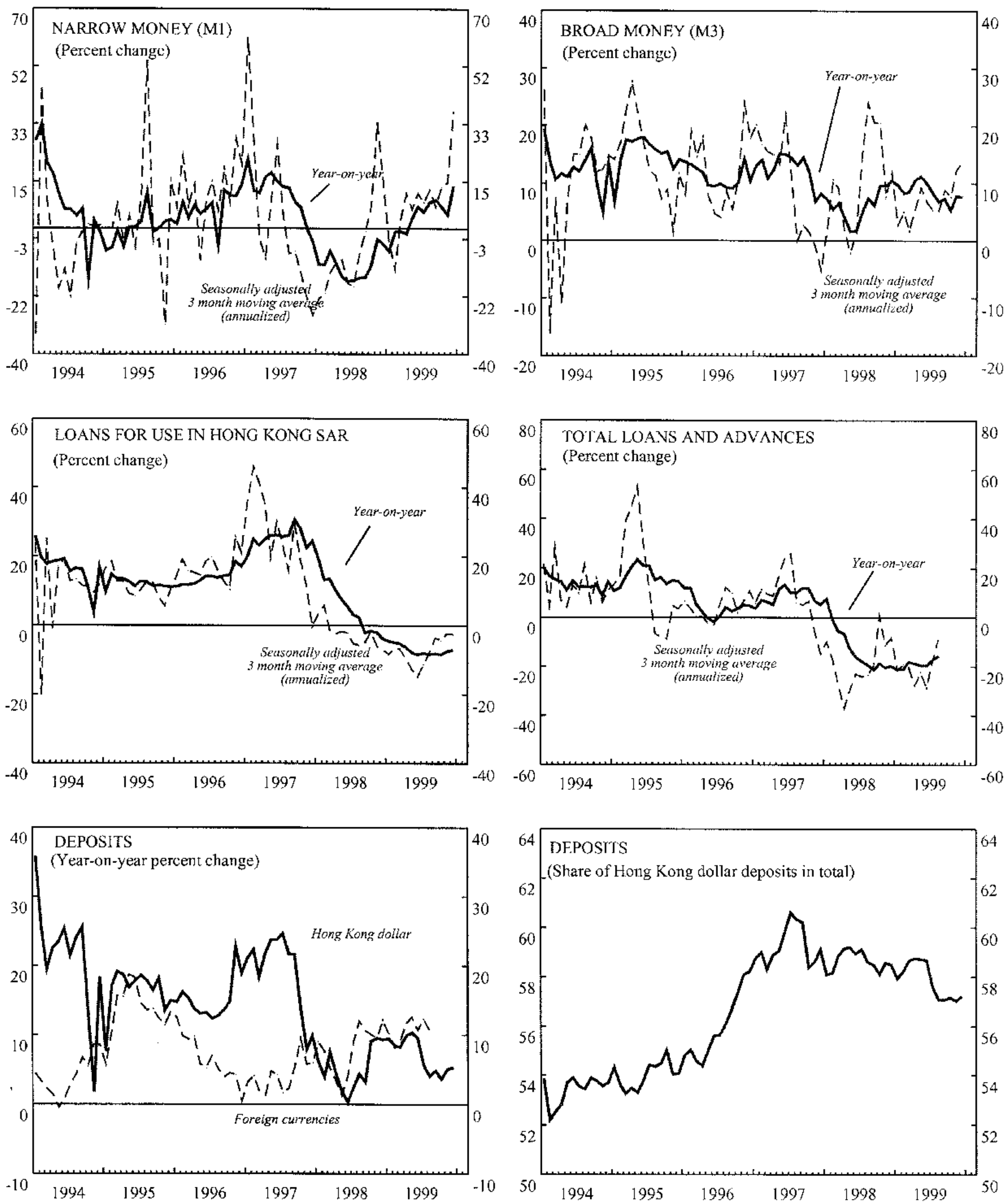
	FY 1996	FY 1997	FY 1998	Projections							
				FY 1999		FY 2000		FY 2001		FY 2002	
	Actual	Actual	Actual	Budget	Staff	MRF	Staff	MRF	Staff	MRF	Staff
	(In percent of GDP)										
Revenue	17.5	21.2	17.0	16.6	17.6	19.3	19.0	20.2	19.6	20.5	19.3
Tax	14.6	16.7	12.4	12.4	12.2	...	12.3	...	12.9	...	13.7
Earnings and profits tax	7.0	6.9	5.9	5.0	4.9	...	4.7	...	5.6	...	6.1
Stamp duties	1.1	2.2	0.8	1.0	0.9	...	1.4	...	1.5	...	1.7
Nontax	2.9	4.5	4.7	4.2	5.5	...	6.7	...	6.7	...	5.6
Land sales	2.2	3.4	1.5	2.5	2.9	...	3.1	...	3.3	...	3.4
Earnings from fiscal reserves 1/	0.7	0.7	2.4	0.9	1.5	...	1.3	...	1.1	...	1.0
Change in net worth of Land Fund	0.0	0.5	0.8	0.9	1.0	...	1.1	...	1.1	...	1.1
Privatization	...	...	...	...	...	1.2	1.2	1.1	1.1	...	0.0
Expenditure	15.3	14.7	18.9	19.5	19.2	19.7	19.2	19.5	18.5	19.5	18.2
Current	11.3	11.3	13.0	14.5	13.6	14.2	13.6	14.1	13.2	14.1	13.0
Capital	4.0	3.4	5.9	5.0	5.5	5.5	5.6	5.5	5.3	5.4	5.3
Equity injections	0.9	0.2	2.4	1.6	1.9	1.7	1.7	1.6	1.6	1.5	1.5
Other capital	3.2	3.2	3.5	3.4	3.6	3.8	4.0	3.8	3.7	3.9	3.7
Overall balance	2.2	6.6	-1.8	-2.9	-1.5	-0.4	-0.2	0.6	1.0	1.0	1.1
Balance excluding:											
Asset transactions 2/	0.8	3.0	-4.1	-5.5	-5.1	...	-5.2	...	-4.0	...	-3.0
Fiscal impulse 2/	-0.7	-0.9	3.6	...	0.0	...	-0.2	...	-0.2	...	-0.2
Fiscal reserves	14.6	34.2	34.3	32.1	33.8	30.9	32.5	29.4	31.3	28.6	30.5
Fiscal reserve guidelines											
Maximum		36.9	40.5	42.8	42.7	42.6	42.6	42.6	42.5	41.9	49.9
Minimum		22.1	24.3	25.7	25.6	25.6	25.6	25.6	25.5	25.2	25.1

Sources: Data provide by the Government Secretariat Finance Bureau; and staff projections.

1/ Includes cash payments made, on a calendar-year basis, by the Exchange Fund for earnings on the government's equity holdings.

2/ Excluding the impact of land premium, earnings from stock holdings, privatization receipts, and equity injections.

Chart 4
Hong Kong SAR
MONEY, CREDIT, AND DEPOSITS, 1994-99



Source: Monthly Statistical Bulletin, Hong Kong Monetary Authority.

reflecting the continued consolidation in Japanese banks, a decline in lending to the Mainland following the bankruptcy of the Guangdong International Trust and Investment Corporation (GITIC), and the decline in domestic private investment noted above. Given the limited lending opportunities, banks have engaged in fierce competition in the mortgage market, which is perceived as being relatively safe, primarily through mortgage refinancing, rather than new loans. While nominal interest rates have fallen, the real prime lending rate (BLR)—based on *ex post* inflation—increased from 7½ percent in September 1998 to 15 percent in August 1999 (Chart 3), falling back to 12½ percent by December. However, with deflation slowing, *ex post* real interest rates have begun to decline, and *ex ante* real interest rates are likely to be lower.[8]

11. **Despite the inevitable pressures arising from declining output and the regional crisis, the financial position of the banking system remains generally strong (Table 3)**. Non-performing loans stabilized at about 10 percent of assets in the third quarter of 1999, while the capital-adequacy ratio of the banking system increased to 20 percent of risk-weighted assets. Given the decline in offshore lending noted above, banks' foreign exchange assets and liabilities have continued to fall, but more slowly than in 1998; net spot and forward positions remain in broad balance (Table 4).[9] Following the bankruptcy of GITIC, credit to Mainland-related entities has declined, but in an orderly fashion; in December 1999, an agreement in principle was reached on the restructuring of Guangdong Enterprises (a major Mainland corporation), setting an important precedent for future restructurings.

12. **In early 1999, the authorities announced that they would reduce their Hong Kong SAR equity holdings, largely acquired during the August 1998 intervention, to 5 percent of the Exchange Fund's portfolio**. To this end, they set up an independent company—Exchange Fund Investment Limited (EFIL)—to manage the government's local equity holdings, and dispose of them in an orderly fashion. In November 1999, the EFIL launched the Tracker Fund, a listed investment vehicle linked to the Hang Seng Index (Box 4). The initial offering of US$4½ billion (20 percent of the portfolio earmarked for disposal) was well received, and the EFIL anticipates more shares to be disposed of through the tap mechanism of the Tracker Fund depending on market demand.

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[8]Unfortunately, no measure of inflationary expectations is available in Hong Kong SAR.

[9]There are no comprehensive data on external debt in Hong Kong SAR and those that are available must be interpreted carefully given Hong Kong SAR's role as an offshore financial center. As of June 1999, the joint BIS-IMF-OECD-World Bank statistics show bank loans of US$246 billion, US$ 34 billion of debt securities issued abroad, and $2 billion of nonbank trade credits (see www.oecd.org/dac/debt/htm/jt_ochonkon.htm).

Table 3. Hong Kong SAR: Banking Sector Indicators 1/

(In percent of interest-bearing assets, unless otherwise noted)

	1996	1997	1998		1998	1999	
			June	Sep.		June	Sep.
Profitability							
Operating profit to shareholders' funds	18.2	17.9	12.5	12.3	11.0	11.6	12.0
Post-tax profit to shareholders' funds	16.2	15.7	10.7	10.5	9.4	9.7	10.4
Return on assets (operating profit)	2.0	1.9	1.0	1.4	1.2	1.2	1.3
Return on assets (post-tax profit)	1.8	1.7	1.2	1.2	1.0	1.0	1.1
Net interest margin	2.6	2.4	2.3	2.3	2.3	2.3	2.3
Cost-income ratio	37.0	37.8	39.6	40.7	39.6	38.1	38.2
Asset quality 2/							
Bad debt charge to total assets	0.2	0.2	0.4	0.4	0.6	0.6	0.5
As percent of total credit exposures 3/							
Provisions 4/	1.7	1.6	2.1	2.1	2.6	2.9	2.6
Classified 5/ exposures							
Gross	2.3	1.7	3.2	4.3	6.1	8.0	6.9
Net of specific provisions	1.4	1.0	1.9	2.9	4.3	5.8	5.0
Net of all provisions	0.7	0.1	1.1	2.1	3.5	5.1	4.4
As percent of total loans							
Provisions 4/	1.9	2.0	2.6	2.7	3.3	3.9	4.1
Classified 5/ loans							
Gross	2.7	2.1	3.7	5.0	7.3	10.1	10.3
Net of specific provisions	1.7	1.2	2.1	3.4	5.1	7.3	7.3
Net of all provisions	0.8	0.1	1.1	2.3	4.0	6.3	6.2
Overdue loans 6/ to total loans	2.4	1.8	3.0	3.8	5.1	7.0	7.5
Capital adequacy							
Equity to assets ratio 2/	10.0	9.9	9.7	9.7	9.1	9.2	9.3
Capital-adequacy ratio 7/	17.8	17.5	18.2	18.6	18.5	19.5	20.1
Liquidity							
Loan to deposit ratio (all currencies)	59.4	68.6	66.4	62.0	58.9	56.5	55.0
HK dollar loan to deposit ratio 8/	71.1	78.6	78.9	74.8	71.6	70.3	70.6

Source: Data provided by the Hong Kong Monetary Authority.

1/ Figures relate to Hong Kong SAR office(s) only, unless otherwise stated.

2/ Figures relate to Hong Kong SAR office(s) and, in the case of local banks, include overseas branches except for the bad debt charge and credit card charge-off ratio.

3/ Credit card exposures include loans and advances, acceptances and bills of exchange held, accrued interest, and commitments and contingent liabilities to or on behalf of nonbanks.

4/ Amount of total provisions outstanding.

5/ Those loans or exposures graded as "substandard," "doubtful," or "loss."

6/ More than three months overdue loans and bills and rescheduled loans.

7/ Consolidated ratios of all locally incorporated institutions.

8/ Includes swap deposits.

Table 4. Hong Kong SAR: Foreign Exchange Position of Authorized Institutions, 1995-99

(In billions of U.S. dollars)

	1995	1996	1997	1998	1999 Sep.
Assets	1,804	1,940	1,975	1,492	1,367
Spot	772	736	740	615	562
Banks	376	327	334	323	319
In Hong Kong SAR	39	36	32	27	23
Outside Hong Kong SAR	337	290	302	296	297
Nonbanks 1/	396	409	406	292	243
In Hong Kong SAR 1/	96	120	141	119	108
Outside Hong Kong SAR	300	289	265	173	135
Forward	1,032	1,204	1,235	877	805
Liabilities	1,799	1,933	1,974	1,490	1,360
Spot	770	738	752	609	549
Banks	568	518	514	363	289
In Hong Kong SAR 1/	39	36	32	27	23
Outside Hong Kong SAR	529	481	481	337	266
Nonbanks 1/	202	220	238	245	260
In Hong Kong SAR 1/	141	157	167	172	182
Outside Hong Kong SAR	61	63	71	73	78
Forward	1,029	1,196	1,223	881	812
Net Spot	2	-2	-11	6	13
Net Forward	4	8	12	-4	-6
Net Position	6	7	1	3	6

Sources: Tables 2.8, 2.9, 3.2 in HKMA Monthly Statistical Bulletin; and BIS.

1/ Calculated residually.

Box 4. The Tracker Fund

In August 1998, in the midst of intense speculative pressures, the Hong Kong SAR authorities intervened in the stock market, purchasing HK$118 billion of domestic equities in a period of about two weeks. The intervention was financed primarily from Exchange Fund resources, and included shares in 33 firms in the Hang Seng Index (HSI), amounting to 2–12 percent of the firms' total shares issued. The intervention, aided by the improving external environment, succeeded in calming markets. Over the 18 months since the intervention, the HSI rebounded sharply, resulting in substantial capital gains for the authorities (as of end–October 1999, the value of their portfolio before the disposal exceeded HK$200 billion).

At the outset, the authorities stressed that the intervention was undertaken in exceptional circumstances, and that they intended to unwind their equity holdings over time without disrupting market conditions. To this end, they set up an independent company—Exchange Fund Investment Limited (EFIL)—to manage and dispose of their local equity holdings; they also disclosed full details of their holdings to the market. In his March 1999 budget speech, the Financial Secretary announced that the government would reduce its domestic equity holdings to 5 percent of the Exchange Fund's total portfolio.

In late 1998, the EFIL asked 20 investment firms to put forward proposals as to how best to dispose of its holdings; on the basis of these proposals, it appointed three financial advisors in early 1999. It was decided to initiate the process through sales of a unit trust tracking the performance of the HSI—the Tracker Fund State Street Bank and Trust Company was appointed as trustee and State Street Global Advisors (HK) Limited as its fund manager.

The Tracker Fund was launched in early November 1999, with an initial discount of 5¼ percent to a reference market price (with additional incentives to encourage long-term retail investors).[1] Despite skepticism by a number of market analysts—based on concerns that demand for an index fund would be weak in Hong Kong SAR— it proved a considerable success, aided by favorable market conditions as well as the attractive discount. The initial public offering (IPO) of HK$10 billion was oversubscribed three times, prompting an increase in the size of the IPO to HK$33⅓ billion. Within this, retail investors were allocated HK$23⅓ billion, and the remainder given to institutional investors.[2]

While there had been some concerns that retail investors might seek to sell their shares immediately to realize the initial discount, this did not in practice prove a major problem. Retail investors sold approximately 10 percent of the issued shares on the first day of trading, but without a noticeable impact on the market. This partly reflected strong demand for the fund by institutional investors, for whom it is a useful arbitrage tool. Looking to the future, with the composition of the HSI likely to change—in some market observers' view, substantially, as the structure of the Hong Kong SAR economy changes—the Tracker Fund's portfolio will need to be periodically rebalanced. While this could lead to additional market volatility, given the Tracker Fund's small size (about 1 percent of market capitalization), the impact would appear manageable.

All in all, the Tracker Fund represents a very good beginning toward divesting the Exchange Fund's Hong Kong SAR equity holdings, achieved with minimum disruption to the market (and, albeit less importantly, at a considerable profit). However, the authorities observed that the scope for further disposals in this fashion was limited (because a further offering of a similar size would exhaust all the stock that could be combined into a portfolio tracking the index). The EFIL would therefore be undertaking further consultations with its financial advisors to determine how best to dispose of these remaining shares.

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[1]Retail investors were given effective discounts ranging from 5¼ to 15 2/5 percent, depending on the length of the period their units are held, with an immediate discount of 5¼ percent. Institutional investors were offered an initial discount of 5¼ percent.

[2]The Tracker Fund also has a tap mechanism, which provides for further issues in response to market demand.

II. Outlook

13. **Since the first quarter of 1999, Hong Kong SAR has been experiencing a relatively rapid recovery**. While not yet broadly based, its strength has surprised many observers, and both outside analysts and the staff have revised their forecasts significantly upward. The pace of recovery appears to be in line with the experience during Hong Kong SAR's previous recession, and since the first quarter of 1999 has been comparable to that of the other economies affected by the Asian crisis (Chart 5).

Comparative Forecasts

	1999			2000		
	IMF	Consensus[1]	Authorities	IMF	Consensus[1]	Authorities
Growth (in percent)	2	1.9	1.8	4.3	4.1	...
Inflation (in percent)	-4	-3.6	-4	0	-0.2	...
Current account (US$ bn.)	5	6.4	...	4	5.2	...

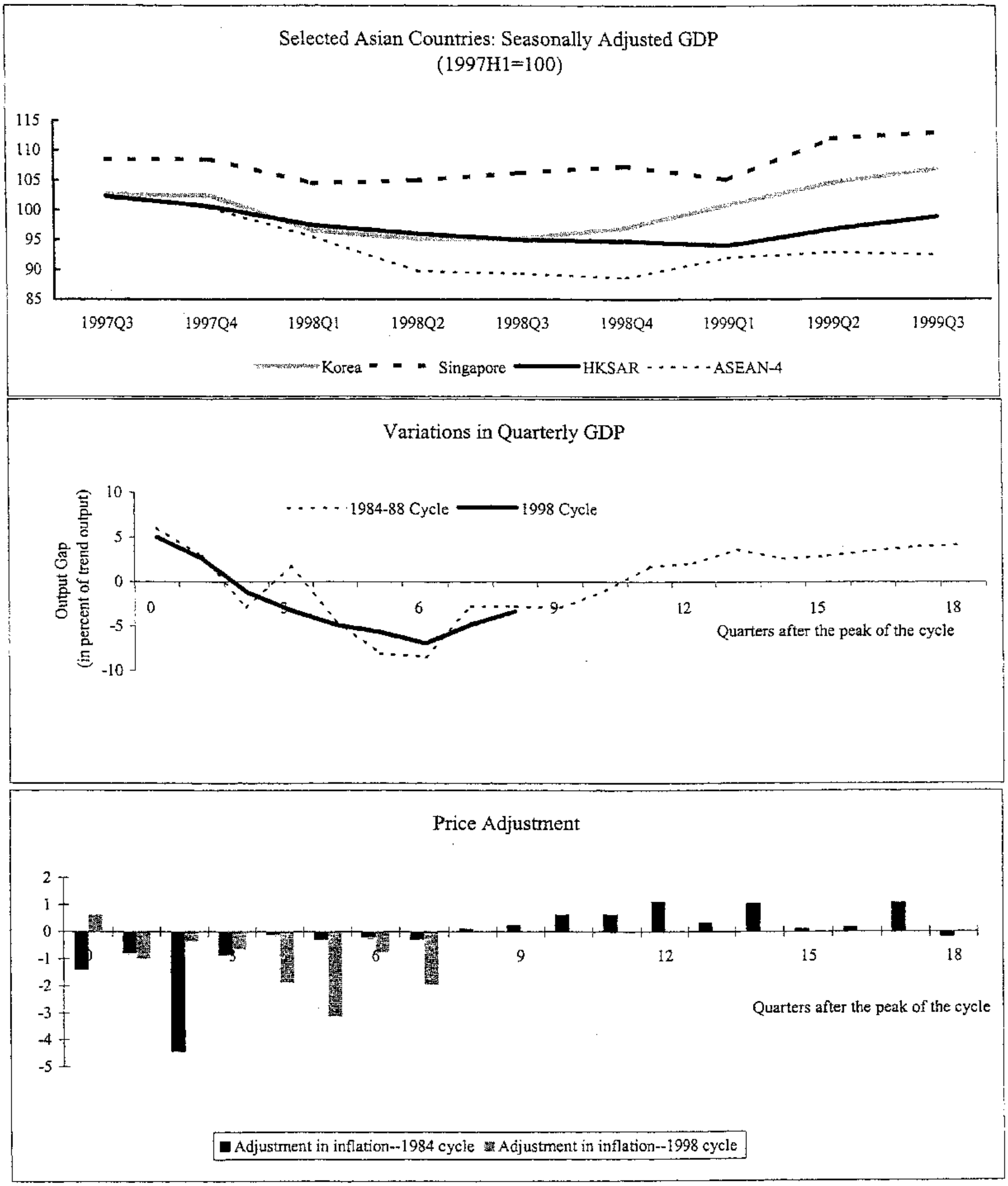
[1]January 2000.

14. **Looking to the future, Hong Kong SAR will benefit from a further improvement in the external environment, including continued robust growth of output and exports in the Mainland**. At the same time, as price adjustment is completed, CPI inflation will increase to the level in Hong Kong SAR's trading partners, resulting in a significant easing of short-term real interest rates. Against this background, the staff projects that GDP growth will pick up to 4¼ percent in 2000 and to 4¾ percent in 2001, aided by a recovery in private investment and inventory restocking, falling back to 4¼ percent thereafter as output returns to potential (Table 5).[10] Unemployment would decline gradually to 2¼ percent by 2005, close to the pre-crisis average, as the labor force continues to rise and real wages adjust with a lag. The external surplus would remain at about 2¾ percent of GDP, boosted by the impact of China's prospective accession to the WTO (Section III.D).

15. **This baseline scenario is, however, subject to a number of risks which could slow down the recovery**. Hong Kong SAR remains heavily dependent on developments abroad, particularly in the United States, Japan and the Mainland (Box 5). In particular, the stock market in Hong Kong SAR, which is still close to its historic high, is vulnerable to a correction in U.S. stock prices. On the domestic front, a pickup in private investment could be delayed if real interest rates remained high, due either to higher U.S. interest rates or—more importantly—if deflation was more prolonged than the staff presently projects.

[10]As a result of the 1998/99 recession, the staff estimates that there is an output gap of about 8 percent of GDP. Over the medium term, this gap is projected to be closed, in roughly equal proportions, by a combination of above trend growth and a drop in the level of potential output due to capital restructuring as a result of the crisis.

Chart 5. Hong Kong SAR: Speed of Recovery



Source: Staff estimates.

Table 5. Hong Kong SAR: Medium-Term Projections, 1997–2005

		Staff Projections							
	1997	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (percent change)	5.0	-5.1	2.0	4.3	4.8	4.3	4.2	4.2	4.3
Real domestic demand	8.2	-8.9	-2.1	5.4	4.7	4.1	4.0	4.0	4.1
Private consumption	6.2	-6.7	1.5	4.3	5.0	4.0	4.0	4.0	4.0
Gross fixed capital formation	12.7	-6.4	-14.0	4.0	5.5	5.0	4.8	4.8	4.8
Foreign balance (contribution)	-3.4	4.3	4.1	-1.0	0.2	0.2	0.2	0.3	0.3
Saving and investment (percent of GDP)									
Gross domestic saving	31.1	30.2	29.5	29.1	29.3	29.5	29.7	29.8	30.0
Gross domestic investment	34.6	29.7	26.7	27.0	27.0	27.2	27.3	27.4	27.6
Saving-investment balance	-3.4	0.5	2.8	2.1	2.3	2.3	2.3	2.4	2.3
Inflation (percent change)									
Consumer prices	5.8	2.8	-4.0	0.0	2.0	2.5	3.5	3.5	3.5
GDP deflator	5.9	0.9	-5.0	-0.9	2.1	2.4	3.3	3.3	3.2
Employment (percent change)	4.6	1.8	1.7	2.6	2.4	2.3	2.3	1.5	1.4
Unemployment rate (percent)	2.2	4.7	6.1	5.0	4.0	3.2	2.3	2.2	2.2
Government budget (percent change)									
Revenue	21.2	17.0	17.6	19.0	19.6	19.4	19.5	19.5	19.5
Expenditure	14.7	18.9	19.2	19.2	18.5	18.3	17.8	17.3	17.2
Consolidated budget balance	6.6	-1.8	-1.5	-0.2	1.0	1.1	1.7	2.2	2.3
Fiscal reserves at March 31 1/	34.5	34.3	33.8	32.5	31.4	30.5	30.0	30.1	30.3
Merchandise trade (percent change)									
Export volume	6.1	-4.3	2.6	8.7	8.7	7.0	7.0	7.0	7.0
Domestic exports	2.2	-7.9	-9.0	8.5	8.0	7.0	7.0	7.0	7.0
Reexports	6.8	-3.7	4.5	8.7	8.7	7.0	7.0	7.0	7.0
Import volume	7.2	-7.2	0.5	9.4	8.4	6.8	6.8	6.8	6.8
Retained import volume	7.9	-5.6	-5.3	8.0	7.0	6.3	6.3	6.3	6.3
Export value	4.2	-7.4	1.9	10.2	9.7	8.1	8.1	8.1	7.0
Import value	5.2	-11.5	0.2	11.1	9.2	7.9	7.9	7.9	6.8
Terms of trade	0.7	1.5	-0.4	-0.2	0.2	0.0	0.0	0.0	0.0
External balance (in billions of US$)									
Merchandise trade balance	-21.1	-10.9	-8.2	-10.6	-10.7	-11.0	-11.4	-11.8	-12.0
In percent of GDP	-12.3	-6.7	-5.1	-6.5	-6.1	-5.9	-5.7	-5.4	-5.1
Goods and nonfactor services balance	-5.3	1.4	5.0	4.0	4.7	5.0	5.4	5.9	6.3
In percent of GDP	-3.1	0.8	3.2	2.4	2.7	2.7	2.7	2.7	2.7

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

1/ Fiscal reserves at end–FY 1997 include HK$197 billion balance in the Land Fund (14.9 percent of GDP).

Box 5. The Impact of Developments in the Mainland of China on Hong Kong SAR

Following the start of reform and "opening up" of the Mainland in the late 1970s, the Hong Kong SAR and the Mainland economies have become increasingly linked, reflected in the following trends:

- **A steady shift in manufacturing facilities from Hong Kong SAR to the Southern part of China**, with foreign direct investment by Hong Kong SAR-based firms totaling 70 percent of GDP by 1997 (Chart B). Correspondingly, the importance of manufacturing activity and domestic merchandise exports in Hong Kong SAR has declined.

- **A boom in entrepôt trade as the Mainland opened up to the outside world**, accelerating further in the first half of the 1990s (in part reflecting the shift in production facilities noted above). However, this trend has reversed since 1995 as Mainland ports have become increasingly competitive. Despite this trend, trade with the Mainland continues to remain important; reexport trade with the Mainland is over ¾ of Hong Kong SAR's total exports, while over 30 percent of its domestic exports are destined for the Mainland.

- **Increasing fundraising by Mainland enterprises in Hong Kong SAR**, peaking in early 1997. This dropped off sharply in 1998 due to the Asian crisis, and to emerging problems in Mainland financial institutions and enterprises.

- **The Mainland has also been a major investor in Hong Kong SAR**, with cumulative flows totaling about $18 billion (10 percent of Hong Kong SAR's GDP) by 1997; there are also substantial investments in the property sector.

The growing integration of Hong Kong SAR with the Mainland has been reflected in a generally high correlation between their economic cycles.[1] As a result, and given the Mainland's highly regulated capital account and Hong Kong SAR's liquid financial markets, Hong Kong SAR has also become a "risk management center" for the Mainland. For example, during the recent crisis market participants would take short positions on the Hong Kong dollar in response to renminbi devaluation fears. This can be seen in the close correlation between movements in renminbi and Hong Kong dollar forwards, as well as in equity market developments.

Many observers have raised questions as to the potential impact of a devaluation of the renminbi on Hong Kong SAR. While the staff continues to believe that there is no need for a devaluation of the renminbi, a hypothetical scenario, based on an illustrative 10 percent devaluation of the renminbi, suggests that the direct impact on the current account would be small. While Hong Kong SAR's trade balance would worsen by 1 percent of GDP, this would be partly offset by higher Mainland reexports, and profit remittances from Hong Kong SAR-owned enterprises on the Mainland. As regards the capital account, while correlation between Mainland and Hong Kong SAR equity prices and forward exchange rates have in fact declined in recent months, market participants are generally of the view that contagion effects are likely to be significantly weaker than they might have been during the crisis.

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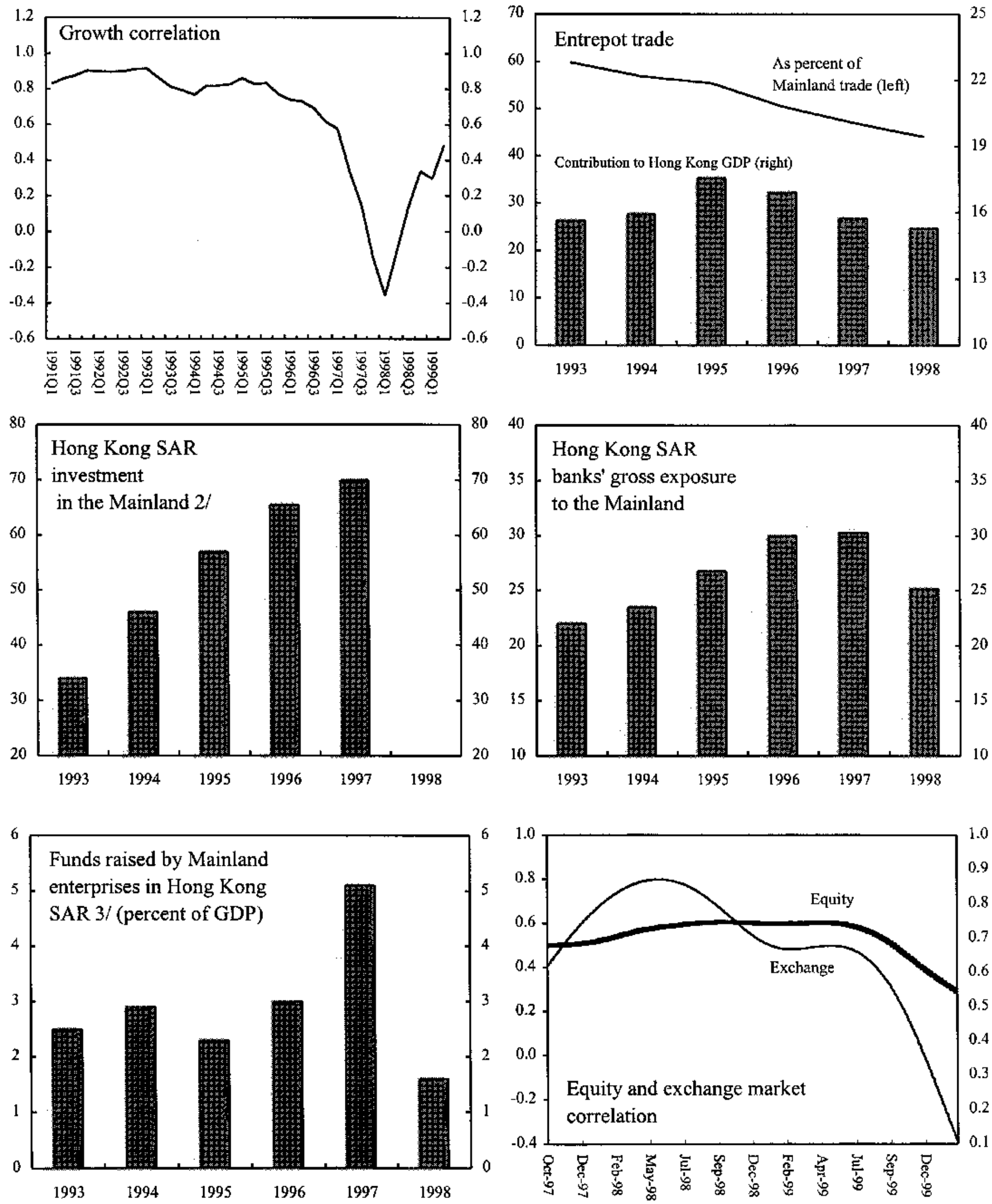
[1]However, the correlation has decreased since 1995, possibly in part reflecting the omission of Hong Kong SAR factor income from investments in the Mainland (quarterly GNP data are not available).

[2]HKMA data suggest, however, that the overall exposure of Hong Kong SAR banks to Mainland and Mainland-related risk is less than 10 percent of portfolios.

Chart B. Linkage between the Mainland of China and Hong Kong SAR



1/ Correlation between cyclical components of Hong Kong SAR GDP and Chinese industrial production.

2/ Includes investment by foreign enterprises based in Hong Kong SAR.

3/ Excludes new issues by redchips, for which no data are available.

III. Report on the Discussions

16. **During the Asian crisis, Hong Kong SAR has undergone an exceptionally painful period of adjustment, and has faced periods of intense pressure on the linked exchange rate system.** Despite these difficulties, the authorities—notwithstanding some controversial measures—have successfully maintained and even strengthened the rules-based system; and, aided by the improving external environment and supportive macroeconomic policies, recovery is now clearly underway. Against this background, discussions on short-run policy issues focused on the linked exchange system and how best to support the nascent recovery. Looking to the medium term, the discussions centered on the authorities' proposals to further strengthen the banking system and the securities markets to enhance Hong Kong SAR's position as an international financial center; and the appropriate role of government in facilitating the ongoing restructuring of the economy in response to technological changes and regional developments, including China's prospective entry to the WTO.

A. Maintaining the Linked Exchange System

17. **The authorities noted that, following the stock market intervention in August 1998, financial market pressures had eased considerably.** While the improvement in the external environment had clearly played a role, they believed that the intervention—combined with the exchange system and securities market reforms that followed—had contributed to the market stabilization and had helped restore confidence, and that the adverse effects on the market had been limited. This said, they reiterated that intervention had been undertaken under exceptional circumstances to prevent systemic failure of the market, and did not constitute a departure from their traditional "hands-off approach." The successful launch of the Tracker Fund clearly demonstrated their commitment to divest their equity holdings in an orderly and transparent manner. The mission's discussions with private market participants confirmed that concerns about the adverse effects of the intervention—which were widespread a year ago—had generally dissipated, although some remained concerned that the reduction in the free float in the equity market as a result of the intervention had added to volatility.

18. **The authorities noted that the technical reforms undertaken in the fall of 1998 to strengthen the linked exchange system, had thus far worked well.** The introduction of the discount window facility had reduced interest rate volatility in the inter-bank market, although it had not been tested under situations of intense market pressures. Moreover, the gradual shift of the convertibility undertaking rate from US$1=HK7.75 to the linked rate of US$1=HK$7.8 was proceeding smoothly.[11] The staff supported the authorities' intention to

[11] The convertibility undertaking rate—US$1=HK$7.779 as of January 14, 2000—is the rate at which the HKMA undertakes to purchase banks' clearing balances in exchange for U.S. dollars (there is no formal undertaking to sell U.S. dollars for Hong Kong dollars at a particular rate). This is being gradually shifted to the linked rate of US$1=HK$7.8, which applies to the issue of currency in circulation. Under the present system, there is no
(continued…)

consider further strengthening the convertibility undertaking and extend transferability between the various components of the monetary base, once the two rates were unified.

19. **In general, the authorities observed that the experience of the last two years had strengthened, not weakened, their commitment to the linked exchange rate**. While fixed exchange rates did involve certain costs, these were of a short term nature, and did not in their view constitute an argument to change a system which had been demonstrated over time to be in the long-run interest of Hong Kong SAR. In this connection, the discipline of the fixed exchange rate forced necessary improvements in efficiency and structural reforms, rather than postponing them. Furthermore, the link provided a transparent anchor for economic decision making, and continued to enjoy strong political and public support.

20. **The mission strongly agreed that the linked exchange rate system, which is the centerpiece of the rules-based approach to policymaking in Hong Kong SAR, remained appropriate**. The smooth functioning of the system depended importantly on the underlying flexibility of the economy. In this connection, the staff's empirical work suggested that price adjustment in Hong Kong SAR was indeed generally rapid; the Phillips curve in Hong Kong SAR is relatively steep, and deviations in the real exchange rate from trend have also corrected rapidly. In addition, while asset markets had experienced price bubbles, it appeared that this tendency was no greater than in the United States, suggesting that the linked exchange system had not contributed unduly to asset price volatility (Box 2).

21. **While prices had generally adjusted quite rapidly in the current recession, the staff observed that the continued growth in real wages was a potential concern**. While the statistics likely understated the degree of adjustment taking place, and in larger establishments much adjustment was taking place through labor shedding, there were some signs of nominal wage rigidity in some sectors, which could slow the rate at which unemployment declined (Box 3). The authorities agreed that real wage growth was high, but—given labor shedding—believed that profitability had not suffered that much. In any event, with the labor market exceptionally free by international standards, this was the result of private market decisions in which the government could not intervene.

22. **Looking ahead, the authorities believed that the improvement in the regional situation, along with the reforms implemented in the past 18 months, had rendered Hong Kong SAR less vulnerable to market pressures**. Nevertheless, they remained very concerned that large global investors could potentially wield excessive influence in medium-sized capital markets such as those in Hong Kong SAR, and strongly believed that further measures to address this issue—which are presently being discussed in the Financial Stability Forum—were needed.

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transferability between currency in circulation and bank clearing balances, so this difference cannot be arbitraged. See Annex III, SM/99/4, 1/8/99, for a detailed discussion.

B. Supporting the Recovery

23. **The authorities observed that the recovery had been quicker than anticipated, and signs of a 'V' shaped rebound were emerging**. For 2000, they were optimistic that recovery would continue, although much would depend on the performance of the external sector and private investment. While the recovery owed much to external developments, the expansionary fiscal stance since FY 1998—set within a clear medium-term framework to restore balance—had helped mitigate the direct impact of the crisis, while remaining consistent with the Basic Law.[12] The mission agreed.

24. **For FY 2000, the budgetary process is still in the very early stages**. The staff's preliminary projections suggest that, on present policies, the deficit could narrow to 0.2 percent of GDP, driven by a cyclical improvement in revenues and proceeds from the privatization of the Mass Rail Transit Corporation (MRTC); and thereafter returning to surplus. The mission observed that such an outturn would be somewhat better than projected in the medium-term framework in the last budget, and should therefore be acceptable from the perspective of the Basic Law; with the economic recovery still not broadly based, a tightening of the underlying fiscal stance would not appear desirable. The authorities broadly agreed, noting that while they had a strong desire to reduce the budget deficit, they wished to avoid an abrupt withdrawal of stimulus.

25. **The authorities noted that, over the longer term, the growth of social expenditures was a concern**; the cost of the health service in particular could increase very substantially in the future due to the aging population. Against this background, they were undertaking consultancy studies of both health and education provision. While these reviews had yet to be finalized, they saw scope for better targeting of public subsidies, higher fees and charges, and greater private sector involvement. More generally, they were seeking to reduce civil service costs (through an employment freeze and an enhanced productivity program), salary reductions for entry level staff (presently above private sector levels), and greater outsourcing.

26. **On the revenue side, some observers have suggested that, given the relatively large dependence on property and asset-related revenues, revenue diversification might be desirable**. In his 1999 budget speech, the Financial Secretary noted that the authorities had undertaken some preliminary work on a consumption tax, but that this was not the right time to pursue it; recently, however, discussion of this issue has intensified, and the authorities have indicated that they are gathering views on possible changes to the tax structure, in advance of the upcoming budget. Given the limits on the ratio of expenditure to

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[12] The Basic Law requires the authorities to "strive to avoid deficits." The definition of the overall fiscal balance relevant for the Basic Law includes land revenue, privatization receipts, and earnings on the government's domestic stock holdings. These have only a limited impact on domestic demand, and are excluded from the staff's measure of the structural balance.

GDP under the Basic Law, the relatively low tax rates in Hong Kong SAR, and Hong Kong SAR's high fiscal reserves (which make revenue volatility manageable), the case for revenue diversification depends primarily on an assessment of the long-run sustainability of the present revenue stream over time. In light of the ongoing structural changes in the economy (Section III.D), this issue deserves further study.

27. **With unemployment at historically high levels, job creation and training programs remain a very high priority.** Between June 1998 and September 1999, about 90,000 job opportunities were created through infrastructure and public works projects; in addition, about 194,000 training and retraining positions were provided in 1998/99. These efforts would be further accelerated in 2000. A Youth Pre-employment Training program was also launched to address youth unemployment (which is presently 29 percent in the 15-19 year old age group). The authorities underscored that the Comprehensive Social Security Scheme (CSSA) continued to provide adequate support to the truly needy.[13]

C. Strengthening the Financial Sector

28. **The authorities observed that the banking sector had weathered the crisis relatively well.** Bank capitalization remained strong; the level of NPLs was now stabilizing; delinquency rates on mortgage lending remained very low; and, while profits had declined by 11 percent in the first half of 1999 due to higher provisioning, they were 19 percent higher than in the second half of 1998. Exposure to Mainland and Mainland-related enterprises remained a concern for some banks, but the situation was manageable and was largely a profitability rather than a solvency issue. Looking to the future, the banking system should benefit from the recovery in the economy, although credit demand had not yet begun to pick up. The competition in the mortgage market had led to a substantial reduction in margins, which could adversely impact bank profitability, and the HKMA had issued a letter to authorized institutions cautioning against excessive price-cutting.

29. **Following the recommendations of a consultancy study on the Hong Kong SAR banking sector, in July 1999, the authorities announced a three-year reform program,** comprising deregulation of remaining interest rate rules by 2001 (Box 6); further liberalization of restrictions on foreign banks; regulatory improvements, including the development of a more formal risk-based supervisory system; increased financial disclosure; and studies on the introduction of a credit register and a deposit insurance scheme. The authorities expected that these reforms would lead to increased competition in the banking sector, which—along with the large costs associated with technological changes such as electronic banking—could result in intensified pressures on a number of smaller banks. Thus, they—and most market participants—believed that consolidation of the domestic banking sector would be needed. This process should be market driven; while questions remained as to how rapidly some of the smaller family-owned banks might move, the authorities noted

[13]See SM/99/4, 1/8/99, Box 1, for a description of the CSSA.

Box 6. Interest Rate Liberalization in Hong Kong SAR

Since January 1981, interest rates on Hong Kong dollar bank deposits below HK$500,000 have been subject to the Interest Rate Rules (IRRs), operated by the Hong Kong Association of Banks (HKAB). In 1994–95, the HKMA started to liberalize the system, beginning with time deposits of one week and above (70 percent of the total). However, following the Mexican crisis, further liberalization was postponed to avoid increasing market volatility in the run up to the transfer of sovereignty in 1997. At present, the IRRs apply to time deposits of six days or less, current account and savings deposits, accounting for 31 percent of Hong Kong dollar deposits.

In July 1999, in response to the recommendations of the Banking Consultancy Report (BCR), and after consultation with the banks, the HKMA has proposed a two stage deregulation of the remaining IRRs. Time deposits of less than seven days (0.1 percent of deposits) would be liberalized in July 2000, and the remaining IRRs on current and savings account (30.5 percent of deposits) would follow in July 2001. The liberalization is likely to have the following main effects:

- **The efficiency of the banking system will improve**, as cross subsidization is eliminated and pricing becomes more transparent and market based.

- **Interest rates on the liberalized deposits will rise, and—as in 1994–95—move increasingly closely with HIBOR** (Table). As a result, they will tend to be more volatile.

- **Banks' net interest margins will be reduced** (the BCR's central estimate is 17 basis points (bp); private estimates are about 25 bp); banks would seek to offset this through higher lending rates, higher fees and charges, and cutting costs. The impact would be greatest on the larger banks, which have the largest relative share of current and savings deposits. The 1994–95 liberalization had little discernible impact on margins, possibly because banks were able to raise the spread between longer term rates and HIBOR (Table).

- **Competition for deposits among banks will increase, and the structure of bank deposits could change (as in 1994–95)**. The BCR argued that this could add to pressures on some smaller banks, since they presently do not have to compete for savings and current account deposits on a price basis. There would also be potential for substantial shifts in market share (although this also did not happen during 1994–95).

While the elimination of the IRRs will have significant benefits, it could lead to additional volatility if it were undertaken in unsettled economic conditions (such as have been seen during the Asian crisis—Table). Consequently, the HKMA has indicated deregulation will be postponed if the underlying economic and financial conditions are unfavorable. This has been defined in terms of a set of specific indicators of economic and financial conditions, two consecutive quarters of positive GDP growth; stabilization of the HIBOR-LIBOR differential at pre-crisis levels; various indicators of banking system health; and regional economic stability.

Table. Mean Interest Differential Between Time Deposits and HIBOR

	Jan. 1991-Sep. 1994		Oct. 1994-95		Nov. 1995-June 1997		July 1997-Nov. 1999	
Maturity								
One week	1.41	(0.55)	1.11	(0.45)	0.90	(0.10)	1.52	(2.14)
One month	0.79	(0.52)	0.43	(0.17)	0.64	(0.04)	0.93	(0.90)
Three months	0.47	(0.47)	0.28	(0.14)	0.63	(0.05)	0.94	(0.82)
Six months	0.45	(0.46)	0.28	(0.13)	0.64	(0.05)	1.11	(0.85)
One year	0.21	(0.41)	0.30	(0.15)	0.68	(0.07)	1.14	(0.76)

Notes: Boxed area indicates interest rate subject to IRRs. Standard deviations in parentheses.

some encouraging signs (such as the formation of a consortium of banks in connection with the marketing of Mandatory Provident Fund related products). The mission observed that the publication of a clear timetable for the reforms provided an important window of opportunity for the institutions affected to assess their options and take appropriate action.

30. **The corporate sector also appears to have weathered the crisis reasonably well thus far**. While most financial indicators deteriorated in 1998, there have been few reports of bankruptcies or closures. The authorities and private sector noted that many corporates were downsizing and restructuring, and aiming to keep cash flow strong and reduce debt liabilities. However, a number of the mission's interlocutors expressed concern that profitability might take some time to recover, especially if real wages and real interest rates remained high.

Hong Kong SAR Corporate Sector Indicators, 1993-99 1/

	1993	1994	1995	1996	1997	1998
	(In percent, unless otherwise noted)					
Pre-tax margin 2/	53	52	57	50	52	26
Gearing ratio 3/	30	34	37	35	36	45
Return on equity	15	15	15	15	13	9
Interest cover 4/	14	23	17	18	38	19

Source: Stock Exchange of Hong Kong and Bloomberg Professional.

1/ The data relate to the 29 nonfinancial HSI companies; figures are averages weighted by companies' share in total market capitalization.

2/ Defined as pre-tax income over total revenue.

3/ Defined as total debt over company equity.

4/ Defined as earnings before interest and taxes over interest expenses (ratio). The ratio indicates the number of times earnings exceed interest payments.

31. **In the March 1999 budget speech, the Financial Secretary announced a comprehensive market reform package for the securities and futures markets**. This comprised a merger of the Stock Exchange of Hong Kong and the Hong Kong Futures Exchange and their clearing houses, with the merged company—the Hong Kong Exchange and Clearing Limited—expected to begin operations in 2000; strengthening the financial infrastructure, including a scripless securities market and straight-through processing;[14] the

[14]So that all transactions—from initial trade to change of ownership record—are conducted electronically in one continuous chain without the need to manually transfer information.

introduction of a composite Securities and Futures Bill to modernize the structure of the securities markets and strengthen the supervisory capacity of the Securities and Futures Commission (presently with the Legislative Council); and the start of a second stock market—the Growth Enterprise Market (GEM)—for emerging growth companies (which began in November 1999). These changes—which have generally been well received by market participants—are expected to increase competitiveness and efficiency in the securities markets, and enhance Hong Kong SAR's position as a world class financial center.

D. "Reinventing" Hong Kong SAR

32. **Over the coming years, both the authorities and private sector representatives believed that the Hong Kong SAR economy was likely to undergo major structural changes** (referred to by some as "reinventing" Hong Kong SAR). In particular, the role of the property sector in the economy was expected to shrink; technological progress was forcing major changes in the services sector, especially in banking and telecommunications; and there would be important changes in the economic relationship with the Mainland. In particular, Hong Kong SAR's role as an entrêpot was likely to decline with the growth of Mainland ports, and some believed that over a longer horizon Shanghai could emerge as a competing financial center. At the same time, however, Hong Kong SAR would be well placed to assist with the financial and economic reforms underway in the Mainland, as well as participating in the rapid growth in its services sector.

33. **China's prospective entry to the WTO will tend to accelerate these changes**. On one hand, Hong Kong SAR's position as the main window to the Mainland will—over time—diminish. However, it will also open up major opportunities in financial and managerial services, retailing and wholesaling, and tourism, where Hong Kong SAR was well placed to compete (Box 7). While the authorities were still evaluating the potential impact, they generally viewed China's accession as very positive for Hong Kong SAR.

34. **Hong Kong SAR has in the past adapted to such changes quickly and flexibly, aided by its generally "laissez-faire" approach**. Over the past year, however, some observers—citing government involvement in the Cyberport and Disneyland projects[15]—have questioned whether elements of an industrial policy were being introduced. The authorities stated that the government's involvement in these two projects reflected specific circumstances[16] and not a shift in their underlying philosophy, and that the traditional policy

[15]The Cyberport is designed to provide advanced communication infrastructure; it also has a substantial residential property development component. The Disneyland project is an amusement park to be constructed by the Walt Disney Company in collaboration with the government.

[16]The authorities said that the Cyberport would help develop the information infrastructure; the Disneyland project, despite a modest internal rate of return, would give rise to substantial spin-off benefits for Hong Kong SAR.

Box 7. The Impact of China's Accession to WTO on Hong Kong SAR[1]

On November 15, 1999 after 13 years of negotiations, China and the United States reached a bilateral agreement on the terms of China's entry into the WTO. Provided negotiations with other WTO members, including the EU, can be completed promptly, China could join the WTO in the second half of 2000. To date, only limited details of the agreement have been announced; and the final terms of accession will depend also on the outcome of the remaining negotiations. However, the key elements include:[2]

- **Substantial trade liberalization,** including sharp tariff reductions, non-tariff restrictions on non-agricultural products, and provision of full trading and distribution rights to foreign firms.

- **A major liberalization of the services sector**, including telecommunications, insurance, securities business, and banking (where full national treatment will be provided by 2005).

- **Elimination of import quotas on the Mainland's textile exports by 2005**, when the Multi Fiber Agreement (MFA) expires, but subject to anti-surge provisions through 2008.

Given the close linkages with the Mainland (Box 5), WTO accession will have important implications for Hong Kong SAR. In broad terms, these are likely to include:

- **Domestic exports and entrêpot trade will increase**. However, despite the Mainland's very large share in each, the impact may initially be limited since (i) Hong Kong SAR does not produce goods in the most liberalized sectors, such as agricultural products and automobiles; (ii) much of both domestic and entrêpot trade is related to the Mainland's processing industry which already operates under a very free trade regime so that the impact of WTO will be limited; and (iii) Hong Kong SAR's value added on reexports *to* the Mainland is much less than on reexports *from* the Mainland, which will increase more slowly. From 2005, as the Mainland's textile exports increase with the elimination of MFA, entrêpot trade will increase more rapidly.

- **WTO accession will accelerate bank and enterprise restructuring on the Mainland, which will result in increased demand for financial, accounting, and legal services.** This will lead to an increase in Hong Kong SAR's services exports, and indirectly boost both the financial and property sectors.

- **Hong Kong SAR's foreign direct investment into the Mainland will rise significantly in response to the services sector liberalization**, especially in the financial, telecommunications, distribution and freight forwarding sectors. Latterly, elements of Hong Kong SAR's textile industry (which accounts for half of domestic exports) could shift to the Mainland in response to the elimination of the MFA.

- **Over the longer term, WTO accession will increase the integration of the Mainland and Hong Kong SAR, and strengthen competition.** It will accelerate structural adjustment in Hong Kong SAR, as low value-added service and manufacturing production moves to the Mainland, and reduce Hong Kong SAR's role as the main window to the Mainland, increasing competitive pressures with other financial centers.

At the present stage, it is very difficult to make any quantitative predictions of the impact of WTO accession, either for the Mainland or Hong Kong SAR. However, based on the above, the staff would expect that there would be positive effects on GDP growth and the current account balance in Hong Kong SAR in the short run, with the latter offset by increased foreign direct investment outflows. Over the medium term, if the textile sector moves to the Mainland, the trade balance could deteriorate, but provided structural adjustment takes place rapidly, this would be offset by exports from higher value-added sectors, by increasing elements of investment income inflows from Hong Kong SAR's investments (in many ways similar to the experience in the early 1990s).

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[1]See "A Note on the Impact of China's Accession to the WTO on Hong Kong SAR," Selected Issues Paper (forthcoming) for further details.

[2]Further details are available at http://www.uschina.org/public/991115a.html.

of "positive nonintervention" would continue. In this connection, they intended to focus on strengthening infrastructure, environment, and education (as stressed in the Chief Executive's 1999 Policy Address), which they saw as central to supporting Hong Kong SAR's transformation into a knowledge-based economy. The mission strongly agreed with this approach.

35. **In recent years, a number of observers have raised questions about the extent of domestic competition in Hong Kong SAR, suggesting that certain sectors were dominated by relatively few participants**. These concerns have been heightened by the absence of a formal Competition Law (which has been strongly espoused by the Hong Kong Consumer Council (HKCC), the statutory body presently charged with investigating alleged anti-competitive behavior). The staff's empirical work confirmed that Hong Kong SAR's transformation from a manufacturing-based economy to a service-oriented economy has resulted in some loss in domestic competitiveness—because the services sector is less competitive—although it remains as strong as the average in OECD countries (Box 8).

36. **The authorities stated that although some domestic sectors were dominated by a small number of players—an inevitable consequence of the relatively small size of the Hong Kong SAR economy—the economy was very open and competition in Hong Kong SAR's domestic markets was relatively strong**. Furthermore, they had responded to the HKCC's recommendations on various sectors (such as interest rate deregulation and the opening up of the telecommunication market) positively and promptly, and in addition made their own efforts to strengthen competition in several sectors. For these reasons, they believed that the present sectoral approach remained appropriate; a formal competition law, in their view, would simply result in increased bureaucracy and litigation. While the mission appreciated these points, it observed that the absence of any substantive *ex ante* penalties for anti-competitive behavior—except in those sectors that were subject to specific regulations—could lead to incentive problems, underscoring the need for continued close monitoring.

E. Other Issues

37. **A pilot transparency report—the "Report on Observance of Standards and Codes"—on Hong Kong SAR was published in September 1999**. The report commended the Hong Kong SAR authorities for achieving a high degree of transparency in several key spheres of economic policymaking and regulation, but pointed out a few areas where transparency practices could be further improved.[17] The report is hyperlinked from the HKMA web site, and has received generally positive press coverage; however, the mission found that awareness among market participants was very limited. The authorities indicated that they intended to participate in the pilot project for the voluntary release of staff reports.

[17] These included more frequent updates of budgetary projections, and maintenance of a high degree of transparency and accountability in the new securities market regulations and supervision.

Box 8. How Competitive are Markets Within Hong Kong SAR?

Hong Kong SAR's highly competitive economy has long been credited with facilitating rapid price adjustment to shocks under the linked exchange rate, and contributing to high long-run output and productivity growth. Recently, however, a number of observers have questioned whether the economy is as competitive as it appears. Since oligopolistic behavior—according to some theories—can result in countercyclical behavior of price markups,[1] this could potentially hinder adjustment under the link. Against this background, the staff has undertaken an econometric study[2] to measure the degree of competitiveness using estimated markup of price over cost—a widely accepted measure of the degree of competition in product markets—at the industry level.[3]

The main findings of the study are the following:

- **Hong Kong SAR's product markets are about as competitive as those in the average OECD country.** For the economy as a whole, markup over marginal cost in Hong Kong SAR was 37½ percent, while that for the OECD was 39 percent, during the period 1986–97.

- **Within Hong Kong SAR, on average, the manufacturing sector is more competitive than the services sector.** The marginal cost markup in the manufacturing sector is 30 percent, as opposed to 40 percent in the services sector.

- **Given the substantial shift toward service-based industries from manufacturing, this implies that competition in Hong Kong SAR may have become less intense over the sample period.** The change in the industry mix is estimated to have raised the average markup by 7¾ percent over this period.

- **Markups are strongly procyclical in services, while they are slightly countercyclical in manufacturing.** Thus the shift noted above has likely raised the overall procyclicality of average markups.

These findings lead to two broad conclusions:

- First, the underlying competitiveness of the Hong Kong SAR economy appears about average by OECD standards. This said, there is no room for complacency, particularly since—given the linked exchange rate—Hong Kong SAR may well aspire to be more competitive than the average.

- Second, although the shift in the industry mix toward service industries may have dulled the competitive edge of the economy somewhat, it has raised short-run price flexibility by increasing the overall procyclicality of markups. Thus, there is no evidence that the structure of the economy—or changes in it—has adversely affected adjustment under the link.

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[1]For example, if industry price is set by an oligopoly, then during periods of high demand the gains from undercutting the industry by individual firms increase; thus, to prevent a breakdown of the cartel, the oligopoly reverts to a lower price (and lower markup). For a survey of similar models in the context of countercyclical markups in U.S. industries, see Julio Rotemberg and Michael Woodford, "The Cyclical Behavior of Prices and Costs," *NBER Working Paper 6909*, January 1999.

[2]See Eric Zitzewitz," Competition, Cyclical Fluctuations, and Long-run Growth in Hong Kong SAR," in the Selected Issues Paper, February 2000.

[3]The estimates are based on a sample of 85 industries (26 manufacturing, 59 service—including financial and property-related) for the period 1986–97, for which data was available.

38. **Hong Kong SAR publishes a wide range of high quality economic and financial data which are disseminated in a timely fashion.** In April 1999, the authorities released the first ever balance of payments accounts, covering transactions in 1997. Publication of detailed annual (for 1998) and quarterly (for first quarter 1999) balance of payments accounts is expected by June 2000, consistent with the authorities' SDDS obligations. The mission welcomed this, but noted the need for more detailed and timely fiscal data during the year, and publication of domestic and foreign assets and liabilities of the banking system on a residency basis.

IV. Staff Appraisal

39. **During the Asian crisis, despite its very strong fundamentals, Hong Kong SAR underwent a painful period of recession and adjustment, including periods of intense pressure on the Hong Kong dollar.** In the face of these difficulties, the authorities—aided by some unorthodox measures—successfully defended and even strengthened the linked exchange rate, a major achievement. An appropriately supportive fiscal policy, combined with job creation and retraining programs, helped mitigate the impact on the domestic economy (although, given Hong Kong SAR's small size and openness, this was inevitably substantial).

40. **The necessary adjustment in prices under the linked exchange rate system is well under way.** Property prices and rentals have fallen sharply, consumer prices are deflating rapidly, and the real effective exchange rate has returned to its pre-crisis level. While adjustment in labor costs has been slower, this again underscores the overall flexibility and resilience of the economy. Aided by the pickup in the regional economy, Hong Kong SAR is now experiencing a strong recovery. While this recovery is not yet broadly based, and much will depend on external developments as well as the speed with which the remaining domestic price adjustment is completed and corporate profitability improves, the outlook for 2000 and beyond is generally encouraging.

41. **The staff continues to strongly support the linked exchange rate, which is the centerpiece of the rules-based approach to policymaking and is supported by Hong Kong SAR's strong fundamentals, flexible economy, and resilient banks.** The seven technical measures introduced in the fall of 1998, while not yet substantively tested, have worked well to date and the gradual shift of the convertibility undertaking rate toward the linked rate of $1=HK$7.8 is proceeding smoothly. Once the two rates have been unified, there is scope to further strengthen convertibility and transferability within the system.

42. **For FY 2000, fiscal policy will need to continue to balance the need to provide support for the nascent recovery and the provisions of the Basic Law.** Given the cyclical improvement in revenues as activity and asset markets strengthen, the FY 2000 target (of a small deficit) set out in last year's medium-term forecast should be achievable, provided that the MRTC privatization goes ahead as planned. In the view of the staff, this would be an acceptable result from the perspective of the Basic Law; with the economic recovery not yet

broadly based, a tightening of the underlying fiscal policy stance would not appear desirable at this point. Over the medium term, rising social expenditures are likely to require increases in fees and charges; in light of the structural changes in the economy, which could alter the existing tax base, there is also a case to review the revenue structure to determine if further diversification is required.

43. **While unemployment has stabilized, it remains high and—with ongoing corporate restructuring and lagging real wage adjustment—may decline only gradually during 2000**. As the authorities note, developments here depend primarily on private sector decisions; the authorities, for their part, have appropriately sought to further strengthen employment and training programs, especially for youth unemployed. The CSSA continues to provide an adequate safety net for the neediest, while limiting adverse effects on work incentives.

44. **Over the past year, the banking system has demonstrated its strength and resilience to external shocks**. This owes much to the high quality of the regulatory and supervisory framework, which is widely acknowledged to be among the best in the region. The upcoming reforms of the banking system will improve efficiency and competitiveness, but—along with technological changes—may increase pressures on a number of smaller banks. The publication of a clear reform timetable provides an important window of opportunity for the necessary consolidation in the banking sector to take place.

45. **Following the intervention in the stock market in August 1998, the authorities successfully begun to divest their equity holdings; the staff welcomes the authorities' intention to continue this process in an orderly and transparent fashion**. The staff also welcomes the government's initiatives to strengthen the securities markets and legislation, which will be central to help ensure that Hong Kong SAR remains a world class financial center in an increasingly competitive global environment.

46. **Over the coming years, the Hong Kong SAR economy will undergo major structural changes, due both to technological changes in key service industries and the evolving relationship with the Mainland, including as a result of WTO entry**. Hong Kong SAR has in the past adapted to such changes swiftly and flexibly, aided by its well-deserved reputation as one of the most transparent, well-governed, and least interventionist places in the world to do business. The staff believes that the policy of positive nonintervention, which has been the watchword of economic development in Hong Kong SAR for many years, remains appropriate, supported by government efforts to strengthen infrastructure, education and the environment. Domestic competition issues continue to merit close attention, especially since there are no substantive penalties if firms engage in anti-competitive behavior.

47. **Hong Kong SAR publishes a wide range of high quality economic and financial data, which are generally adequate for surveillance, and good progress is being made in addressing the main gaps in coverage**. The staff welcomes the progress that has been made toward meeting Hong Kong SAR's obligations under the Special Data Dissemination

Standard, especially the publication of the first ever set of balance of payments accounts. The staff encourages the authorities to publish more detailed and timely fiscal data, and domestic and foreign assets and liabilities of the banking system on a residency basis, as a precursor toward a monetary survey.

48. **The staff welcomes the authorities' intention to participate in the pilot project for the voluntary release of Article IV consultation staff reports.**

49. The staff recommends that the next Article IV consultation discussions be held in accordance with the standard 12–month cycle.

Hong Kong SAR—Fund Relations

I. Membership Status

As a Special Administrative Region of the People's Republic of China, Hong Kong SAR is not a member of the Fund. However, annual consultation discussions have been held with the Hong Kong authorities since October 1990, and the staff also holds discussions with the authorities in connection with the staff's International Capital Markets reports. STA has provided Hong Kong SAR with technical assistance in the area of balance of payments statistics and Hong Kong SAR officials have attended INS courses on balance of payments and monetary statistics, and financial programming. The Hong Kong Monetary Authority is a participant in the New Arrangements to Borrow, in an amount of SDR 340 million. At present, there is no outstanding borrowing by the Fund under the New Arrangements to Borrow.

II. Exchange Rate Arrangement

The Hong Kong dollar has been linked to the U.S. dollar under a currency board arrangement since October 1983 at a rate of HK$7.8/US$1. The market rate fluctuates around the linked rate, usually within a margin of less than 1 percent. There are no restrictions on current or capital transactions in Hong Kong SAR, and the Hong Kong dollar is freely convertible.

Hong Kong SAR—Statistical Issues

Hong Kong SAR provides statistics to the Fund on a timely basis for surveillance and publication in *International Financial Statistics,* and has subscribed to the SDDS.

Over the past year, Hong Kong SAR has made progress toward meeting the requirements of the SDDS in the area of balance of payments data. In April 1999, the authorities published the first ever balance of payments statistics covering transactions in 1997. Although BPM5 standards were adopted, the required details of the financial account were not provided. In order to overcome this drawback, the authorities launched a more comprehensive survey on external financial flows in May. The first set of complete annual balance of payments accounts for 1998, as well as quarterly balance of payments data for the first quarter of 1999, which meet the SDDS coverage requirements for the prescribed components, will be disseminated by end–June 2000.

However, there are still areas where data deficiencies remain, including:

- Domestic and foreign assets and liabilities of the banking system are not classified by residency principle. Fully disaggregated data are not available on the banking system's domestic assets and liabilities in accordance with the Fund's methodology.
- Monthly fiscal data are highly aggregated, and available with a one-month lag.
- Production-based GDP estimates at constant prices are not compiled.
- GFS data are not reported to STA.

These data deficiencies hamper analysis of the external financial position of the banking system and competitiveness of services industries. The mission will reiterate the need to address these drawbacks early.

Hong Kong SAR

Survey of Reporting of Main Statistical Indicators

As of end—November 1999

	Exchange rates	International reserves	Reserve/ base money	Central Bank Balance Sheet	Broad money	Interest rates	Consumer price index	Exports/ Imports	Current account balance 1/	Overall government balance 2/	GDP/GNP
Date of latest observation	Oct. 7	Sep 1999	Aug. 1999	Sep. 1999	Sep. 1999	Oct. 6	Aug. 1999	Aug. 1999	Aug. 1999	FY 1998/99	Q2 1998
Date received	Oct. 7	Oct. 7	Sep. 29	Nov. 1999	Nov. 1999	Oct. 6	Sep. 23	Sep. 28	Sep. 28	March 1999	Aug. 1999
Frequency of data	D	M	M	M	M	D	M	M	M	A, Q	Q
Frequency of reporting	D	M	M	M	M	D	M	M	M	A, Q	Q
Frequency of publication	D	M	M	M	M	D	M	M	M	A, Q	Q
Source of data	C, N	N	N	N	N	C, N	N	N	N	N	N
Mode of reporting	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M
Confidentiality	C	C	C	C	C	C	C	C	C	C	C

1/ Merchandise trade balance. Balance of goods and nonfactor services reported quarterly, with the same lag as GDP data. Full current account data are not compiled.

2/ Fiscal year beginning April 1.

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IMF Concludes Article IV Consultation with People's Republic of China in Respect of the Hong Kong Special Administrative Region

On February 18, 2000, the Executive Board concluded the Article IV consultation with People's Republic of China in Respect of the Hong Kong Special Administrative Region.[1]

Background

The Asian crisis hit the Hong Kong SAR economy hard in 1998, despite its generally strong fundamentals. External demand fell sharply, and the depreciation of the yen and the crisis country currencies led to a sharp real appreciation in the Hong Kong dollar. Driven by rising risk premia, real interest rates rose markedly, and asset prices dropped by 40-50 percent. As confidence ebbed, market pressures intensified, culminating in a major speculative attack in August 1998. Fearing erosion of domestic confidence in the economy, and concerned that markets were being manipulated, the authorities intervened in the stock markets. Aided by an improvement in the external environment, the intervention succeeded in calming markets.

In response to the crisis, the authorities eased fiscal policy—within the framework of a medium plan to restore budget balance, and significantly strengthened job creation and retraining efforts. Adjustment under the linked exchange rate system has proceeded generally rapidly, reflected in the sharp falls in asset prices and—from late 1998—the emergence of consumer price deflation. As a result, and aided by the appreciation of the yen and crisis-country currencies, by late 1999 the real effective exchange rate of the Hong Kong dollar had returned to its pre-crisis level. In the labor market, adjustment in larger enterprises has taken place primarily through employment shedding; while nominal payroll per employee has slowed sharply, it has continued to rise in real terms.

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[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. In this PIN, the main features of the Board's discussion are described.

GDP continued to fall (in seasonally adjusted terms) through the end of 1998. Clear signs of recovery emerged in the first half of 1999, helped by the fast pace of economic growth in the Mainland of China and the sharp rebound in the earlier crisis-hit economies in the region. Financial and asset markets rose as external confidence returned, and from the second quarter, real GDP picked up sharply, driven by a rebound in consumption in response to rising wealth and consumer confidence; rising reexport trade with the Mainland; and latterly higher public investment in housing and infrastructure projects. As yet, however, private investment—and domestic credit demand—remains weak, reflecting corporates' efforts to reduce gearing ratios; continued caution by banks, and still high but declining short-term real interest rates.

Despite the inevitable pressures arising from declining output and the regional crisis, the financial position of the banking system remains generally strong. Non performing loans stabilized at about 10 percent of assets in the third quarter of 1999, while the capital adequacy ratio of the banking system increased to 20 percent of risk weighted capital. In late November, the authorities successfully launched the Tracker Fund, a listed investment vehicle linked to the Hang Seng Index, as a first step towards substantially reducing the equities they had bought in the August 1998 intervention.

Executive Board Assessment

Executive Directors observed that, despite its very strong fundamentals, Hong Kong SAR had undergone a painful period of recession and adjustment during the Asian crisis, including periods of intense pressure on the Hong Kong dollar. In the face of these difficulties, the authorities successfully defended and even strengthened the linked exchange rate. A supportive and timely fiscal policy, combined with job creation and retraining programs helped mitigate the impact on the domestic economy—although, given Hong Kong SAR's small size and openness, this was inevitably substantial. Directors attributed this successful turnaround of the economy to the authorities' skillful economic management, the credibility of policy-making in Hong Kong SAR, and the economy's flexibility and resilience.

Directors observed that the adjustment in prices necessitated under the linked exchange rate system was generally well under way, and—following a significant appreciation in the early part of the Asian crisis—the real effective exchange rate had returned to its pre-crisis level. However, some Directors expressed some concern that adjustment in labor costs was lagging, especially in the face of rising unemployment. Aided by the pickup in the regional economy, Hong Kong SAR was now experiencing a solid economic recovery. While the recovery was not yet broadly based, and much would depend on external developments, as well as the speed with which the remaining domestic price adjustment was completed and corporate profitability improved, Directors believed that the outlook for 2000 and beyond was generally positive.

Directors continued to strongly support the linked exchange rate system, which was underpinned by Hong Kong SAR's strong fundamentals, flexible economy, and resilient banking system, and was the lynchpin of the rules-based approach to economic policymaking. In this respect, they noted that the seven technical measures introduced in the fall of 1998 had worked well to date and the gradual shift of the convertibility undertaking rate to the linked rate was proceeding smoothly.

Given that the recovery was not yet broadly based, Directors considered that for the fiscal year 2000 a structural tightening of the fiscal position should be avoided. Allowing for the cyclical improvement in revenues, and the privatization of the Mass Transit Railway Corporation, the target of a small deficit set out in last year's medium-term forecast should nonetheless be achievable. Over the medium term, rising social expenditures would likely require increases in fees and charges; in light of the structural changes in the economy, which could alter the existing tax base, there was also a case to review the revenue structure to determine if further revenue diversification was required.

Directors observed that, while unemployment had stabilized, it remained high and might decline only gradually during 2000. They therefore strongly supported the authorities' efforts to further strengthen employment and training programs, especially for the youth unemployed.

Directors observed that the banking system had demonstrated its strength and resilience to external shocks over the past year, aided by the high quality of the regulatory and supervisory framework. Directors welcomed the upcoming reforms of the banking system, noting that these would improve efficiency and competitiveness. However, along with the anticipated technological changes, these reforms could exert increased pressures on a number of smaller banks. In this respect, they noted that the recent publication of a clear reform timetable by the authorities provided an important window of opportunity for the necessary consolidation in the banking sector to take place.

Directors noted that the intervention in the stock market in August 1998, aided by the improvement in the external situation, had stabilized financial markets, and that the adverse effects from this action had been less than anticipated. In this connection, they welcomed the successful launch of the Tracker Fund, which was a very good start toward divesting the equity holdings acquired during the intervention. They encouraged the authorities to continue this process in an orderly and transparent fashion. They also welcomed the authorities' initiatives to strengthen securities markets and legislation, which would be central to help ensure that Hong Kong SAR remained a world class financial center in an increasingly competitive global environment.

Directors observed that the Hong Kong SAR economy would likely undergo major structural changes in coming years, due both to technological advances in key service industries and the evolving relationship with the Mainland, including as a result of WTO entry. Hong Kong SAR had in the past adapted to such changes swiftly and flexibly, aided by its well-deserved reputation as one of the most transparent, well-governed, and least interventionist places in the world to do business. Preserving Hong Kong SAR's economic performance in an increasingly competitive external environment will require a continuing effort to strengthen the regulatory framework, upgrade skills, and foster technological innovation. In this connection, Directors believed that the policy of positive nonintervention supported by government efforts to strengthen infrastructure, education, and the environment remained appropriate. They underscored, however, that domestic competition issues continued to merit close attention, particularly as the economy became more oriented toward services and because there were no substantive penalties in certain unregulated sectors, if firms engaged in anti-competitive behavior. In this regard, several Directors urged the authorities to consider the establishment of a formal Competition Law.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 1999 Article IV consultation with Hong Kong SAR is also available.

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

	1996	1997	1998	1999	
Real GDP (percent change)	4.5	5.0	-5.1	2.0	1/
Real domestic demand	2.5	8.2	-8.9	-2.1	1/
Foreign balance (contribution)	1.9	-3.4	4.3	4.1	1/
Saving-investment balance (percent of GDP)	-1.4	-3.4	0.5	2.8	1/
Gross domestic saving	30.7	31.1	30.2	29.5	1/
Gross domestic investment	32.1	34.6	29.7	26.7	1/
Inflation (percent change)					
Consumer price	6.3	5.8	2.8	-4.0	
GDP deflator	5.9	5.9	0.9	-5.0	1/
Employment (percent change)	3.5	4.6	1.8	1.8	
Unemployment rate (percent)	2.8	2.2	4.7	6.1	
Real wages	0.4	1.0	0.1	...	
Government budget (percent of GDP) 2/					
Revenue 3/	17.5	21.2	17.0	17.6	1/
Expenditure	15.3	14.7	18.9	19.2	1/
Consolidated budget balance 3/	2.2	6.6	-1.8	-1.5	1/
Reserves at March 31 4/	14.6	34.5	34.3	33.8	1/
Money and credit (percent change, end-period)					
Narrow money (M1)	14.2	-4.3	-5.0	13.6	
Broad money (M3)	10.5	8.2	10.5	7.7	
Loans for use in Hong Kong SAR	17.1	24.4	-3.8	-7.1	
Interest rates (percent, end-period)					
Best lending rate	8.5	9.5	9.0	8.5	
Three-month HIBOR	5.5	9.1	5.8	5.9	
Merchandise trade (percent change)					
Export volume	4.8	6.1	-4.3	2.6	1/
Domestic exports	-8.4	2.1	-7.9	-9.0	1/
Reexports	7.5	6.8	-3.7	4.5	1/
Import volume	4.3	7.2	-7.2	0.5	1/
Export value	4.0	4.2	-7.4	0.1	
Import value	3.0	5.2	-11.5	-2.5	
External balance (in billions of US$)					
Merchandise trade balance 5/	-18.4	-21.1	-10.9	-8.2	1/
In percent of GDP	-11.9	-12.3	-6.7	-5.1	1/
Goods and nonfactor services balance 5/	-2.2	-5.9	0.8	5.0	1/
In percent of GDP	-1.4	-3.4	0.5	3.2	1/
Foreign exchange reserves (in billions of U.S. dollars, end of period)	63.8	92.8	89.6	96.3	
(In months of retained imports)	10.7	14.6	17.5	19.8	1/

Sources: Data provided by the Hong Kong SAR authorities; and IMF staff estimates and projections.
1/ Staff estimates.
2/ Fiscal year begins April 1.
3/ Includes change in the net worth of the Land Fund.
4/ Fiscal reserves at end–FY 1997 include the HK$203 billion balance in the Land Fund (15.3 percent of GDP).
5/ National account basis.