

**People's Republic of China—Hong Kong Special Administrative Region:
2000 Article IV Consultation—Staff Report and Public Information Notice on the
Executive Board Discussion**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2000 Article IV consultation with the People's Republic of China—Hong Kong Special Administrative Region, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 3, 2000** with the officials of the People's Republic of China—Hong Kong Special Administrative Region on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on January 12, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its February 16, 2001 discussion** of the staff report that concluded the Article IV consultation.

The documents listed below will be separately released.

Selected Issues paper
Statistical Appendix

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

Staff Report for the 2000 Article IV Consultation Discussions

Prepared by the Staff Representatives for the Consultation Discussions Held in 2000
In Respect of the Hong Kong Special Administrative Region¹

Approved by Wanda Tseng and Shigeo Kashiwagi

January 12, 2001

- The consultation discussions were held in the Hong Kong Special Administrative Region of the People's Republic of China during October 20–November 3, 2000. The staff team comprised R. Teja (Head), J. Aziz, J. Gobat, and D. Iakova (all APD), and W. Lee (Resident Representative). Ms. Jin Qi and Mr. A. Wong (OED) attended key meetings.
- The mission met with Financial Secretary Mr. Donald Tsang, Chief Executive of the Hong Kong Monetary Authority, Mr. Joseph Yam, and a wide range of officials and private sector representatives.
- The recovery that began in 1999 has gained momentum in 2000. Growth for the year is projected to reach 10 percent, with inventory restocking providing most of the impetus on the demand side. Market confidence has increased, with strong capital inflows pushing money market rates below U.S. levels. However, domestic demand growth is likely to ease in 2001, slowing the pace of recovery to more sustainable levels. Near-term risks include a hard landing in the United States; faltering regional growth; and deepening political and financial sector problems in Taiwan Province of China.
- Against this background, discussions on short-run policy focused on the stance of fiscal policy in view of the economic recovery. For the medium term, discussions centered around structural issues that needed to be tackled to enhance Hong Kong SAR's role as an international financial center, and meet the challenges that could arise from the Mainland's entry into the WTO.
- The authorities have indicated a willingness to once again publish the staff report.
- The principal authors of this report are R. Teja and J. Aziz.

¹The 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.

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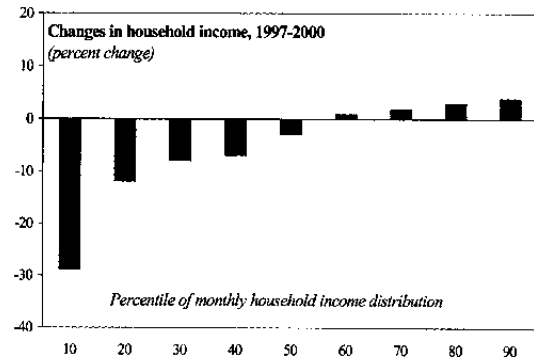
I. ECONOMIC BACKGROUND AND OUTLOOK

1. **The recovery from the Asian crisis has gained momentum.**
 - **The regional crisis hit the economy with full force in 1998.** Asset prices collapsed and the economy plunged into a severe recession, with output declining by 5 percent in 1998. Although the currency board arrangement precluded exchange rate depreciation to shore up demand, the flexibility of price and factor markets did deliver, after some delay, a robust recovery. Fiscal policy was managed flexibly, with traditional surpluses giving way to a temporary deficit in FY 1998/99. Even the controversial stock market intervention of August 1998 turned out to be profitable.²
 - **Output has rebounded in 2000 (Chart 1).** Initially, the turnaround was driven by net exports, but since late 1999 domestic demand—spurred by restocking of inventories—has become the dominant driver of growth. Private fixed investment picked up, but the recovery in consumption has been tentative. The unemployment rate declined only slowly from its 1999 peak of over 6 percent to about 4½ percent in late 2000.
 - **Prices have, however, continued to fall, reflecting property market developments.** Deflation has eased considerably (2 percent annually in November 2000, half that in 1999). However, the prolonged deflation has not reflected generalized demand weakness, but rather a gradual response to developments in the property market. More than half of the cumulative deflation since late 1998 is accounted for by the slow response of rents—as contracts are gradually renewed—to the correction in property prices. Also, about 15 percent of the cumulative price decline is from lower food prices, mirroring trends on the Mainland.
 - **Export performance has been strong, mainly reflecting the pickup in the region (Chart 2).** Export values fell in 1998 and were stagnant in 1999, but are estimated to have grown by about 17 percent in 2000, driven by higher Mainland reexports. Deflation—especially the housing cost component that is key to a service-based economy—has helped unwind the real exchange rate appreciation that occurred during the Asian crisis, and may have also helped boost export performance.
 - **Market confidence has strengthened (Charts 3 and 4).** Strong foreign portfolio inflows earlier in the year led to a surge in stock prices, but then weakened in line

²In 1998, the authorities suspected that speculators were manipulating markets and engaging in a “double play” against Hong Kong SAR—i.e., taking short positions on the currency *and* in stocks. (The calculation was that even if the currency peg held, upward pressure on interest rates would force down stock prices—and so make the stock position pay off.) To break up the play, the government used its accumulated fiscal reserves to buy US\$15 billion worth of stocks, which helped stabilize the market. Since then, equity prices have doubled.

with the U.S. market to settle around pre-crisis levels. Capital inflows also pushed money market rates below those in the United States for most of 2000. Overall, monetary conditions are liquid, as reflected in a rising bank deposit-to-loan ratio.

- **However, income disparity has widened.** As Hong Kong SAR's transformation from a manufacturing-based to a service-based economy became more pronounced in the 1990s, income inequality increased, reflecting rising wage premium for skilled labor. However, over the last three years this trend has accelerated. Households in the lower half of the income distribution suffered a significant decline in income, as labor retrenchment and wage adjustments were concentrated among low-skilled workers, while income in the upper half of the distribution rose slightly.



2. **Growth is projected to slow markedly in 2001 to a more sustainable 4 percent (Table 1).** Based on the economic rebound during the first three quarters of the year, the staff estimates that GDP growth in 2000 will be around 10 percent. However, economic activity is projected to decelerate in 2001, reflecting: (i) a slowdown in the world economy; (ii) the waning of the boost from inventory restocking, much of it trade related, which contributed half of the growth last year; (iii) moderate consumption growth, reflecting soft consumer confidence and the unwinding of stock market wealth effects; and (iv) weak investment, as implied by surveys and recent asset price volatility. Even so, demand should be sufficient to underpin GDP growth of about 4 percent in 2001. Deflation is expected to give way to low inflation, as rents firm up. Strong services income—from tourism, trade, and financial services—is expected to raise the current account surplus 7 percent of GDP.

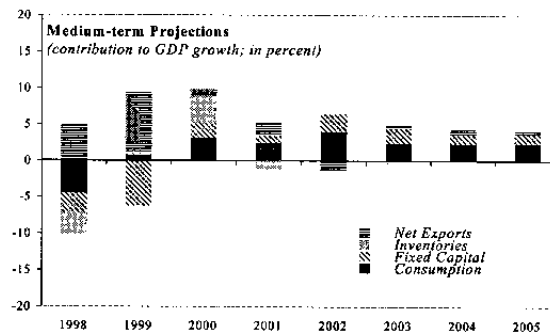
3. **These projections are subject to a number of risks:**

- **Further decline in domestic property prices.** While helpful from a long-run competitiveness point of view, this may dampen consumer and investor sentiment. Econometric work by the staff, discussed in the forthcoming background papers, confirms that real estate prices have a strong impact on bank lending and investment—even in manufacturing (via balance sheet and collateral effects).
- **A hard landing in the United States.** This would dent both direct exports (about 4 percent of GDP) and reexports from the Mainland (with value added of about 5 percent of GDP). Roughly, if U.S. import demand fell by 5 percent, Hong Kong SAR's GDP growth could be pared by ½ percent. Also, the stock market closely follows those in the United States, with a daily correlation coefficient of 0.7 between the Hang Seng and NASDAQ indices. The high correlation is surprising, since the Hang Seng is not nearly as technology-weighted as the NASDAQ.

- **Higher oil prices.** As a service-based economy whose energy needs are largely coal supplied, the direct impact of higher oil prices is small compared to the indirect effects via lower world demand. The staff estimates that a US\$5 per barrel increase in oil prices over the baseline US\$28 per barrel could shave off ½ percentage point from GDP growth in 2001, raise inflation by ⅓ percent, and reduce the current account surplus by ¾ percent of GDP.
- **Economic problems in Taiwan Province of China.** Unless sentiment on the region is hit, the direct impact on Hong Kong SAR should not be large: Taiwan Province of China's share of Hong Kong SAR domestic exports and reexports is just 3 percent and 6 percent, respectively. Moreover, after removing the effects of U.S. equity prices, the correlation between stock market indices is not significant (Chart 3). There is also anecdotal evidence that capital flowing out of Taiwan Province of China is seeking safe haven in Hong Kong SAR. While this benefits the latter in the short run, it also exposes the economy to a sudden reversal of capital flows.

4. **For the medium term, current account surpluses and GDP growth in the 4-5 percent range is forecast (Tables 2 and 3).** Growth is projected to rise above 5 percent in 2002, boosted temporarily by a pickup in investment and consumption as oil price effects are unwound and real interest rates decline.

Thereafter, growth slows to its potential rate as domestic demand decelerates to trend levels.³ Slower domestic demand growth is offset by higher exports and service receipts, reflecting earnings from the trade reforms in the Mainland. With the current account surplus broadly unchanged, capital is exported on a net basis, mostly as direct investment to the Mainland after its accession to the WTO. Inflation should revert to the positive, but modest, levels of trading partners.



II. REPORT ON THE DISCUSSIONS

5. **As Hong Kong SAR is mostly an intermediating economy, short-term macroeconomic policy plays a smaller role than long-term capacity building.** Reflecting the fact that almost half of value added arises from the intermediation of regional capital and trade flows, economic policy has emphasized prudent institutional arrangements over short-term demand management. Thus, fiscal policy, constrained by the 1997 Basic Law, has generally not been countercyclical—except during the Asian crisis. Likewise, under the

³The potential growth rate of 4 percent is based on total factor productivity growth of just over 2 percent annually, the rate achieved in the 1980s and 1990s during the transition from manufacturing to services. Productivity growth will be sustained by efficiency gains from structural changes, as Hong Kong SAR becomes a higher value-added service economy.

currency board regime, monetary policy is subordinated to the exchange rate peg. Against this background, discussions on short-run policy centered on the appropriateness of the fiscal stance in light of the strong economic recovery. On the structural side, the focus was on measures to enhance Hong Kong SAR's role as an international financial center and to meet the challenges arising from the Mainland's entry into the WTO.

A. Near-Term Policies

6. **The staff anticipates that the fiscal balance in FY 2000 will be close to zero (Table 4).** Although a deficit of ½ percent of GDP was planned at the start of the fiscal year (April-March), the authorities noted that privatization receipts were lower than expected and shortfalls were possible in investment and land-related receipts (which account for over one-third of all revenue).⁴ Taken together, these could result in a slightly higher deficit of about 1 percent of GDP. However, given the government's usual tendency to under-spend relative to the Budget, the staff's forecast is for a smaller deficit of ¼ percent of GDP.

7. **On present policies, the budget could post a modest surplus in FY 2001/02.** Most of the improvement arises from higher revenue—the lagged structure of income taxes means that the rebound of 2000 has yet to be fully reflected in tax receipts. Expenditure savings are also expected from civil service reform undertaken since 1998. Thus, it does not appear that discretionary measures will be needed to meet the institutional imperative to balance the budget over the medium term (Box 1). The authorities thought it unlikely that the fiscal stance in FY 2001/02 would depart significantly from their medium-range forecast. At the time of the consultation mission, preparation of the next budget was still in the early stages.

8. The Mandatory Provident Fund (MPF), which became operational in December 2000, is expected to raise the overall savings rate only modestly. The scheme is fully funded, with contributors choosing among competing investment funds that are privately managed, but regulated by the MPF Schemes Authority. The gross flow of contributions is expected to be around ¾–1 percent of GDP annually. However, the savings behavior of most people—more than 60 percent of total households—is unlikely to be affected, since their savings rate is well above the MPF's mandatory contribution of 5 percent of income. Only for those households whose current saving rate is below this will the MPF need to higher saving. The impact on the economy's aggregate savings should thus be modest.

⁴Accumulated fiscal surpluses amount to 35 percent of GDP. In the authorities' accounts, earnings and capital gains on these reserves, realized and unrealized, are transferred to the budget as investment income, and account for about 10 percent of total revenue. When the reserve fund intervened in the domestic stock market in 1998, the portfolio reallocation did not have any budgetary impact—nor will the planned reversal of this transaction. However, *capital gains* on the portfolio did give rise to a large fiscal transfer in FY 1999/00. The decline in equity prices in 2000 implies a smaller budgetary transfer in FY 2000/01.

BOX 1. FISCAL POLICY—SOME INSTITUTIONAL FEATURES

1. BACKGROUND

Except for the recent recession, Hong Kong SAR has generally not used fiscal policy as a countercyclical policy tool (Chart 5). Since 1985, the fiscal balance has been in deficit only twice—of which the last one was related to the Asian crisis. As a result, the government has accumulated a large fiscal reserve amounting to 35 percent of GDP in April 2000.

Aside from traditional conservatism, the scope for discretionary fiscal policy is also limited by Hong Kong SAR's de facto constitution—the Basic Law. The Basic Law stipulates, without exactly defining the economic terms it uses, that the government:

- Strive to achieve fiscal balance, avoid deficits, and keep expenditure growth commensurate with the growth rate of GDP;
- Keep taxes low, benchmarked to the rates prevailing at the time of the 1997 Basic Law; and
- Maintain the region's status as a free port (i.e., no import tariffs).

2. STRUCTURE

At a more disaggregated level, Hong Kong SAR's public finances have the following features:

- **The tax burden is low (9 percent of GDP) and the tax system is simple.** The profit tax rates are 16 percent on corporations. The salary tax rates consist of four marginal rates with 17 percent the top rate.
- **The tax base is narrow.** Income taxes account for about a quarter of all revenue, although a majority of the working population is outside the tax net. There are no general consumption taxes nor any duty on imports.
- **Nontax sources account for half of revenue,** mostly proceeds from land sales and investment income.
- **Education (19 percent) and health (12 percent) are the major areas of public expenditure.**
- **Welfare spending has nearly doubled over the past decade, and now accounts for 11 percent of public expenditure.** This reflects expanding cash and housing assistance programs for elderly, immigrants from the Mainland and the unemployed.
- **Compared to education and health spending, the corresponding fees and charges are low.**

3. LONG-TERM OUTLOOK

Structural developments on both domestic and external fronts could strain the stability of Hong Kong SAR's long-term public finances. Like other advanced countries, Hong Kong SAR is facing demographic challenges. Since the 1980s, Hong Kong SAR has benefited from a rising working age population. However, the share of working age population (15–64 age group) is projected to fall from 72 percent of total population at present to 66 percent by 2026. This could affect the economy and public finances in several ways:

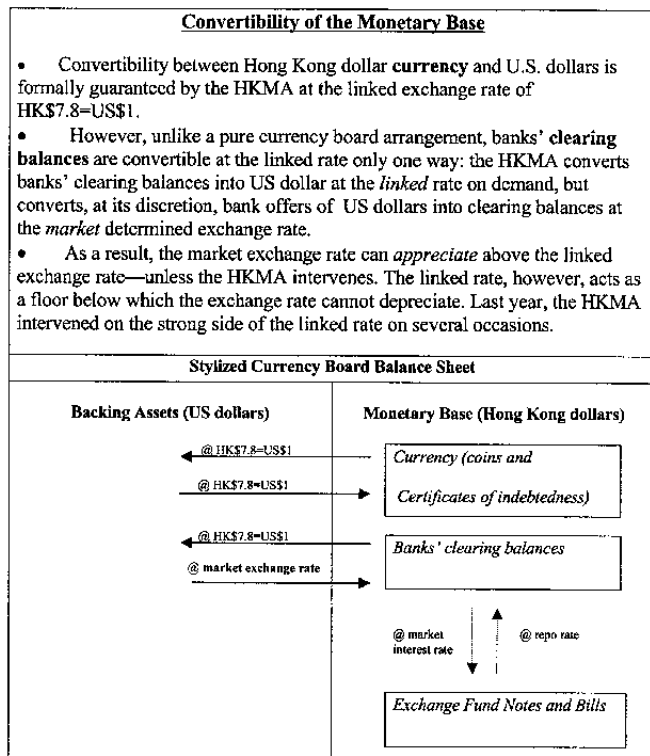
- Potential growth could decline unless there are large and sustained productivity gains.
- Growth in revenue from income-based taxes could slow down in line with GDP.
- Health expenditure could continue to rise owing to aging and rising demand for health services. It is estimated that public health costs could rise from current 2½ percent of GDP to 6 percent of GDP by 2016.
- As a service-based economy, additional budgetary pressures could also arise from the need to upgrade the education system and quality of its workforce to remain competitive.

These developments could put pressure on the fiscal balance. This is especially the case since it is unlikely that nontax revenue—mostly land sales and investment income—will grow fast enough to offset the rise in expenditure and slowdown in tax revenue. Staff estimates indicate that even if productivity growth was to remain unchanged at the high level experienced in the 1990s, the overall fiscal balance could turn negative by 2015. Moreover, spending growth could outpace GDP growth by 2010, thereby running against the injunctions of the Basic Law. To this end, maintaining fiscal balance would require a mix of expenditure cuts, especially in nonage sensitive areas, political sensitive reforms to areas such as education, health and welfare, rising user charges and other revenue-enhancing measures.

B. Exchange Rate Policy

9. **Downward pressures on the exchange rate have been mild and infrequent, and interest rate volatility too has declined.** A key factor here has been a more benign external environment. However, the authorities also cited the technical measures introduced in late 1998 in response to the financial crisis, including a rediscount facility to help banks absorb temporary surges in liquidity demand.

10. **The authorities indicated that they were open to further refinements to the currency board arrangement, but thought that the system was now working well.** The exchange rate regime in Hong Kong SAR differs somewhat from a pure currency board arrangement in that not all components of the monetary base are freely interchangeable. This implies that there is a market exchange rate—determined in the inter-bank funds market—that can, and does, deviate from the linked rate. Critics contend that this deviation from a pure currency board arrangement opens up room for discretionary monetary policy. The authorities noted that the introduction of *two-way* convertibility for clearing balances was discussed earlier in the year, but it was decided to keep the system unchanged for the time being. The HKMA felt that this arrangement provided it a small degree of freedom in its daily operations, but without compromising the credibility of the currency board regime. The staff agreed that deviations from the linked rate were in practice small, so that any enhancement in policy credibility would be minor.



11. **The mission reiterated its support for the linked exchange rate system.** The currency board has underpinned confidence in Hong Kong SAR as a stable financial center, and to date the economy has responded to cyclical shocks and structural changes efficiently. While there had been concern in markets that the Hong Kong dollar could come under pressure if the renminbi trading band was widened, such fears have now dissipated. Staff analysis confirms that the effects of a wider renminbi trading band would indeed be limited: direct trade competition with the Mainland is negligible; reexports trade with the Mainland depends more on port facilities and traditional trading arrangements than on exchange rate differentials; and finally demand for Hong Kong SAR's major export to the Mainland—financial services—is likely to remain strong in the foreseeable future.

C. Long-Term Fiscal Challenges

12. **In the last few years, the operational fiscal balance—after excluding asset-related items—has become negative.**⁵ The authorities are concerned that this deterioration could be a structural—namely, due to a secular narrowing of the tax base—rather than a cyclical phenomenon. Accordingly, they have set up the Task Force on Review of Public Finances to investigate the causes of the deterioration and an independent Advisory Committee to examine the merits of introducing different taxes, such as a broad-based goods and services tax (GST). The Task Force and the Advisory Committee are expected to issue their reports by end-2001. Meanwhile, a mission from the Fund's Fiscal Affairs Department visited Hong Kong SAR in November to advise on the technical aspects of introducing a GST. The mission concluded that introducing a GST in Hong Kong SAR, while feasible, would pose administrative challenges: effective controls over cross-border flows of goods are lacking (given the territory's status as a free port), and key revenue collecting departments have no experience in administering broad-based consumption taxes. Overcoming these challenges would take time.

13. **Over the long run, Hong Kong SAR's public finances could encounter other stresses.** As discussed in the forthcoming background papers, social spending is likely to rise over the next two decades, reflecting an aging population and the need to upgrade education (the latter not just to remain competitive, but also to curtail growing income inequality). This increase in spending could outpace GDP growth, and along with the possible narrowing of the tax base strain the budget, and thereby test the fiscal principles set out in the Basic Law. Staff analysis shows that these pressures are unlikely to surface before 2010, which gives the authorities time to implement additional expenditure-constraining and revenue-enhancing measures. On the revenue side, a broadening of the tax base could alleviate long-run stresses. However, expenditure-side measures may also be needed. The mission recommended that consideration be given to greater cost-sharing in the health sector, including higher user fees—with safeguards for the needy—and more private insurance. User fees, which have been unchanged since November 1996, cover about 3 percent of the total cost of the services provided by public bodies.

D. Structural Changes

14. **In the coming years, the economy is likely to undergo major structural changes, hastened by the Mainland's upcoming accession to the WTO (Box 2).** This will pose significant challenges, including restructuring the economy to meet the new kinds of demand for advanced financial and managerial services from the Mainland, and the loss of some traditional activities (such as trans-shipment trade and low value-added financial

⁵The operational balance—defined to exclude land-related revenue, investment income, and government equity injections in state enterprises—shifted from a surplus of ¾ percent of GDP in the early and mid-1990s to a deficit of 4¾ percent of GDP in the past two years.

BOX 2. HONG KONG SAR'S ECONOMIC LINKAGES WITH THE MAINLAND

The two economies have become increasingly integrated over the years, with Hong Kong SAR becoming a platform for Mainland exports and a supplier of financial services:

- Manufacturing facilities rapidly shifted from Hong Kong SAR to the Mainland. The share of manufacturing dropped from 25 percent of GDP in 1984 to 6 percent of GDP in 1999.
- Domestic exports gave way to rising reexports trade. The share of reexports in Hong Kong SAR's total exports have more than doubled since 1984 to 88 percent in 1999, reflecting growing outward processing trade with the Mainland.
- The tradable services sector now dominates Hong Kong SAR's economy. By end-1999, services accounted for 86 percent of GDP, of which the share of trade and financial services stood at 48 percent of GDP. In 1999, trade in goods and services stood at 260 percent of GDP, and cross-border financial transactions at 220 percent of GDP.

As a result of these changes, Hong Kong SAR has been transformed largely into an *intermediating economy*—intermediating international trade and capital flows.

- The Mainland dominates Hong Kong SAR's reexport trade. About 40 percent of Mainland trade is intermediated by Hong Kong SAR (Chart 6).
- Hong Kong SAR and the Mainland do not compete in export markets except for a few goods.
- Hong Kong SAR is one of the largest foreign direct investors in the Mainland and investment flows have remained strong despite the crisis.
- Mainland enterprises have used extensively Hong Kong SAR's financial markets to raise funds and manage risk. This reflects the Mainland's still underdeveloped capital markets. After a temporary decline following the Asian crisis, new issuance increased in 2000.
- Direct bank lending to the Mainland has been limited. Bank exposure to the Mainland peaked at 30 percent of GDP in 1997, but has since declined to about 18 percent of GDP. However, the indirect exposure is higher than that, since a portion of loans booked for use in Hong Kong SAR is used by the borrowers for their Mainland investments.

Over the coming years, the economic relationship between Hong Kong SAR and the Mainland is likely to change as the latter enters the WTO. On the trade front, Hong Kong SAR's role as an entrépot is anticipated to decline as competition from ports in the Mainland increase. However, the impact will be felt largely on transshipment trade—whose contribution to GDP is relatively small—rather than net reexports (20 percent of GDP), as much of this business is based on the better quality-control and management facilities in Hong Kong SAR. With entry into the WTO, as the Mainland opens up its markets to foreign financial firms, Hong Kong SAR's role in intermediating financial transactions in the Mainland will likely decline. Barring the shift of some low value-added financial services to the Mainland, this is unlikely to have a major impact as long as the Mainland maintains capital controls and its financial markets remain relatively less developed. Indeed, Hong Kong SAR will likely gain from the new opportunities in financial and managerial services that will arise from economic reforms in the Mainland.

services). However, there is broad agreement that the net impact of accession is likely to be positive (see SM/00/26, 2/8/2000). At the same time, the authorities believe that there will be only a limited impact from Taiwan Province of China's entry into the WTO, which would require it to eventually eliminate remaining barriers to direct trade with the Mainland. The volume of intermediated Mainland-Taiwan Province of China trade is small (6 percent of Hong Kong SAR reexports), and some trade would continue to pass through the territory, reflecting capacity constraints and sunk costs by Taiwanese businesses to build an extensive financial and trading network.

15. **Many observers continue to voice concerns about the extent of domestic competition in some sectors.** At the last Article IV discussions, Directors supported the government's traditional noninterventionist ethos. However, they noted that domestic competition—a key factor behind the economy's successful adaptation to structural changes in the 1980s and 1990s—needed to be closely monitored as there were no substantive penalties against anti-competitive behavior in unregulated sectors (e.g., parts of retail trade). During this mission, observers such as the Hong Kong Consumer Council pointed out that the lack of a general competition law was hindering the government's own efforts in this area: at times it was difficult even to begin an investigation into anti-competitive behavior, since no regulation or code can be shown to have been violated. The authorities, however, have chosen a sector-wise approach, which they believe to be more effective and which had enhanced competition in several areas (banking, telecommunications, and broadcasting). They remained concerned that a wide-ranging competition law could lead to excessive regulation and litigation.

E. Banking and Financial Sector Reforms

16. **Hong Kong SAR banks endured the recession relatively well, despite the high exposure to the property sector.** At an average 18 percent, bank capitalization has remained well above the Basel standard, the ratio of nonperforming to total loans of local banks has started to decline from its peak of 10½ percent in the third quarter of 1999, and profitability has turned up. These are impressive achievements, especially in light of the fact that the *direct* exposure of banks to the real estate sector alone accounts for half of all loans. As discussed in the background papers, this resilience derives from (i) prudent banking practice (e.g., high liquidity ratios, conservative collateral valuation, low loan to collateral value ratios); (ii) strong legal

Banking Indicators
(For all authorised institutions unless otherwise indicated, in percent)

	Hong Kong SAR				U.S.	EU-11
	1997	1998	1999	H1/2000	1998	1998
Return on assets (domestic banks)	1.9	1.2	1.3	1.7	0.9	0.4
Capital adequacy ratio 1/	17.5	18.5	18.7	18.7	12.2	11.7
Non-performing loans (domestic banks)	2.1	7.3	9.8	8.6	2.2	3.9
Property loans (percent of domestic loans)	44.3	46.5	49.4	50.2	...	...
Loan/value ratio (new mortgage loans)		56.0	57.6	57.3	...	...
Equity financing loans (percent of loans)	3.0	0.8	0.9	0.8	...	...
Claims on the Mainland (percent of assets)	4.9	4.5	3.6	3.5	...	...

Sources: HKMA, Bankscope, U.S. Federal Reserve.

1/ Locally incorporated authorized institutions.

institutions (e.g., effective bankruptcy and foreclosure, which has kept nonperforming loans on mortgages below 1½ percent); and (iii) effective supervision (e.g., frequent on and off-site examination, good accounting and disclosure requirements).

17. **Nevertheless, to better assess risks, the authorities indicated that they are favorably disposed to the Financial Sector Assessment Program (FSAP).** The financial system is arguably the most crucial part of the economy, and accounts for one quarter of value added. However, given Hong Kong SAR's standing as a regional financial center, standard measures of vulnerability are either unavailable (e.g., external debt, which is not compiled) or can be misleading (e.g., gross reserves/short-term debt, which is bound to be low in an international financial center). The FSAP would provide an opportunity to conduct a comprehensive assessment of the strengths and vulnerabilities that go beyond standard indicators (Table 5). A final decision on FSAP is expected in early 2001.

18. **The HKMA has embarked on a gradual liberalization of remaining interest rate rules operated by the Hong Kong Association of Banks.** The first stage, in July 2000, involved removing the anti-competitive ceilings on time deposits of less than 7 days. Since these deposits make up just 0.1 percent of Hong Kong dollar deposits, the move had little impact. In the next and more important phase, scheduled for July 2001, the ceiling for savings deposits, which make up about 30 percent of Hong Kong dollar deposits, will be eliminated. If easy liquidity conditions persist, and the interest rate ceiling remains nonbinding, the move should not have any immediate impact. However, as discussed in SM/00/17 (2/1/2000), more competition for deposits over the longer term could lower banks' average net margin of banks by ¼ percent.

19. **Despite the strong recovery, loan growth remains low.** Through October 2000, banks' domestic lending grew by just 2½ percent year-on-year. The authorities attributed the slow rate to weak credit demand, pointing out that the pickup in investment was being financed mainly internally and through the stock market. The mission noted that supply-side factors could also be at work, with banks circumspect in the face of low property values and inadequate financial transparency in small and medium enterprises (SMEs). As a result, banks have begun to compete more aggressively in the safer market for home mortgages. Against this background, the mission commended recent efforts to raise corporate disclosure and catalyze the establishment of a commercial credit reference agency.

20. **Considerable progress has been made in upgrading securities regulations and financial infrastructure, but the process has further to go.** Recent achievements include: (i) merger of the exchanges and clearing houses, which will reduce costs and consolidate risk management; (ii) establishment of a U.S. dollar clearing system to settle transactions within the Asian time zone, thereby reducing settlement risk and encouraging others to settle transactions in Hong Kong SAR; (iii) the proposed introduction of deposit insurance, which is under public consideration and is being structured to minimize moral hazard (it is proposed to limit deposit insurance with a cap of HK\$100,000—about US\$13,000—per depositor, and to impose a flat fee of 10 basis points per annum on all deposits); (iv) a move to more risk-based supervision of banks and regular assessment of cross market risk—

banking, securities, derivatives, and insurance—by a council of financial regulators; and (v) the introduction of a composite Securities and Futures Bill, which will raise the regulatory framework to international standards. Nevertheless, there remains scope for further strengthening financial infrastructure. For example, there is no liquid market for private debt in Hong Kong SAR—puzzling for a relatively advanced financial center. The staff noted that the recent establishment of the Mandatory Provident Fund should help to increase the demand for long-term debt instruments. However, it also may be necessary to enhance corporate transparency, thus allowing credit agencies to rate more SMEs.

21. **The divestment of domestic stocks acquired in August 1998 is progressing smoothly.** So far, about a third of the authorities' holdings has been sold—at a substantial profit—through the independently managed Tracker Fund, an index fund that follows the Hang Seng Index (HSI). The authorities stated that they will continue with the present policy of releasing every quarter a portion of their holdings into the market through a “tap facility” of the Tracker Fund. However, as the initial domestic equity portfolio does not precisely match the HSI, partly due to compositional changes in the HSI, it is unlikely that the objective of retaining only 5 percent of the overall portfolio in stocks can be reached via the Tracker Fund alone. The portfolio mismatch problem is not a binding one in the near term, and the authorities meanwhile are exploring alternatives.

F. Data and Transparency

22. **Hong Kong SAR now complies with the Fund's Special Data Dissemination Standards, including the international reserves template.** The mission commended the authorities for this achievement. It noted that the statistical agency plans to publish international investment position data by June 2002, allowing the release of external debt statistics a year ahead of schedule. The authorities also plan to produce production-based GDP estimates at constant prices by 2002. The staff welcomed these developments, while urging efforts in two further areas, namely, the production of a monetary survey and the reporting of fiscal data in the Fund's *Government Finance Statistics* format.

23. **Last year's Report on the Observance of Standards and Codes contained a very positive evaluation of Hong Kong SAR, with recommendations in only a few areas.** The report covered the transparency of statistics and the financial system, and self-assessments in insurance, securities, accounting and audit. On key recommendations:

- **Midyear review of the fiscal situation.** The authorities did not believe this would enhance transparency, since information available through October was generally insufficient to generate a revised forecast: stamp duties, land, and investment together account for half of revenue, but are highly volatile.
- **Sensitivity analysis in budget documents.** The authorities agreed in principle, but were unsure how illustrative these would be given the volatile revenue base.
- **Disclosure of the government's contingent liabilities.** The authorities indicated that they needed to consider this suggestion further.

III. STAFF APPRAISAL

24. **There has been an impressive economic recovery over the past year.** GDP has rebounded, unemployment has declined, and market confidence in the economy has remained strong in the face of regional uncertainty and high world oil prices. Despite the weakness in the real estate sector, the financial condition of banks remains strong. These are important achievements. The pace of economic activity in 2001 is projected to decelerate markedly to 4 percent, reflecting the fading impetus from inventory restocking. Although there are risks to the outlook, the slowdown should not be a concern, since it still leaves growth at close to its long-term rate. Deflation, more a property market phenomenon than a sign of generalized demand weakness, is expected to give way to low inflation in 2001.

25. **Hong Kong SAR's rules-based approach to economic policy has been effective.** An impressive aspect of fiscal management has been the ability to combine a pragmatic injection of fiscal stimulus during the Asian crisis with adherence to the principle of fiscal prudence set out in the Basic Law. The small deficit projected for FY 2000/01 reflects an exogenous revenue shortfall from rail privatization and from lower investment income. As such, the current fiscal stance should result in surpluses starting in FY 2001/02 as lags in the tax base are worked off and the cyclical improvement is manifested in revenue. On monetary policy, confidence in the currency board has strengthened, and the linked exchange rate continues to provide a stable policy framework. Measures introduced in 1998 to strengthen the currency board, while yet to be stress tested, appear to be working well.

26. **Despite the institutional disposition to fiscal discipline provided by the Basic Law, stresses could emerge in the long run.** Population aging and the imperative to upgrade skills—to remain competitive and reduce income inequality—will raise health and education spending over the long term. Also, revenue growth could slow as stamp duties and property-related receipts lag behind GDP growth. Given these trends, adherence to the Basic Law beyond the current decade may call for additional measures. One option could be the introduction of a low-rated, broad-based consumption tax. Another would be to allow for greater cost sharing of health care expenditure, including higher user fees—with safeguards for the needy—and more private insurance. In both cases, policy implementation may take time, and the authorities are to be commended for planning ahead.

27. **Prudent banking practice, strong legal institutions, and effective supervision have helped the banking system weather the turbulence of the Asian crisis.** Banks remain well capitalized and profitable, and nonperforming loans have started to decline. The planned liberalization of the last deposit rate ceiling is welcome, and should not be a problem for banks in the near term. Although demand for credit is low, supply factors could also be holding back the recovery of bank lending. The limited transparency of small and medium enterprises has hindered risk-based lending and prompted banks to shift into safer mortgage loans. In this connection, recent efforts to raise corporate transparency, and encourage the establishment of a commercial credit reference agency are important.

28. **Progress in upgrading securities regulations and financial infrastructure will enhance Hong Kong SAR's standing as a financial center.** The move to more risk-based supervision of banks and regular assessment of cross-market risk—banking, securities, derivatives, and insurance—will also reduce the financial system's vulnerabilities. The staff would encourage an early decision to participate in Financial Sector Assessment Program. Further work is needed to develop debt markets and diversify economic risks.

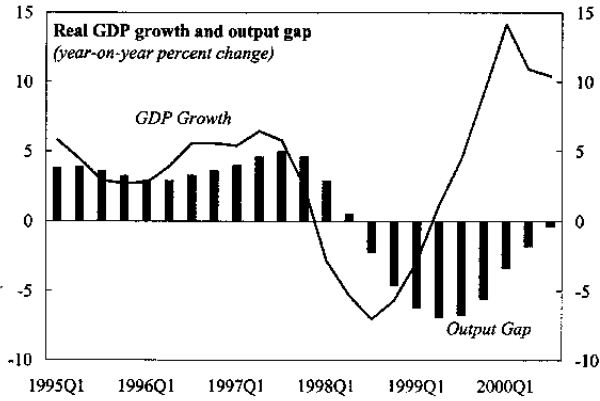
29. **The Mainland's accession to the WTO is a watershed event that should benefit Hong Kong SAR, but it will also entail substantial restructuring.** Trade creation (a share of the Mainland's higher trade and financial services) is expected to exceed trade diversion (a shift of trans-shipment trade and some services to the Mainland). However to take advantage of opportunities, Hong Kong SAR will need to raise competitiveness and upgrade infrastructure, especially education. While Hong Kong SAR is one of the most open economies in the world, with flexible product and factor markets, lowering business costs will remain crucial to the economy's future. Against this background, the authorities will need to continue paying close attention to domestic competition issues in unregulated sectors, especially in the absence of a comprehensive competition law.

30. **Hong Kong SAR is now fully in compliance with the Fund's Special Data Dissemination Standard.** This progress is welcome, and efforts by the Census and Statistics Department to publish data on the international investment position and bring forward the schedule for publishing external debt data to mid-2002 is commendable. However, two areas where statistics can be usefully improved are: (i) presentation of fiscal data on a standardized international format (such as the Fund's *Government Finance Statistics*); and (ii) publication of a monetary survey.

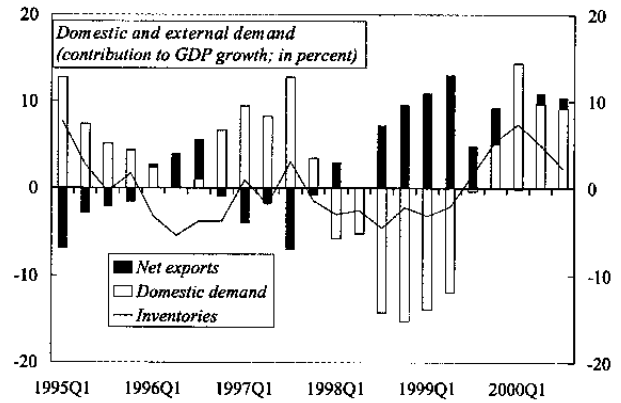
31. **It is recommended that the next Article IV consultation with the People's Republic of China in respect of Hong Kong SAR take place on a 12-month cycle.**

Chart 1: Hong Kong SAR
REAL SECTOR

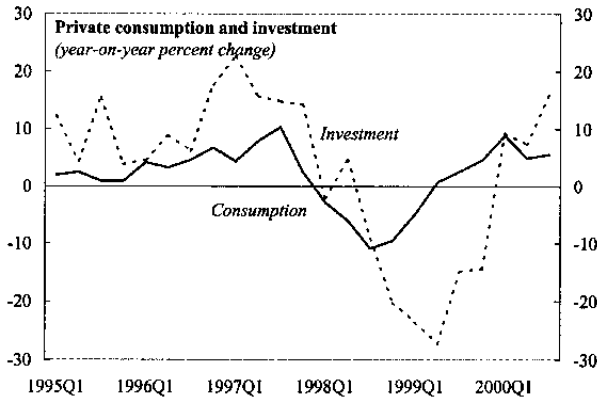
The recovery from the Asian crisis has gained momentum, narrowing the output gap.



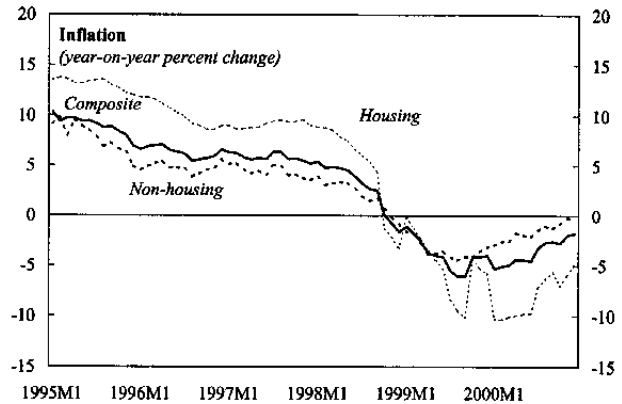
Domestic demand has now displaced external demand as the main driver of growth.



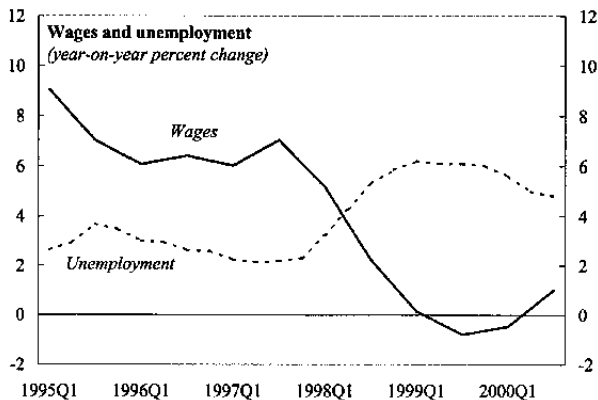
While investment has picked up, consumption growth has been more tentative.



Despite the closure of the output gap, deflation continues, driven by falling housing costs.



Unemployment has eased, and nominal wages have stabilized at a lower level.



Real wage growth is modest compared to the rise in productivity.

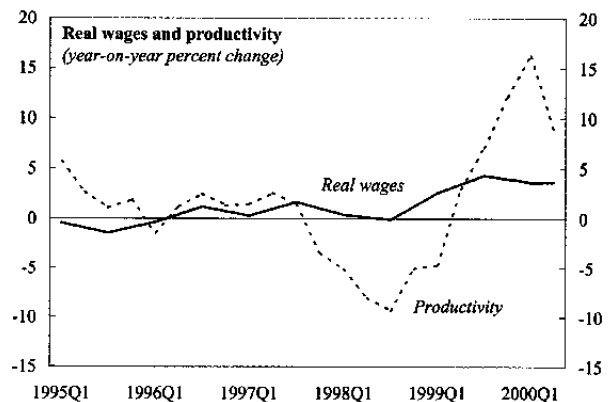
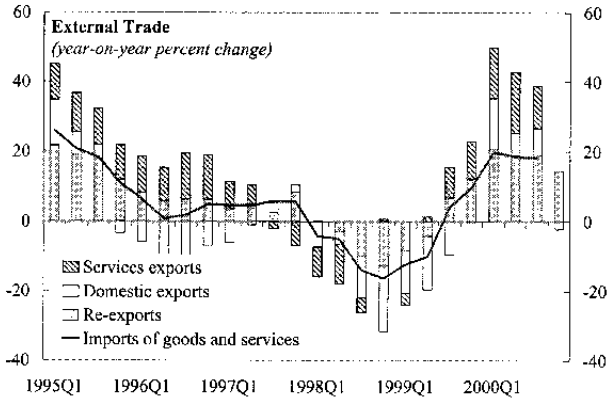
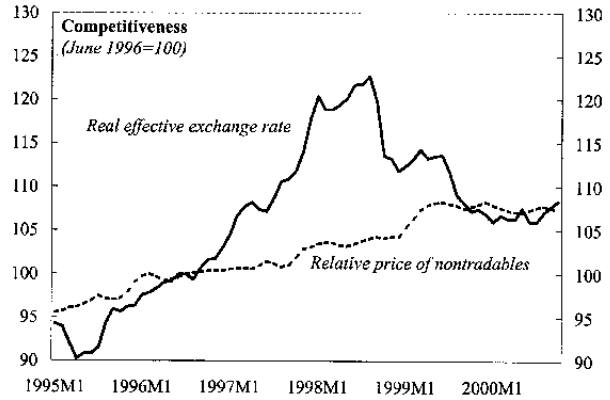


Chart 2: Hong Kong SAR
EXTERNAL SECTOR

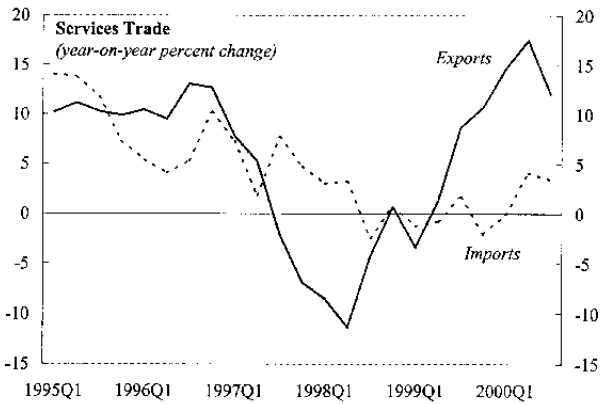
Export growth has been robust.



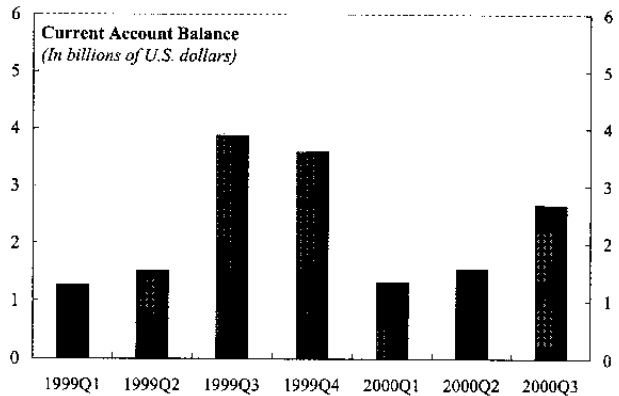
Indices of external competitiveness appear to have improved with deflation.



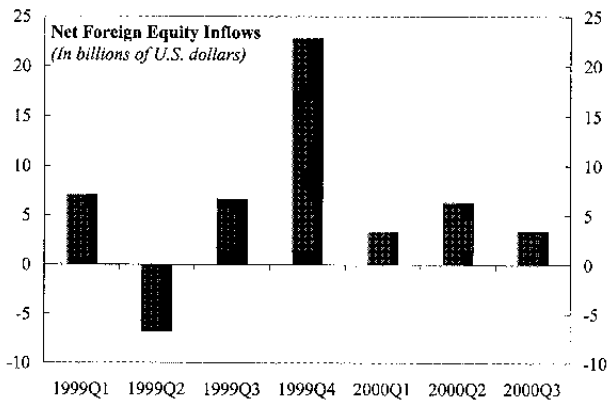
Exports of services have also surged...



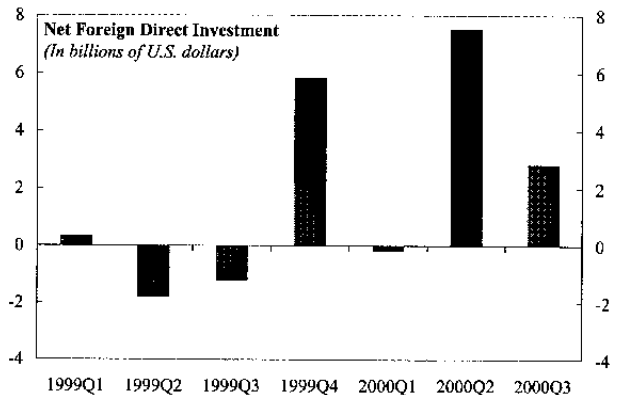
...and the current account balance has remained in surplus.



Net equity inflow has slowed,...

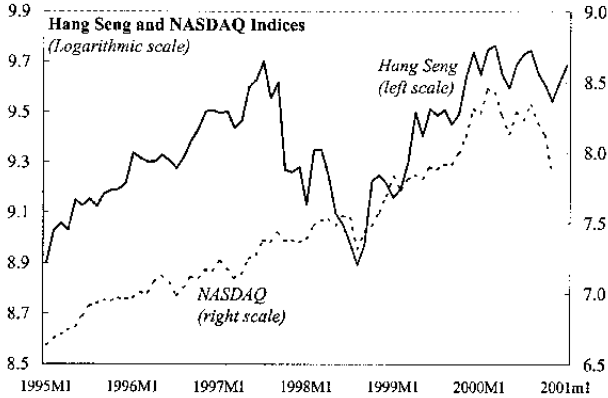


...although foreign direct investment has risen.

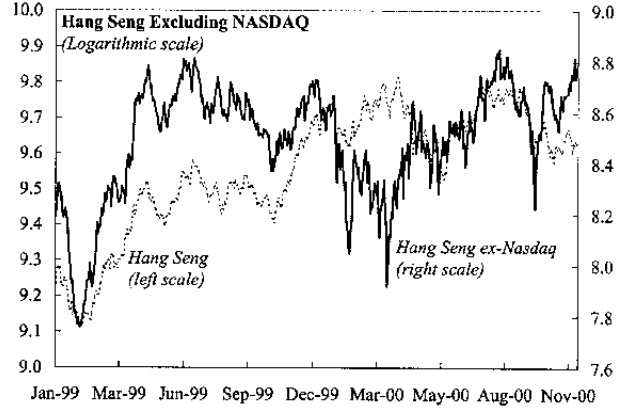


**Chart 3: Hong Kong SAR
MARKET CONFIDENCE**

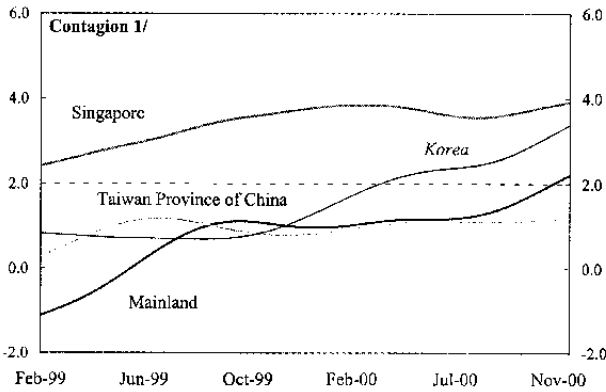
The stock market surged in early 2000, only to weaken in line with U.S. equity prices.



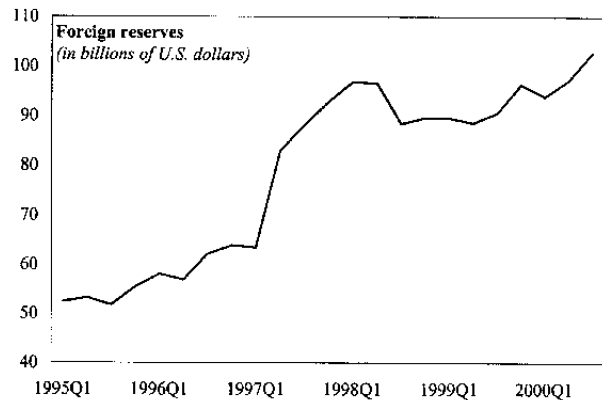
However, if the influence of the U.S. equity market is excluded, the Hang Seng index has gathered strength recently,...



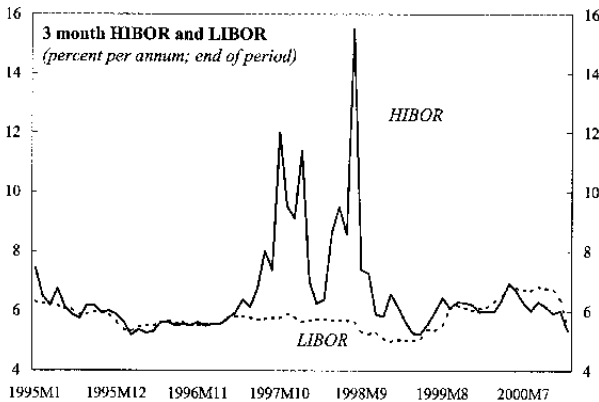
...and correlation between Hong Kong SAR's and some of the regional stock markets has become statistically more significant.



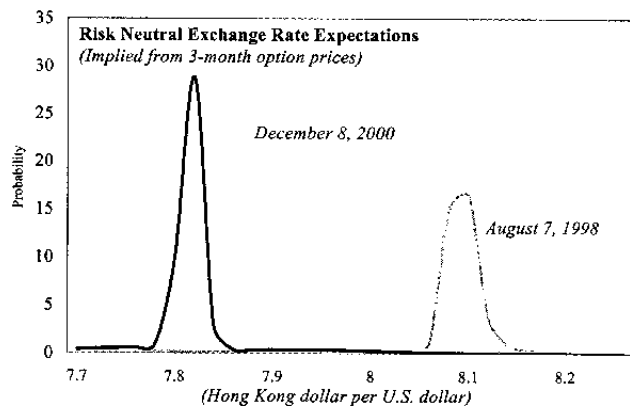
Foreign exchange reserves have risen above pre-crisis levels.



Money market rates have fallen below U.S. levels,...



...while downward pressures on the exchange rate have disappeared.



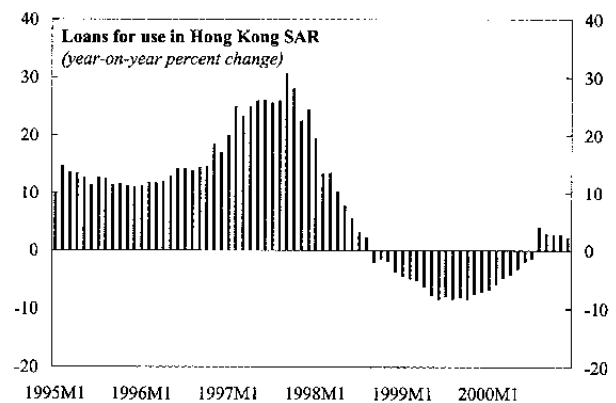
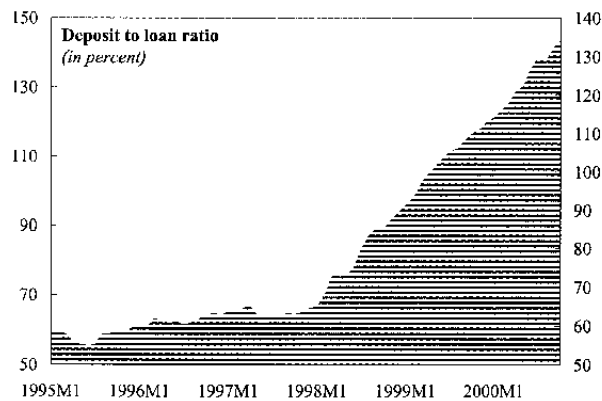
Source: Data provided by the Hong Kong SAR authorities; and Fund staff estimates.

1/ The y-axis measures the t-ratios estimated from 40-day rolling bivariate regressions between the HSI and regional stock market indices (after removing the effects of the NASDAQ). Since the t-ratios are computed by deflating the regression coefficients by standard errors, the noisiness of daily data is partially controlled. A t-ratio value of more than 2 indicates 95 percent statistical significance.

Chart 4: Hong Kong SAR
BANKS

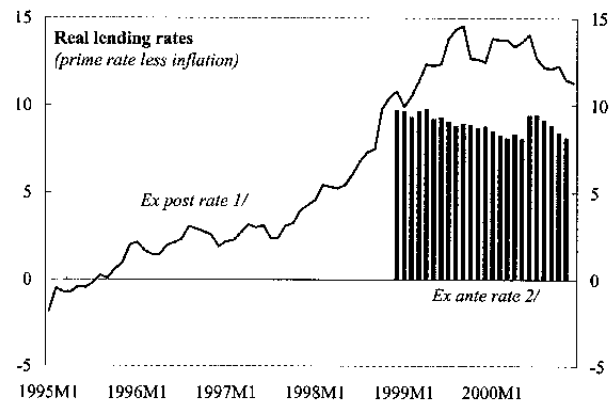
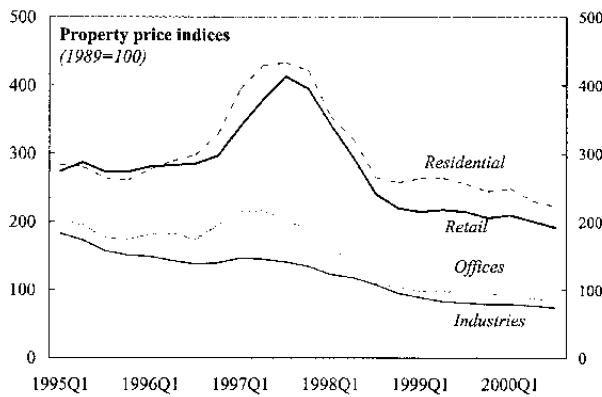
Liquidity in the financial system has increased,...

...as bank lending has not yet recovered,...



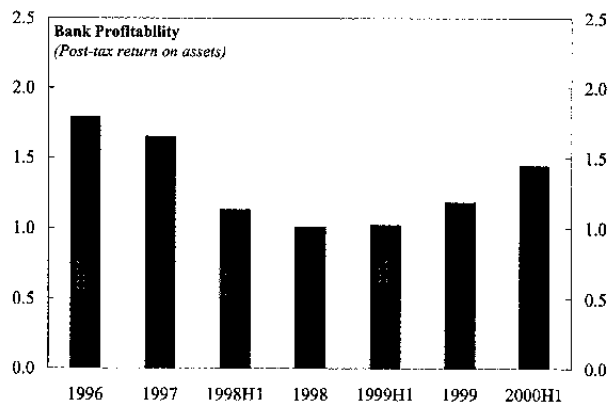
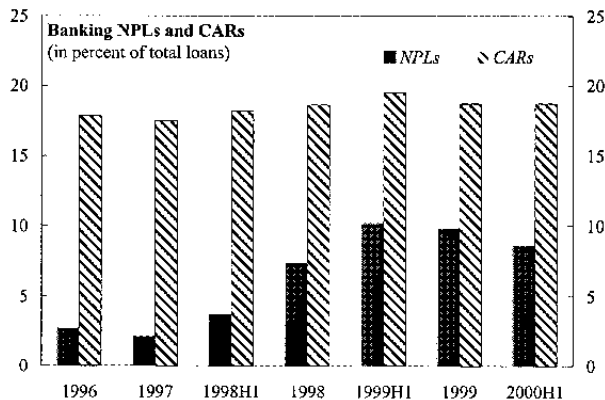
...partly, due to depressed prices for property (that serves as collateral),...

...and high real interest rates.



Bank capitalization has remained high, while nonperforming loans have begun to decline...

... which has raised profitability.



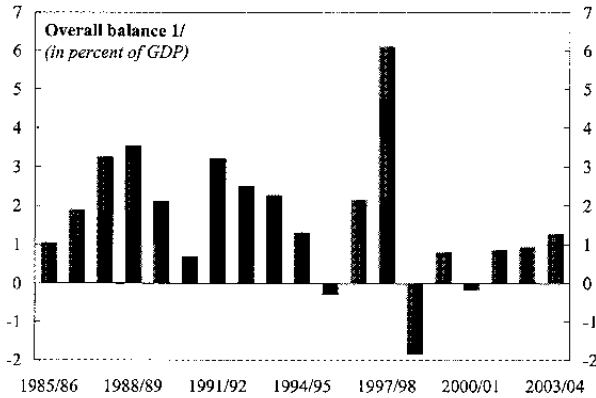
Source: Data provided by the Hong Kong SAR authorities; and Fund staff estimates.

1/ Using 12-month CPI inflation.

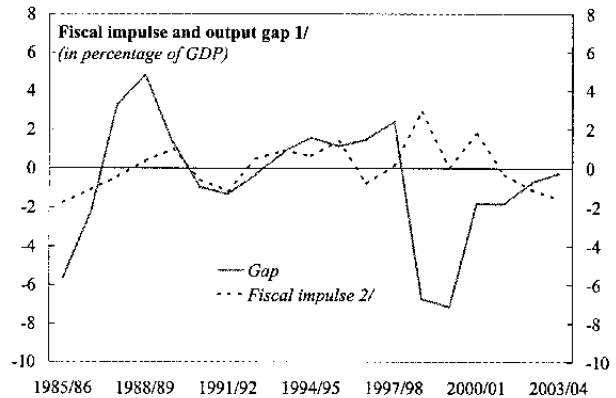
2/ Using consensus forecast of inflation.

Chart 5: Hong Kong SAR FISCAL DEVELOPMENTS

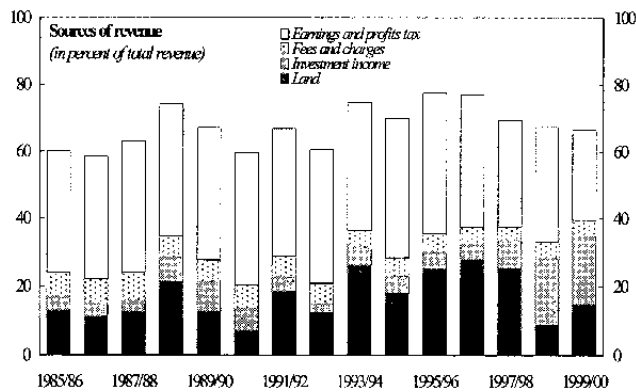
The fiscal balance has traditionally been in surplus...



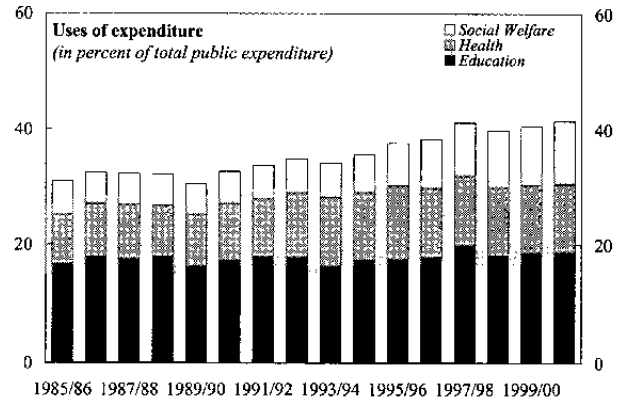
...and fiscal policy generally has not been countercyclical except during the Asian crisis.



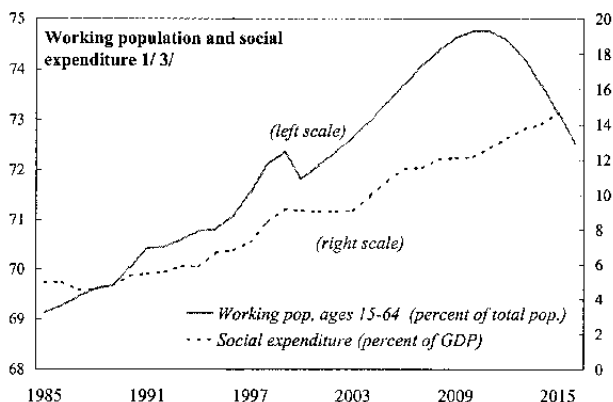
The revenue base is narrow...



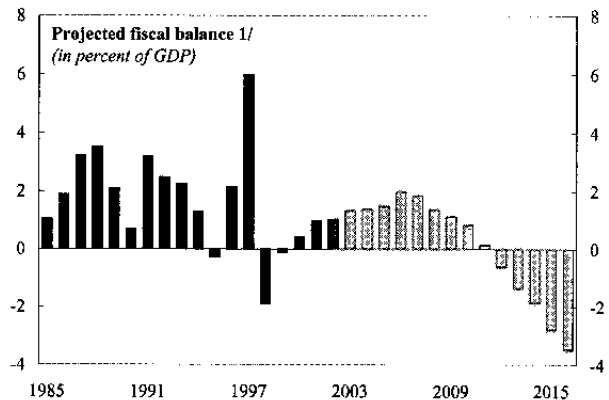
...while social expenditure is rising...



...and projected to rise further as the working population declines.



Accordingly, without active measures, the fiscal balance could eventually move into deficit.



Source: Data provided by the Hong Kong SAR authorities; and Fund staff estimates.

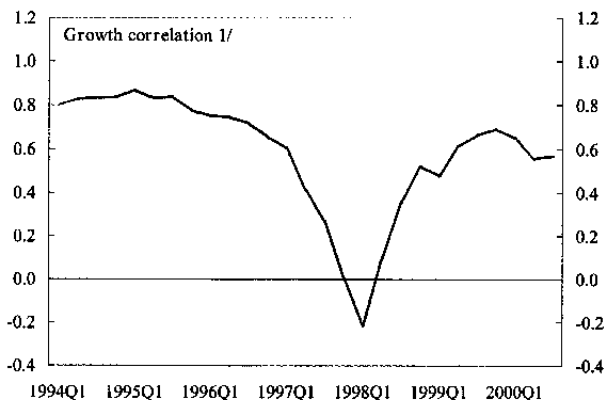
1/ After 1999/00, figures based on Fund staff estimates.

2/ For a detailed discussion of fiscal impulse, including the estimation procedure used, see "Hong Kong: Macroeconomic Impact of Recent Fiscal Measures," Quarterly Bulletin, Hong Kong Monetary Authority, (February 2000).

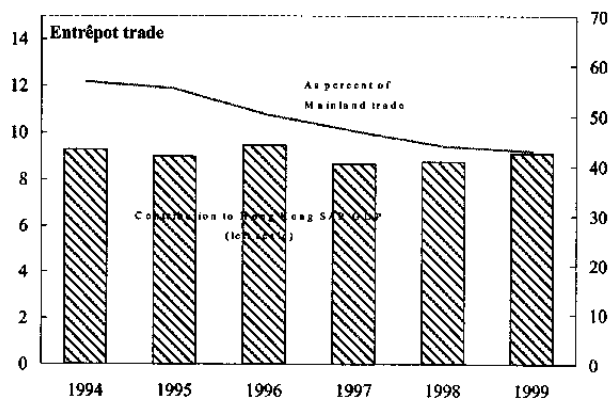
3/ Working population based on official estimates.

Chart 6: Hong Kong SAR ECONOMIC LINKS WITH THE MAINLAND

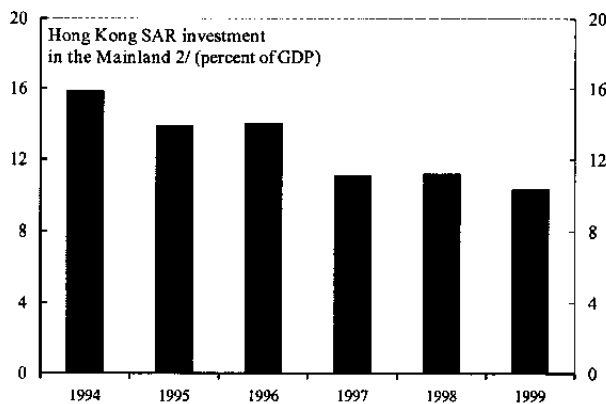
The cyclical link with the Mainland has resurfaced, after decoupling during the Asian crisis.



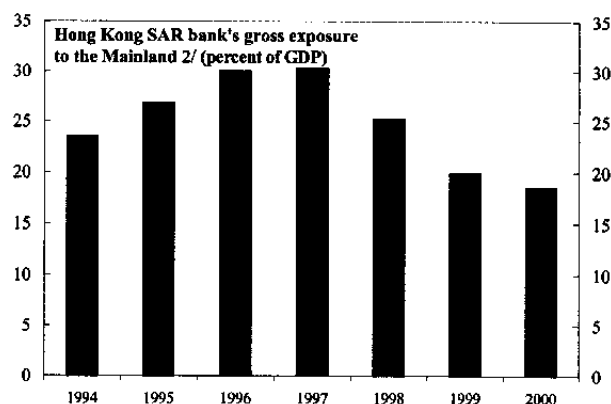
Although, still high, less Mainland trade is conducted via Hong Kong SAR.



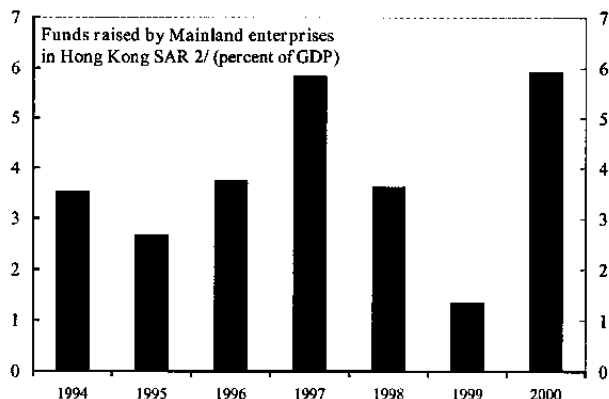
Direct foreign investment to the Mainland has remained strong despite the crisis.



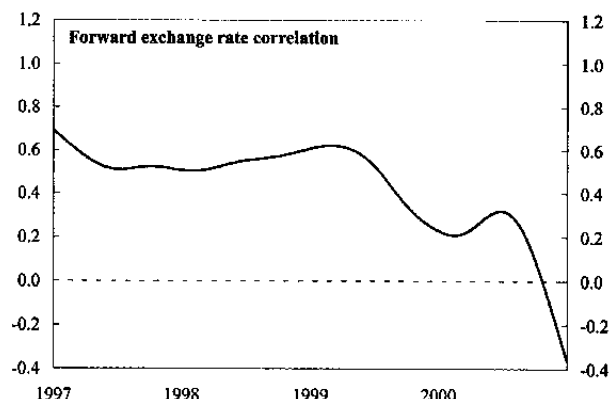
However, Hong Kong SAR banks' exposure to the Mainland has fallen.



On the other hand, nonbank fund raising has risen lately.



Correlation between the renminbi and HK dollar forward rates has fallen sharply.



Source: Data provided by the Hong Kong SAR authorities; and Fund staff estimates.

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

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

Table1. Hong Kong SAR: Selected Economic and Financial Indicators, 1996-2001

Nominal GDP (1999): US\$ 159 billion
 Population (mid-2000): 6.8 million
 GDP per capita (1999): US\$ 23,651

	1996	1997	1998	1999	2000			Staff Projections	
					Q1	Q2	Q3	2000	2001
Real GDP (percent change)	4.5	5.0	-5.3	3.1	14.2	10.9	10.4	10.0	4.0
Contribution									
Domestic demand	2.6	8.4	-10.3	-5.0	14.4	9.7	9.2	9.0	2.2
Private consumption	2.8	3.7	-4.5	0.5	5.3	3.1	3.1	2.9	2.2
Government consumption	0.3	0.2	0.0	0.3	0.3	0.2	0.2	0.2	0.2
Gross fixed capital formation	3.5	4.4	-2.8	-6.2	1.5	1.5	3.6	2.2	1.1
Inventories	-4.0	0.2	-3.1	0.5	7.3	4.9	2.2	3.8	-1.2
Net exports	1.9	-3.4	5.0	8.1	-0.2	1.2	1.3	1.0	1.8
Saving and investment (percent of GDP)									
Gross domestic saving	30.7	31.3	30.4	30.7	29.8	30.5	34.5	31.9	32.0
Gross domestic investment	32.1	34.4	29.0	25.1	28.4	27.6	28.1	26.4	25.4
Saving-investment balance	-1.4	-3.1	1.4	5.6	1.5	2.8	6.4	5.6	6.6
Inflation (percent change)									
Consumer prices	6.3	5.8	2.8	-4.0	-5.1	-4.5	-2.8	-3.7	1.0
GDP deflator	5.9	5.8	0.6	-5.3	-7.0	-7.6	-6.6	-6.3	0.9
Employment (percent change)	3.5	3.2	-1.3	-0.5	1.7	1.9	3.4	3.4	1.8
Unemployment rate (percent)	2.8	2.2	4.7	6.3	5.6	5.0	4.8	5.0	4.6
Real wages	0.4	1.0	0.1	3.8	3.6	4.6	3.3	...	...
Government budget (percent of GDP)									
Revenue	17.5	21.2	17.1	18.9	...	...	...	18.9	20.1
Expenditure	15.3	14.7	19.0	18.1	...	...	...	19.1	19.2
Consolidated budget balance	2.2	6.6	-1.8	0.8	...	...	...	-0.2	0.9
Fiscal Reserves at March 31	14.6	34.6	34.4	36.0	...	...	...	34.8	33.3
Money and credit (percent change, end-period)									
Narrow money (M1)	14.2	-4.3	-5.0	13.9	10.1	7.0	6.7	...	...
Broad money (M3)	10.5	8.2	10.5	7.7	7.7	9.6	8.3	...	...
Loans for use in Hong Kong SAR	17.1	24.4	-3.8	-7.2	-4.9	-2.1	2.9	...	...
Interest rates (percent, end-period)									
Best lending rate	8.5	9.5	9.0	8.5	9.0	9.5	9.5	...	...
Three-month HIBOR	5.5	9.1	5.1	5.7	6.0	6.4	6.3	...	...
Merchandise trade (percent change)									
Export volume	4.8	6.1	-4.3	3.7	20.7	17.7	17.7	16.7	6.5
Domestic exports	-8.4	2.2	-7.9	-7.2	16.1	8.4	8.2	6.1	3.0
Reexports	7.5	6.8	-3.7	5.4	21.4	19.1	19.0	18.2	7.0
Import volume	4.3	7.2	-7.2	0.1	22.8	18.8	18.4	17.4	5.7
Export value	4.0	4.2	-7.4	0.1	20.1	17.3	17.6	16.7	7.6
Import value	3.0	4.9	-11.5	-2.5	22.8	20.4	20.0	17.9	6.6
Terms of trade	1.0	0.7	1.2	-0.7	-0.7	-1.1	-1.3	-0.5	0.1
External balances (in billions of US\$)									
Merchandise trade balance	-18.4	-17.3	-7.8	-3.2	-2.5	-2.5	-1.3	-6.3	-5.0
In percent of GDP	-11.9	-10.1	-4.8	-2.0	-6.4	-6.2	-3.2	-3.8	-2.9
Current account balance 1/	-1.6	-6.2	3.9	10.5	1.3	1.6	2.7	9.6	12.1
In percent of GDP	-1.0	-3.6	2.4	6.6	3.4	3.9	6.4	5.9	7.1
Foreign exchange reserves									
In billions of U.S. dollars, end of period	63.8	92.8	89.6	96.3	93.8	97.1	101.7	...	...
In months of retained imports	10.7	14.6	17.1	19.8	18.2	17.9	17.8	...	...
Exchange rate									
Linked rate (fixed)									
Market rate (HK\$/US\$1, period average)	7.734	7.742	7.745	7.758	7.781	7.790	7.797	...	...
Real effective rate (period average, 1990=100)	136.1	149.5	161.6	151.2	145.0	145.4	145.6	...	...

Sources: Data provided by the Hong Kong SAR authorities; and staff estimates and projections. Staff projections are consistent with the WEO submission of February 13, 2001.

1/ Prior to 1997, figure refers to goods and nonfactor services balance.

Table 2. Hong Kong SAR: Medium-term Projections, 1998-2005

	1998	1999	Staff Projections					
			2000	2001	2002	2003	2004	2005
Real GDP (percent change)	-5.3	3.1	10.0	4.0	5.2	4.5	4.3	4.2
Contribution								
Real domestic demand	-10.3	-5.0	9.0	2.2	6.4	4.1	3.6	3.6
Private consumption	-4.5	0.5	2.9	2.2	3.9	2.2	2.2	2.2
Government consumption	0.0	0.3	0.2	0.2	0.1	0.1	0.1	0.1
Gross fixed capital formation	-2.8	-6.2	2.2	1.1	2.5	2.1	1.4	1.4
Inventories	-3.1	0.5	3.8	-1.2	-0.1	-0.4	-0.1	-0.1
Net Exports	5.0	8.1	1.0	1.8	-1.3	0.4	0.6	0.5
Output gap (in percent of potential)	-6.7	-7.1	-1.8	-1.8	-0.7	-0.3	0.0	0.2
Saving and investment (percent of GDP)								
Gross domestic saving	30.4	30.7	31.9	32.0	31.6	31.9	32.0	32.1
Gross domestic investment	29.0	25.1	26.4	25.4	26.0	26.5	26.5	26.6
Saving-investment balance	1.4	5.6	5.6	6.6	5.5	5.4	5.4	5.5
Inflation (percent change)								
Consumer prices	2.8	-4.0	-3.7	1.0	2.6	3.0	3.0	3.0
GDP deflator	0.6	-5.3	-6.3	0.9	3.1	2.7	2.6	2.8
Employment (percent change)	-1.3	-0.5	3.4	1.8	2.0	1.6	1.6	1.6
Unemployment rate (percent)	4.7	6.3	5.0	4.6	4.1	3.9	3.7	3.5
Government budget (percent of GDP)								
Revenue	17.1	18.8	18.9	20.1	19.5	19.8	20.0	20.0
Expenditure	18.9	18.0	19.1	19.2	18.6	18.6	18.6	18.5
Consolidated budget balance	-1.8	0.8	-0.2	0.9	0.9	1.2	1.4	1.5
Accumulated fiscal reserves (end-year)	34.3	35.9	34.8	33.3	32.4	29.4	30.8	30.3
Merchandise trade (percent change)								
Export volume	-4.3	3.7	16.7	6.5	7.9	9.2	7.9	7.9
Domestic exports	-7.9	-7.2	6.1	3.0	7.0	7.0	7.0	7.0
Reexports	-3.7	5.4	18.2	7.0	8.0	9.5	8.0	8.0
Import volume	-7.2	0.1	17.4	5.7	8.8	9.1	7.7	7.8
Retained import volume	-14.0	-11.7	13.2	2.0	11.0	8.0	6.8	7.1
Export value	-7.4	0.1	16.7	7.6	8.9	10.3	9.0	9.0
Import value	-11.5	-2.5	17.9	6.6	9.6	10.2	8.9	8.9
Terms of trade	1.2	-0.7	-0.5	0.1	0.1	0.0	-0.1	0.0
External balances (in billions of US\$)								
Trade balance	-7.8	-3.2	-6.3	-5.0	-7.0	-7.4	-7.9	-8.3
In percent of GDP	-4.8	-2.0	-3.8	-2.9	-3.8	-3.7	-3.7	-3.7
Current account	3.9	10.5	9.6	12.1	10.9	11.9	13.2	14.5
In percent of GDP	2.4	6.6	5.9	7.1	5.9	6.0	6.2	6.3

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

Table 3. Hong Kong SAR: Medium-Term Balance of Payments

	1998	1999	Staff Projections					
			2000	2001	2002	2003	2004	2005
(In billions of U.S. dollars)								
Current account	3.9	10.5	9.6	12.1	10.9	11.9	13.2	14.5
Goods Balance	-7.8	-3.2	-6.3	-5.0	-7.0	-7.4	-7.9	-8.3
Services balance	9.6	11.7	14.1	14.9	16.0	17.2	18.5	20.2
Income Balance	3.7	3.5	3.4	3.7	3.5	3.7	4.1	4.3
Transfer balance	-1.6	-1.5	-1.5	-1.5	-1.6	-1.6	-1.6	-1.6
Capital and Financial Account	-3.9	-9.8	-9.6	-12.1	-10.9	-11.9	-13.2	-14.5
Capital Account	-2.4	-1.8	-1.9	-2.1	-2.4	-2.6	-2.8	-3.1
Financial Account	-1.5	-8.0	-7.6	-9.9	-8.6	-9.3	-10.3	-11.3
Net Direct investment	-2.2	3.2	1.6	-0.3	-2.3	-4.6	-7.2	-10.3
Portfolio investment	22.1	32.3	35.0	36.3	41.1	44.3	47.6	51.2
Financial derivatives	3.3	12.3	13.2	14.4	15.6	17.1	18.7	20.6
Net bank loans and other investment	-31.6	-46.3	-50.9	-54.4	-57.8	-61.3	-65.4	-69.6
Reserve assets (net change)	6.9	-9.6	-6.5	-6.0	-5.2	-4.7	-3.9	-3.2
Net errors and omissions	0.0	-0.7	0.0	0.0	0.0	0.0	0.0	0.0
(In percent of GDP)								
Current account	2.4	6.6	5.9	7.1	5.9	6.0	6.2	6.3
Goods Balance	-4.8	-2.0	-3.8	-2.9	-3.8	-3.7	-3.7	-3.7
Services balance	5.9	7.3	8.6	8.7	8.6	8.7	8.7	8.8
Income Balance	2.3	2.2	2.1	2.2	1.9	1.8	1.9	1.9
Transfer balance	-1.0	-0.9	-0.9	-0.9	-0.8	-0.8	-0.8	-0.7
Capital and Financial Account	-2.4	-6.2	-5.9	-7.1	-5.9	-6.0	-6.2	-6.3
Capital Account	-1.5	-1.1	-1.2	-1.2	-1.3	-1.3	-1.3	-1.4
Financial Account	-0.9	-5.1	-4.7	-5.8	-4.6	-4.7	-4.8	-5.0
Net Direct investment	-1.3	2.0	1.0	-0.2	-1.2	-2.3	-3.4	-4.5
Portfolio investment	13.6	20.3	21.4	21.2	22.1	22.2	22.3	22.4
Financial derivatives	2.0	7.7	8.1	8.4	8.4	8.6	8.8	9.0
Net bank loans and other investment	-19.4	-29.1	-31.2	-31.8	-31.1	-30.8	-30.7	-30.5
Reserve assets (net change)	4.3	-6.0	-4.0	-3.5	-2.8	-2.4	-1.8	-1.4
Net errors and omissions	0.0	-0.5	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Hong Kong SAR authorities; and staff estimates and projections.

Table 4. Hong Kong SAR: Consolidated Government Accounts, FY 1996-FY 2003

(In percent of GDP)

	FY 1996	FY 1997	FY 1998	FY 1999	Projection							
					FY 2000		FY 2001		FY 2002		FY 2003	
					Staff	Auth.	Staff	Auth.	Staff	Auth.	Staff	Auth.
Revenue	17.5	21.2	17.1	18.9	18.9	19.4	20.1	19.8	19.5	18.9	19.8	19.3
Tax	11.7	12.0	9.1	9.1	12.5	12.3	13.4	...	13.8	...	14.5	...
Earnings and profits tax	7.0	6.9	6.0	5.4	4.8	4.9	5.9	...	6.2	...	6.3	...
Stamp duties	1.7	2.2	0.8	1.0	1.5	1.1	1.5	...	1.6	...	1.6	...
Nontax	5.9	9.4	8.1	9.9	6.4	7.1	6.8	...	5.6	...	5.3	...
Land sales	2.3	4.8	1.5	2.8	3.2	3.3	3.4	...	3.3	...	3.1	...
Investment income	0.7	1.4	3.1	3.4	2.4	2.9	2.3	...	2.3	...	2.2	...
Privatization	...	...	...	...	0.8	0.8	1.1	1.1	...	0.0	0.0	0.0
Expenditure	15.3	14.7	19.0	18.1	19.1	20.3	19.2	19.7	18.6	18.7	18.6	18.7
Current	11.3	11.3	13.0	14.1	14.8	15.7	14.8	14.1	14.7	14.1	14.6	14.1
Capital	4.0	3.4	5.9	4.0	4.3	4.6	4.4	5.6	3.8	4.6	4.0	4.5
Equity injections	0.7	1.8	1.6	0.7	1.3	1.3	1.3	1.3	0.7	0.7	0.7	0.7
Other capital	3.3	1.6	4.3	3.3	3.0	3.3	3.1	4.3	3.1	3.8	3.3	3.8
Overall balance	2.2	6.6	-1.8	0.8	-0.2	-0.9	0.9	0.1	0.9	0.2	1.2	0.7
Structural balance 1/ 2/	-0.2	-0.4	-3.2	-3.2	-4.6	-6.0	-4.2	...	-3.1	...	-1.2	...
Fiscal impulse 2/ 3/	0.0	0.1	2.9	0.0	1.8	3.2	-0.3	...	-1.1	...	-1.7	...
Fiscal reserves	14.6	34.6	34.4	36.0	34.8	35.1	33.3	32.6	31.0	30.3	29.4	28.9

Source: Data provided by the Government Secretariat Finance Bureau; and staff estimates and projections.

1/ The *structural balance* is the fiscal position after removing estimated budgetary effects of the business cycle, and indicates the medium-term orientation of fiscal policy. For details see Robert Hagemann, "The Structural Budget Balance: The IMF's Methodology," IMF Working Paper WP/99/05, (July 1999).

2/ Excludes land sales, investment income, privatization receipts, and equity injections.

3/ *Fiscal impulse* measures the stance of fiscal policy. For a detailed discussion, including the estimation procedure used, see "Hong Kong: Macroeconomic Impact of Recent Fiscal Measures," Quarterly Bulletin, Hong Kong Monetary Authority, (February 2000).

Table 5. Hong Kong SAR: Standard Vulnerability Indicators

	1995	1996	1997	1998	1999	2000
Public Sector						
Fiscal deficit (in percent of GDP)	-0.3	2.2	6.6	-1.8	0.8	-0.2 1/
Accumulated fiscal surplus (in percent of GDP)	13.7	14.6	34.6	34.4	36.0	34.8 1/
External Sector						
Export volume (percent change)	12.0	4.8	6.1	-4.3	3.7	16.7 1/
Domestic exports	2.0	-8.4	2.2	-7.9	-7.2	6.1 1/
Reexports	14.3	7.5	6.8	-3.7	5.4	18.2 1/
Import volume (percent change)	13.8	4.3	7.2	-7.2	0.1	17.4 1/
Current account (in billions US\$) 2/	...	...	-6.2	3.9	10.5	9.6 1/
Net equity inflow (in billions of US\$)	...	...	...	6.4	29.7	17.4 1/
Gross official reserves (in billions of US\$)	55.4	63.8	92.8	89.6	96.3	107.5
In months of retained imports	9.1	10.7	14.6	17.1	19.8	...
In percent of monetary base 3/	249.7	249.0	381.9	360.6	318.4	388.9
In percent of broad money	34.0	32.8	43.5	38.3	39.1	42.2
Short-term debt (in billions of US\$) 4/	212.2	185.2	182.6	99.4	84.0	72.5 Q3
In percent of gross reserves	383.0	290.1	196.7	111.0	87.2	67.4 Q3
1-yr forward exchange rate premium (in pips)	...	161	1153	3264	1035	-38
Real exchange rate (percent change)	-1.3	6.8	9.8	8.1	-6.5	-1.8 Nov.
Financial Sector						
HIBOR(3M)-LIBOR (3M) (In basis points)	21.2	-3.8	159.3	276.6	48.7	-31.4
Hang Seng Index (percent change)	-3.8	28.0	14.2	-28.7	35.6	23.2
Property prices (percent change)	-3.7	3.2	32.4	-30.7	-15.2	-7.2
Banking Sector 5/						
Deposit-loans ratio	59.5	62.8	64.6	89.4	113.0	141.4
Domestic credit growth (excluding trade finance)	11.1	17.1	24.4	-3.8	-7.2	2.3
Real credit growth	1.9	10.2	17.6	-6.4	-3.3	6.0
Capital adequacy ratio 6/	17.5	17.8	17.5	18.5	18.7	18.7 Q3
Nonperforming loans (in percent of total loans) 7, 8/	1.74	2.68	2.08	7.33	9.81	7.72 Q3
Net interest margin (in percent of interest-bearing assets) 7/	2.33	2.58	2.44	2.26	2.29	2.39 H1
Return on assets (post-tax)	1.82	1.79	1.65	1.02	1.18	1.44 H1
Net open spot position (in billions of US\$)	1.9	-1.6	-11.4	6.2	12.4	25.4 Nov.
Net open forward position (in billions of US\$)	3.9	8.3	12.0	-3.6	-5.2	-16.3 Nov.
Exposure to the Mainland (in percent of total assets)	3.7	4.5	4.9	4.5	3.6	3.5 H1
Exposure to property sector (in percent of domestic credit)	...	42	44.3	46.5	49.4	48.1 Q3
Contagion Indicators						
HK\$-Renminbi forward exchange rate correlation (daily)	...	...	0.57	0.73	0.57	-0.06
Hang Seng-NASDAQ correlation (daily)	0.88	0.73	0.05	0.22	0.84	0.75

Sources: Hong Kong SAR authorities, BIS, and staff estimates.

1/ Fund staff estimates.

2/ Data on current account balance is not available before 1998.

3/ Prior to 1998 figures are in percent of M1.

4/ For BIS reporting banks only.

5/ For all authorized institutions, unless otherwise specified.

6/ For all locally incorporated institutions.

7/ For all local banks.

8/ Refers to loans graded as "sub-standard", "doubtful", or "loss".

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 SAR 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.

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.

III. Resident Representative

The Hong Kong SAR sub-office of the Beijing resident representative's office was opened on September 23, 2000. Mr. William Lee, who since July 2000 has been informally functioning as the Resident Representative, formally assumed the position on that date.

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.

Hong Kong SAR is now compliant with the SDDS. In June 2000, the authorities released the first ever quarterly set of balance of payments accounts, covering transactions for 1999, and Q1 2000 accounts in September 2000—thus completing the last of the authorities' SDDS obligations. Hereafter, the annual and quarterly accounts will be released in accordance with the timing stipulated under the SDDS.

The Hong Kong SAR authorities plan to disseminate international investment position statistics starting June 2002 for the reference year 2001. They have also brought forward the time table for publishing external debt data from September 2003 to June 2002. The authorities also plan to begin publishing production-based GDP estimates at constant prices starting 2002.

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

- Domestic and foreign assets and liabilities of the banking system continue to be classified based on data collected from a separate survey rather than banking institutions' balance sheet information, the primary source data for banking sector's analytical accounts. Also, as disaggregated data are not available on the banking system's domestic assets and liabilities in accordance with the Fund's methodology, it is not possible to compile a monetary survey.

These data deficiencies hamper analysis of the external financial position of the banking system and competitiveness of services industries.

Hong Kong SAR

Survey of Reporting of Main Statistical Indicators

As of mid-December 2000

	Exchange rates	Inter-national reserves	Reserve/ base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index	Exports/ Imports	Current account balance	Overall government balance 1/	GDP/GNP
Date of latest observation	Dec. 8	Nov. 2000	Oct. 1999	Sep. 30	Oct 2000	Dec. 8	Oct. 2000	Oct. 2000	Q2 2000	FY 1999/00	Q3 2000
Date received	Dec. 8	Dec. 2000	Nov. 2000	Nov. 11	Nov 2000	Dec. 8	Nov. 2000	Nov. 2000	Oct. 2000	March 2000	Nov. 2000
Frequency of data	D	M	M	M	M	D	M	M	Q	A, Q	Q
Frequency of reporting	D	M	M	M	M	D	M	M	Q	A, Q	Q
Frequency of publication	D	M	M	M	M	D	M	M	Q	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/ Fiscal year beginning April 1.



INTERNATIONAL MONETARY FUND

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Washington, D. C. 20431 USA

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

On February 16, 2001, 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 recovery from the Asian crisis, which began in mid-1999, gained momentum in 2000. Initially, the turnaround was driven by net exports, reflecting the rapid growth of Mainland re-exports (by far the largest component of Hong Kong SAR's trade). Since late 1999, net exports gave way to domestic demand—spurred largely by restocking of inventories—as the dominant driver of growth. Private investment also picked up from the low base of 1999. However, the recovery in consumption has been somewhat slower. The unemployment rate has declined slowly from March-May 1999 peak of 6¼ percent to 4½ percent in late 2000. The prolonged deflation—which has helped unwind the appreciation of the real exchange rate during the Asian crisis, thereby improving external competitiveness—has eased considerably.

Market confidence has strengthened. Riding on strong foreign portfolio inflows, stock prices surged in the early part of the year, before weakening in line with the U.S. market to settle around pre-crisis levels. The capital inflows also pushed money market rates below those in the United States for the better part of 2000. Overall, monetary conditions are liquid, as reflected in

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. This PIN summarizes the views of the Executive Board as expressed during the February 16, 2001 Executive Board discussion based on the staff report.

a rising bank deposit-to-loan ratio. Lending rates, especially on mortgages, have also declined substantially but remain high in real terms due to deflation.

Hong Kong SAR banks endured the recession relatively well, despite the high exposure to the property sector. At an average 18 percent, bank capitalization remained well above the Basle standard, the ratio of nonperforming to total loans has started to decline from its peak of 10½ percent in the third quarter of 1999, and profitability was up. The HKMA also embarked on a gradual liberalization of remaining interest rate rules operated by the Hong Kong Association of Banks—the first phase of which was completed in July 2000. The final phase is scheduled for July this year. Despite the strong recovery, loan growth remains low, with the pick up in investment being financed mainly internally and through the equity market.

Hong Kong SAR's budgetary position has traditionally been in surplus, and fiscal policy generally has not been countercyclical except during the Asian crisis. In response to the crisis, the government eased fiscal policy temporarily, mainly by bringing forward large public sector projects. With the improvement in the economic situation, public investment has been reduced. However, for FY 2000 the government envisages a slightly higher fiscal deficit than budgeted, reflecting a shortfall in privatization revenue.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They were impressed with the rapid economic recovery in 1999-2000 after a short but painful period of adjustment following the Asian crisis. Directors noted that real GDP rebounded, unemployment declined, and market confidence remained strong, despite regional uncertainty and high oil prices. They credited this turnaround to the flexibility of Hong Kong SAR's markets, and to the authorities' pragmatic handling of fiscal policy during the recession.

Directors observed that the continued fall in prices did not reflect generalized demand weakness, but mainly the lagged response of rental contracts to the correction in property prices. They pointed out that deflation had improved Hong Kong SAR's competitiveness by reversing the real exchange rate appreciation that had occurred during the early stages of the Asian crisis. Looking ahead, Directors noted that, according to staff estimates, economic growth in 2001 is likely to slow to its trend rate of around 4 percent, reflecting the fading impetus from stock building and a weaker external environment, while deflation will give way to low inflation. However, downside risks remain, especially if the external environment worsens, and will require continued vigilance by the authorities.

Directors observed that Hong Kong SAR's rules-based approach to economic policy has been effective and reiterated their strong support for the linked exchange rate system, which has been underpinned by commodity and factor price flexibility in the domestic market and continues to provide a stable and transparent policy framework. They observed that the measures introduced by the Hong Kong Monetary Authority in 1998 to strengthen the currency board appear to be working well and welcomed the authorities' intentions to continue refining the system as circumstances warrant.

Directors commended the authorities' long record of skillful fiscal management. They praised the pragmatic injection of fiscal stimulus during the Asian crisis in 1998-99 when, within a medium-term framework of returning to budget balance, traditional surpluses gave way to a deficit. Directors viewed the fiscal stance in 2001-02, as charted in last year's medium-range forecast, to be appropriate.

Over the longer term, Directors noted that the aging of the population and the need to upgrade human capital continually to maintain a competitive service-based economy would put pressure on health and education spending, while revenue growth could slow if stamp duties and other property-related revenues lag behind GDP growth. In this context, Directors welcomed the timely establishment of the Task Force on Review of Public Finances to study the causes of the recent deterioration in the operational fiscal balance, and of an Advisory Committee to examine the pros and cons of a broad-based goods and services tax and alternative revenue-enhancing measures. In this context, a few Directors noted that the particular advantages of Hong Kong SAR's tax system should not be undermined.

Directors recommended that the authorities also consider measures to control the growth in health spending, such as greater cost-sharing arrangements in the area of public health, including more private insurance and higher user fees, with appropriate safeguards for the needy.

Directors expressed concern that income disparity had worsened during the Asian crisis, as real incomes of low-skilled workers declined significantly. They supported the authorities' approach of tackling this issue through greater public efforts in raising skill levels, while also stressing the need to have an adequate safety net in place, especially in view of the aging population.

Directors observed that the banking system had demonstrated its resilience during the turbulence of the Asian crisis. They attributed this resilience to prudent banking practices, strong legal institutions, and an effective supervisory framework. Directors welcomed the scheduled removal of the remaining deposit interest rate ceilings in July 2001, and commended the efforts to establish a commercial credit reference agency.

Directors welcomed the recent steps to reform the securities market that would enhance Hong Kong SAR's reputation as an international financial center, including, in particular, the establishment of a U.S. dollar clearing system in Hong Kong SAR; the proposed introduction of deposit insurance; the introduction of the composite Securities and Futures Bill; and the move to risk-based supervision of banks and regular assessment of cross-market risks. Directors also welcomed the authorities' interest in participating in a Financial Sector Assessment Program.

Some Directors observed that, while the banking sector and equity markets in Hong Kong SAR continue to intermediate the economy's financing needs efficiently, there remains further scope to strengthen the international financial center through the deepening of the private debt market. Directors also welcomed the progress achieved in disposing the domestic equities acquired during the stock market intervention in August 1998 in an orderly and transparent manner.

Directors noted that China's upcoming accession to the WTO is likely to have significant effects over time on the economy of Hong Kong SAR. They observed that, while Hong Kong SAR is likely to lose some traditional activities, such as trans-shipment trade and low value-added financial services, new opportunities will open up as demand for advanced financial and managerial services from the Mainland is expected to rise. Although available studies suggest that, on balance, the impact of accession would be beneficial for Hong Kong SAR, they stressed that, in order to take full advantage of the increased opportunities, Hong Kong SAR will need to continue to pursue steadfastly its efforts to upgrade the economy's infrastructure and human capital.

Directors noted that, although Hong Kong SAR is one of the most open economies in the world, domestic competition issues need to be monitored closely, especially in some of the unregulated sectors, as the lowering of business costs would remain critical to the economy's future. In this connection, they urged the authorities to keep under review the most appropriate ways of ensuring transparent and fair competition, including the option of establishing a formal competition law. They also stressed the importance of improving the quality of corporate accounts and disclosure, especially for small and medium-sized enterprises.

Directors welcomed Hong Kong SAR's compliance with the Fund's Special Data Dissemination Standard. They commended the authorities' efforts to publish data on their international investment position and bring forward the publication of external debt data to mid-2002. They urged the authorities to continue to make progress in publishing a monetary survey and fiscal accounts in a standardized international format.

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.

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

	1997	1998	1999	2000 Est.
Real GDP (percent change)	5.0	-5.3	3.1	10.0
Real domestic demand (contribution)	8.4	-10.3	-5.0	9.0
Foreign balance (contribution)	-3.4	5.0	8.1	1.0
Saving-investment balance (percent of GDP)	-3.1	1.4	5.6	5.6
Gross domestic saving	31.3	30.4	30.7	31.9
Gross domestic investment	34.4	29.0	25.1	26.4
Inflation (percent change)				
Consumer price	5.8	2.8	-4.0	-3.7
GDP deflator	5.8	0.6	-5.3	-6.3
Employment (percent change)				
Unemployment rate (percent)	3.2	-1.3	-0.5	3.4
Real wages	2.2	4.7	6.3	5.0
	1.0	0.1	3.8	...
Government budget (percent of GDP) 1/				
Revenue	21.2	17.1	18.9	18.9
Expenditure	14.7	19.0	18.1	19.1
Consolidated budget balance	6.6	-1.8	0.8	-0.2
Reserves at March 31	34.6	34.4	36.0	34.8
Money and credit (percent change, end-period)				
Narrow money (M1)	-4.3	-5.0	13.9	...
Broad money (M3)	8.2	10.5	7.7	...
Loans for use in Hong Kong SAR	24.4	-3.8	-7.2	...
Interest rates (percent, end-period)				
Best lending rate	9.5	9.0	8.5	...
Three-month HIBOR	9.1	5.1	5.7	...
Merchandise trade (percent change)				
Export volume	6.1	-4.3	3.7	16.7
Domestic exports	2.2	-7.9	-7.2	6.1
Reexports	6.8	-3.7	5.4	18.2
Import volume	7.2	-7.1	0.2	14.8
Export value	4.2	-7.4	0.1	16.7
Import value	4.9	-11.5	-2.5	17.9
External balance (in billions of US\$)				
Merchandise trade balance	-17.3	-7.8	-3.2	-6.3
In percent of GDP	-10.1	-4.8	-2.0	-3.8
Current account balance	-6.2	3.9	10.5	9.6
In percent of GDP	-3.6	2.4	6.6	5.9
Foreign exchange reserves (in billions of U.S. dollars, end of period)	92.8	89.6	96.3	107.5
(In months of retained imports)	14.6	17.1	19.8	...

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

1/ Fiscal year.