December 2010
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People's Republic of China—Hong Kong Special Administrative Region: 2010 Article IV Consultation Discussions—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

In the context of the 2010 Article IV consultation discussions with Hong Kong SAR, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation discussions, prepared by a staff team of the IMF, following discussions that ended on October 28, 2010, with the officials of the People's Republic of China—Hong Kong SAR on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 5, 2010. 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.
- Staff statements updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 22, 2010 discussion of the staff report that concluded the Article IV consultation discussions.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

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

Staff Report for the 2010 Article IV Consultation Discussions

Prepared by the Staff Representatives for the 2010 Consultation Discussions with the People's Republic of China—Hong Kong Special Administrative Region

Approved by Nigel Chalk and Tamim Bayoumi

November 5, 2010

Context: Two potent forces continue to influence Hong Kong SAR's prospects: the unprecedented monetary policy easing in the United States and the solid domestic recovery, in part driven by spillovers from the Mainland. While the substantial expansion of the monetary base—which began in 2008—has stopped, the banking system remains exceptionally liquid and credit growth is now beginning to pick up. Despite the government's efforts—with tighter lending standards, higher real estate transaction taxes, and an increased supply of land—property prices continue to rise.

Main Issues:

- The most pressing challenge over the near term will be to ensure that the ongoing acceleration of property price inflation does not translate into financial risks or unduly amplify the macroeconomic cycle.
- The government should continue to proactively deploy countervailing prudential regulations—to ensure the quality of bank credit remains high—and put in place a sufficiently counter-cyclical budget in the coming fiscal year. However, given the scale of the underlying forces at work—including the strong economic recovery, an improving labor market, and very loose monetary conditions—such policies will, at best, only be able to mitigate the amplitude of the unfolding macroeconomic and asset price cycle.
- Over a longer horizon, policies will need to ensure that Hong Kong SAR can fully capitalize on its unique status as an offshore renminbi center and adapt to the ongoing changes in the global financial regulatory environment.

Mission. A staff team consisting of N. Chalk (Head), A. Ahuja and S. Barnett (APD) visited Hong Kong SAR, October 18−28, 2010. Messrs. Luo, and Yung (OED) participated in the discussions.

Exchange arrangement. Currency board with a trading band of HK$7.75–7.85 per U.S. dollar.

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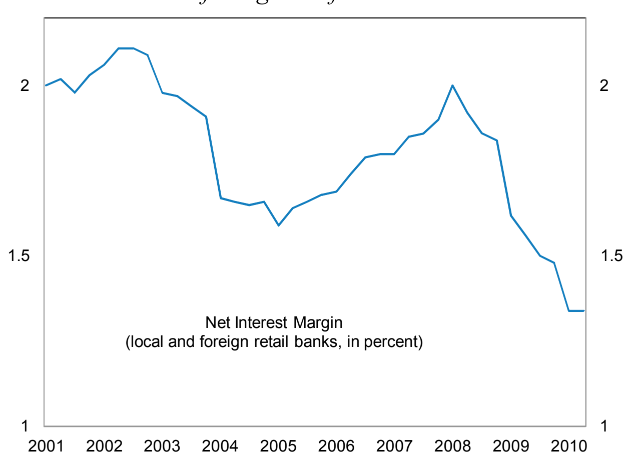
I. A RESURGENT ECONOMY

1. ***Growth***. The economy is recovering briskly with all demand components resuming a strong growth trajectory (Figure 1). Growth is likely to reach 6¾ percent this year and moderate to 5-5½ percent in 2011. Net exports have been buoyed by vigorous growth in the Mainland and the ongoing global recovery. Investment has benefited from the implementation of various multi-year public infrastructure projects and private spending on machinery and equipment has picked up. At the same time, consumption bounced back as labor markets improved and confidence returned. The predominant near-term risks to the outlook are from a weaker external environment, notably an increase in European sovereign risks or a renewed slowdown in the United States. If realized, these risks would spill into Hong Kong SAR through both trade and financial channels.

2. ***Inflation***. Inflation has rebounded from the lows seen in 2009, driven by higher costs for utilities and certain services (such as education, tourism, and transportation). In the coming months, higher property prices will begin to feed through into the housing component of the consumer price index. These price pressures will become increasingly visible in the coming months with inflation expected to reach around 5 percent by end-2011.

3. ***Banking system***. Hong Kong banks have withstood well the financial market volatility of the past year. Despite the compression of net interest margins, profits have risen due to higher fee, trading, and investment income. Capital levels are well in excess of regulatory requirements, average loan-to-deposit ratios are low, and liquidity ratios are very high. At the end of 2010, the temporary blanket deposit guarantee will expire; this should have little impact on the banking system with the increase in the protection limit of the Deposit Protection Scheme from HK$100,000 to HK$500,000 starting from January 1, 2011.

Net interest margins have declined since the onset of the global financial crisis



Banking System Indicators
(end-June 2010, in percent)

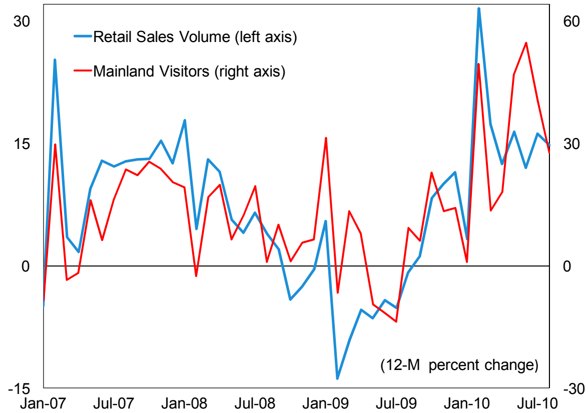
NPL ratios	
Special mention loans	1.53
Classified loans	0.96
CAR	16.2
Tier 1 capital	12.6
Loan-to-deposit ratio 1/	
Total	61.3
HK$	77.6
Liquidity ratio	40.9

1/ End September 2010.

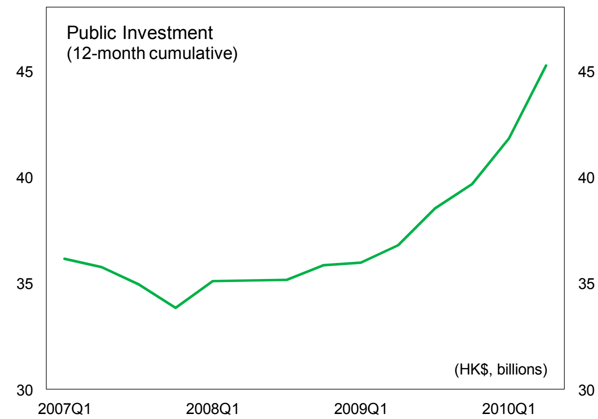
Figure 1. A Robust Recovery

Growth has bounced back with a robust recovery in all components of demand. Inflation has moved onto an upward trajectory.

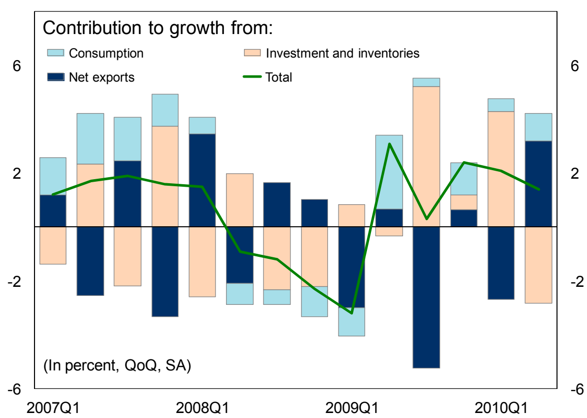
Retail sales have been strong, helped by inflows of Mainland tourists.



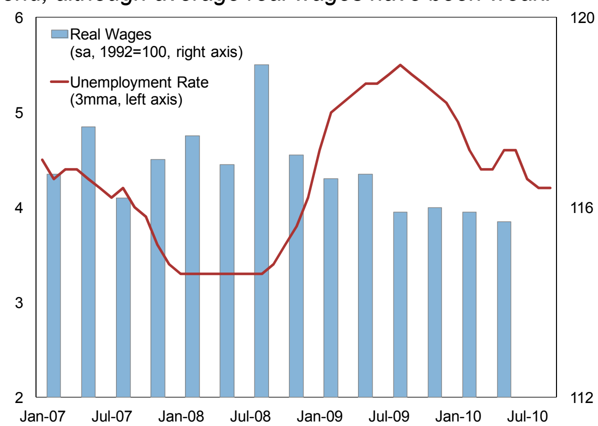
Public investment is picking up as large-scale infrastructure projects get underway.



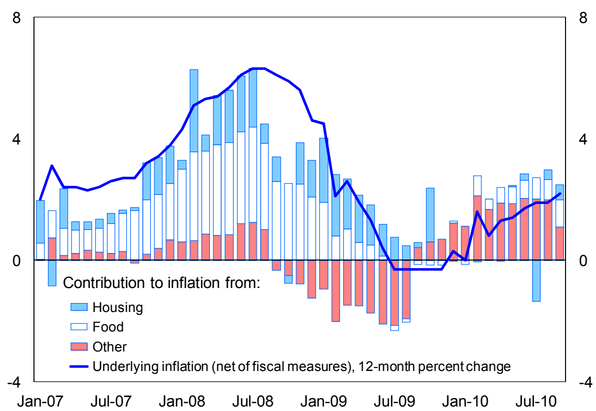
In the second quarter, net exports began to contribute positively to overall growth.



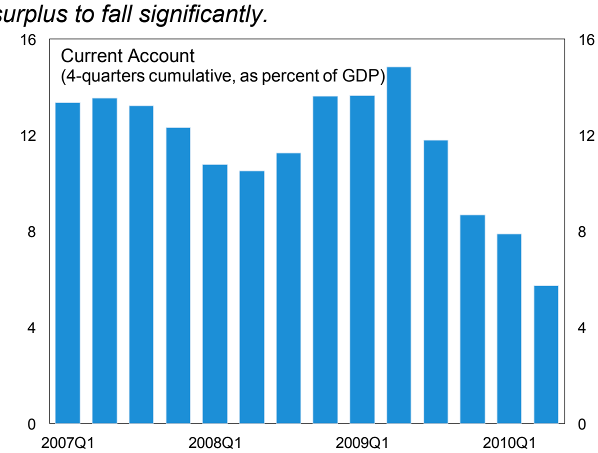
For the past year, unemployment has been on a downward trend, although average real wages have been weak.



Inflation is rising and increases in housing costs have yet to feed through to the headline numbers.



In 2009, weak external demand led the current account surplus to fall significantly.

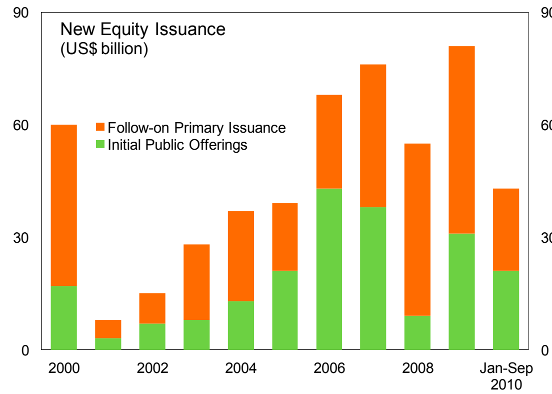


Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.

II. Capital Inflows and Financial Conditions

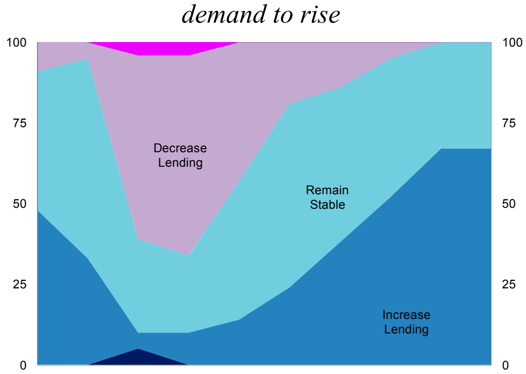
4. ***Inflows***. As the global financial crisis unfolded, extraordinary capital inflows caused the Hong Kong dollar to repeatedly trigger the strong side of the convertibility undertaking. This, in turn, led to the purchase of US$83 billion (or 40 percent of GDP) of foreign currency in 2008–09 and a tripling of the monetary base (Figure 2). Initially, these inflows appeared to be a product of Hong Kong residents repatriating funds and safe haven flows into the Hong Kong banking system. By early 2009, however, these flows were being driven by a rising preference for Asian assets, attracted by the strong recovery and an upswing in new equity issuance, particularly by Mainland companies. Indeed, almost US$80 billion was raised in the Hong Kong stock market in 2009. In addition, an indeterminate amount of inflows have arisen from Mainland residents' purchases of Hong Kong real estate. Since the early part of this year, flows into the Hong Kong dollar have reversed and the exchange rate has moved to the interior of the band. In part, this has been a result of proceeds from public offerings by Mainland companies being moved out of Hong Kong dollar assets and repatriated to the Mainland. As the inflows have abated, the monetary base has stopped expanding. Nevertheless, interbank rates remain close to zero and real interest rates are negative and falling. In addition, the Hong Kong dollar has depreciated by 4 percent in nominal effective terms since mid-year, adding to the expansionary conditions.

New equity issuance has been large and, after a brief lull earlier this year, is now starting to resume



5. ***Outlook***. With the prospects of U.S. monetary policy remaining expansionary for an extended period, there is still a potential for inflows to resume. In addition, after a pause in the middle of this year, initial public offerings have resumed and a large pipeline of new equity issuance is planned. This could create lumpy flows into the Hong Kong dollar, which would then be reversed once the proceeds are drawn down. However, even without further inflows, there is still a very large liquidity overhang remaining in the banking system and this will be a feature of the local environment for some time to come. With the economic recovery more entrenched, the monetary transmission mechanism has reactivated and

The majority of loan officers expect credit demand to rise

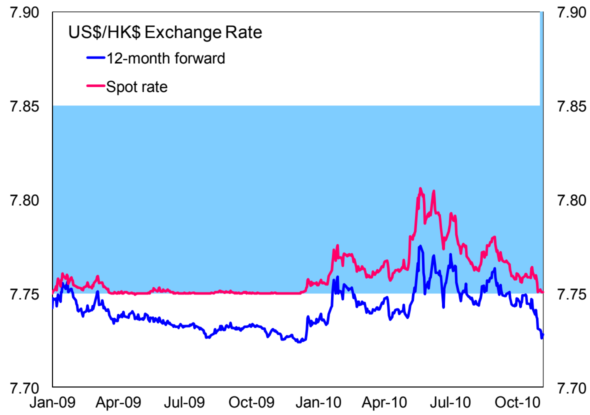


Note: Represenst the expectation of domestic loan demand over the next six months.

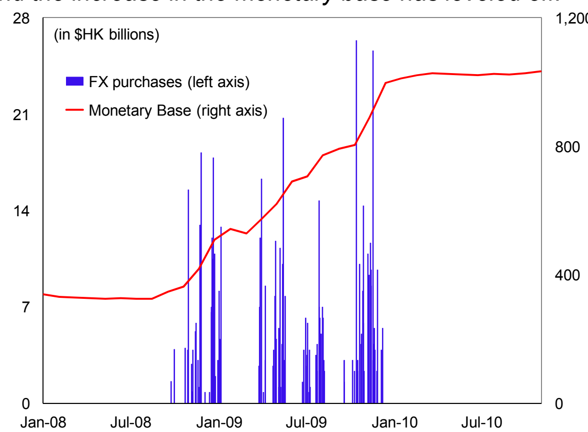
Figure 2. Financial Market Developments

Inflows have eased and the exchange rate has moved toward the center of the band. Nevertheless, there is significant liquidity in the system and credit is beginning to expand.

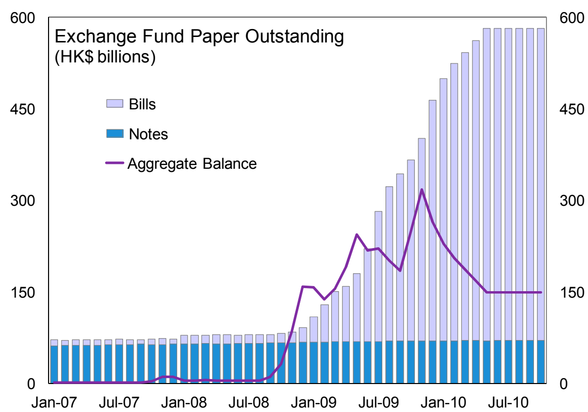
As inflows have abated, the exchange rate has moved away from the strong side of the convertibility band.



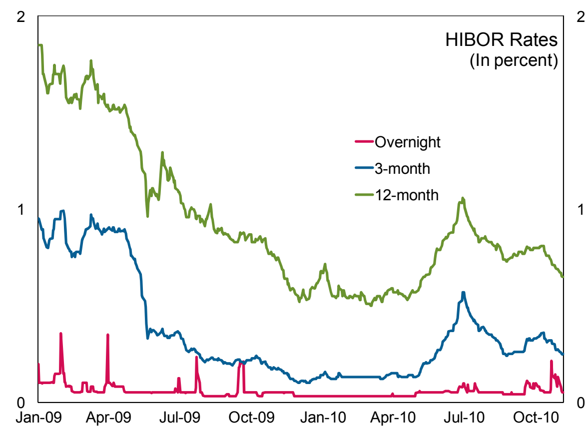
As a result, purchases of foreign currency have stopped and the increase in the monetary base has leveled off.



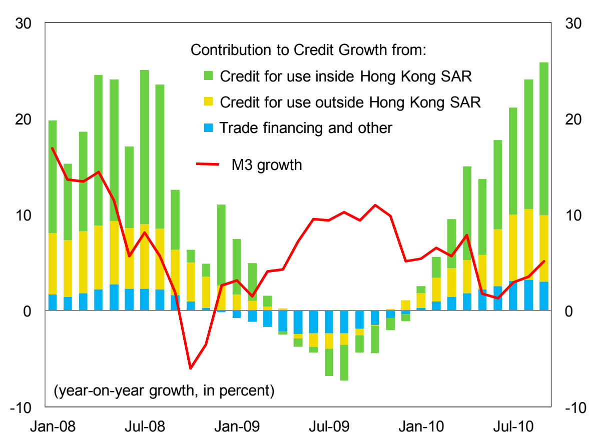
Part of the expansion of the Aggregate Balance has been absorbed through the issuance of Exchange Fund Paper.



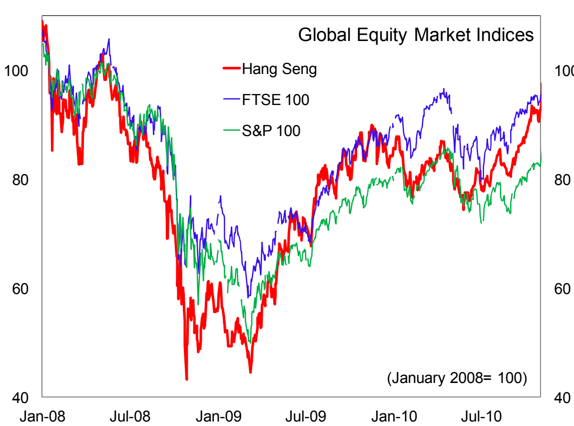
High levels of Hong Kong dollar liquidity mean short-term interest rates remain close to zero.



Credit growth began to pick up earlier this year.



While equities have moved broadly in line with global markets.



Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.

this liquidity is now beginning to translate into a brisk expansion of new credit. Albeit starting from a low base, loans for use inside Hong Kong SAR are now 21 percent higher than the levels reached a year ago. Around one-half of the growth in credit this year has been directed to the property sector. In addition, forward looking loan officer surveys point to a further expansion of lending in the coming months.

III. The Credit-Asset Price Cycle

6. ***Developments***. Residential property prices continue to increase quickly, at a rate that exceeds most regional comparators (Figure 3). Price rises that were initially concentrated in the luxury end of the market have now filtered down into the mass market. For the more expensive segments of the market (flats with saleable area above 100 square meters), prices are now 14 percent above the nominal levels reached in 1997 while, for the mass market, prices are fast approaching their historical peaks. Mortgage lending has picked up and there has been a shift toward floating rate mortgages priced off of interbank rates, increasing the risks to household balance sheets from a sudden reversal of the current low interest rate environment. Nevertheless, this rising cost of housing does also seem to be supported by underlying fundamental forces of supply and demand (see Box 1). In particular:

Recent Asset Price Changes

(As of end-September 2010, YoY change, in percent)

	Property	Equity
Singapore	22.9	15.9
Hong Kong SAR	**18.9**	**6.7**
Taiwan Province of China 1/	18.1	9.7
Japan 2/	13.6	-7.5
Australia	11.5	-2.2
China	10.1	-4.5
New Zealand	3.1	0.9
Indonesia	2.7	41.9
Thailand	2.4	36.0
Korea	1.7	11.9

Sources: CEIC and staff calculations.

1/ Taipei city only.
2/ National capital condominium price.

- The move to interbank rate-linked mortgages has lowered financing costs and household incomes have grown substantially over the past decade. This has meant that housing is far more affordable today than it was in the late 1990s;

- The pipeline of future supply is relatively tight and is likely to be concentrated in the luxury segment of the market where developers' margins are the greatest;

- The vacancy rate for the mass market has been on a steady downward trend for a number of years, which would seem to be indicative of a tight supply-demand environment;

Supply conditions are unusually tight

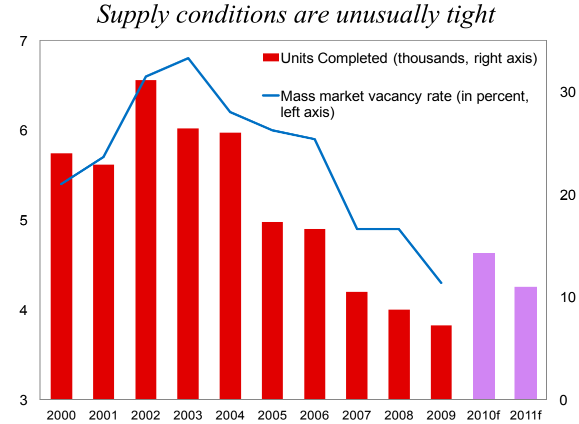
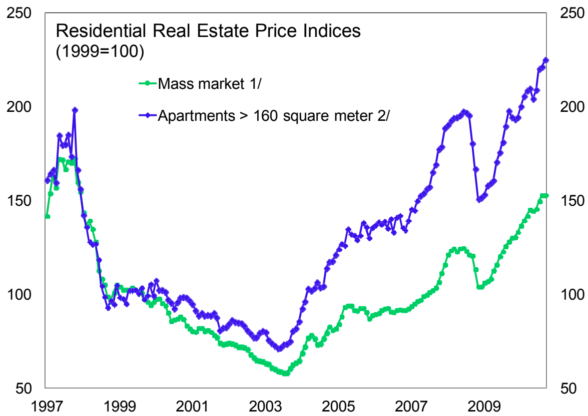


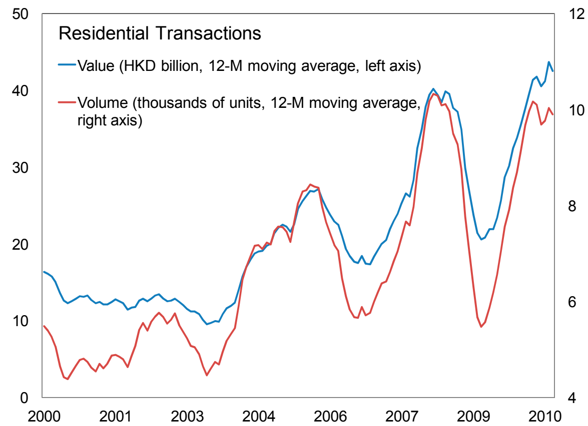
Figure 3. The Real Estate Market

Residential property prices have continued on an upward trend. Mortgage credit is beginning to expand, although is being managed prudently.

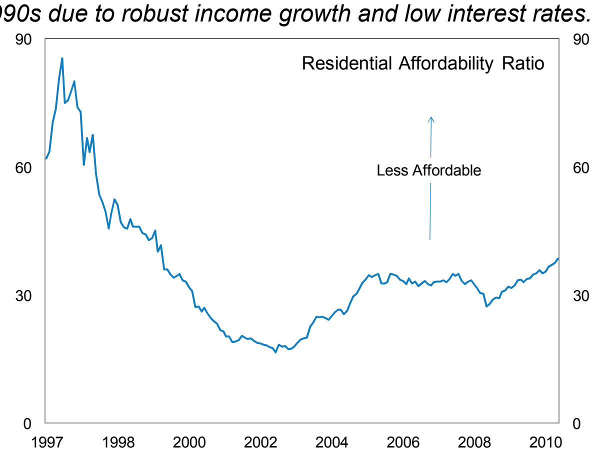
Residential property prices continue to rise across all market segments.



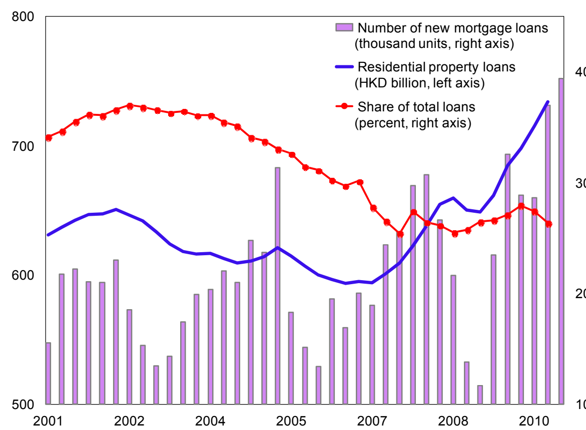
And transaction volumes are strong.



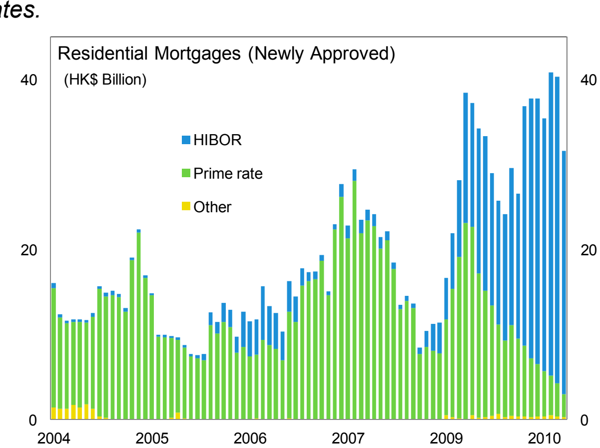
Nevertheless, housing is more affordable now than in the late 1990s due to robust income growth and low interest rates.



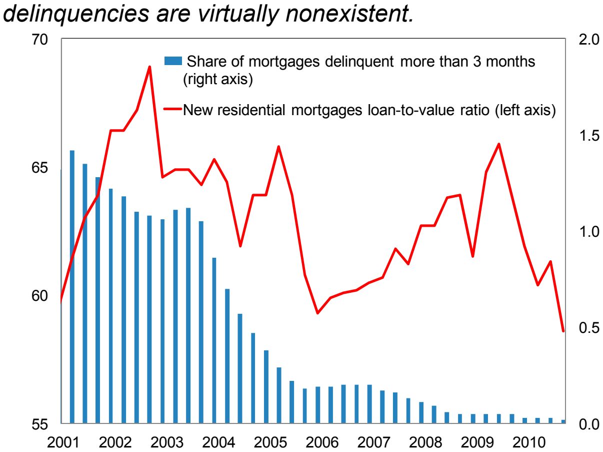
Credit to housing has grown in line with total lending.



With an increasing share of mortgages priced off of interbank rates.



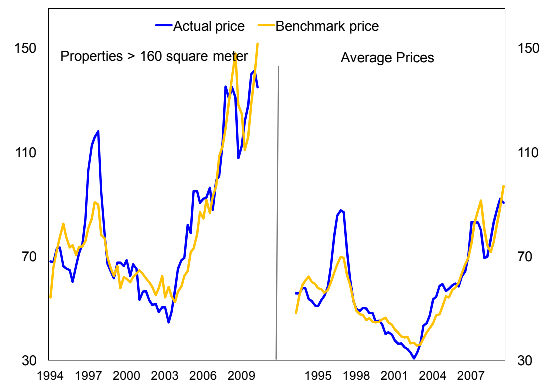
Loan-to-value ratios on new lending remain low and delinquencies are virtually nonexistent.

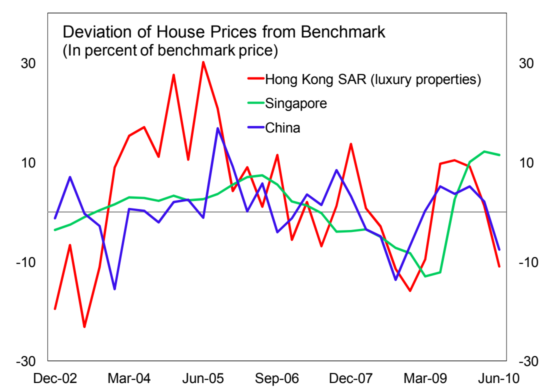


Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.
1/ Defined as apartments less than 100 square meters (Class A, B, and C).
2/ Class E.

Box 1: Are Residential Property Prices Overvalued? [1]

To examine how far Hong Kong residential property prices have deviated from underlying economic forces of supply and demand, a benchmark price is constructed based upon a "no arbitrage" condition between renting and buying a home. In particular, the benchmark represents that price which would equate the annual market rent to the cost of owning a property, taking into account mortgage costs, property taxes, risk premia, expected capital gains, and other costs of ownership. This benchmark has the potential to provide an early warning indicator of market exuberance—i.e., of increasing discrepancies between rental values and market prices—that can be measured both across cities and over time. It is important to note, however, that this measure is just one indicator to examine and does not fully capture all scenarios where prices can become divorced from fundamentals. For example, both rents and prices could rise rapidly and in unison (resulting in actual and benchmark prices that rise in sync). These higher housing costs could ultimately prove not to be supported by underlying improvements in incomes, leading to an eventual correction in both prices and rents.





The key insights offered by this analysis are:

- Although prices are rising rapidly, data up to the first half of 2010 does not suggest that prices are out of line with fundamentals, unlike in 1997. This is true both for the luxury market and for the average property price for Hong Kong SAR as a whole.
- The prudential measures unveiled since October 2009 appear to have had an impact on price growth, reducing the gaps between market and benchmark prices.
- Over the past decade, misalignments in Hong Kong house prices have corrected quickly. Deviations from benchmark prices, on average, have a half life of around 2 to 4 quarters, which is comparable to that of Singapore (5 quarters). This differs from the behavior in the large industrial economies prior to 2008, where deviations from benchmark prices were more persistent, allowing for an accumulation of vulnerabilities to build up, ending in an eventual abrupt adjustment.

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[1] See A. Ahuja and N. Porter, "Are Housing Prices Rising Too Fast in Hong Kong SAR?" IMF Working Paper, forthcoming.

- Rental yields have been fairly constant with prices and rents moving in tandem across various market segments;

- There has been a structural surge in demand—particularly for luxury properties—from both Mainland buyers but also from high net worth individuals relocating to Hong Kong SAR to work in the expanding financial services industry.

7. ***The policy response***. The authorities' response to higher housing costs has proceeded in five broad areas (Box 2):

- *Protecting the integrity of the financial system*. This has included lowering loan-to-value ratios and imposing stricter limits on debt service ratios. In addition, qualification criteria for mortgage insurance have been tightened. Officials indicated that regulatory requirements were being conservatively applied and that they were fully committed to tighten such regulations further, if needed, to ensure that lending is managed prudently and credit quality remains high. The authorities highlighted that banks had to observe the 50 percent debt servicing ratio limit of mortgage applicants. In addition, banks were required to undertake a borrower "stress test" to ensure that customers' debt servicing ratios would not exceed 60 percent, assuming at least a 200-basis-point increase in the prime-based mortgage rate (even though mortgages priced off of the interbank rate were currently far cheaper). The authorities did highlight, however, that, in order to better monitor debt service ratios, the current credit reporting systems should be modified to provide lenders with access to information on all outstanding mortgage borrowing by individual customers (currently, only mortgages delinquent for more than 60 days are reported).
- *Dissuading speculation*. The government has raised stamp duty for luxury properties, prohibited confirmor transactions (i.e., the selling of a property before the original transaction is completed) for properties being sold in the primary market, and increased the penalties for canceling primary market transactions.
- *Increasing the availability of land*. Efforts are underway to ensure that sufficient land is made available to build, on average, 20,000 new private units per year over the next ten years, supplementing the Application List System with government-initiated land sales, and liaising with the Mass Transit Railway (MTR) Corporation and the Urban Renewal Authority to bring residential sites to market.
- *Consumer protection*. The authorities noted that pricing information in the property market could be distorted by a lack of transparency in transactions and that a small number of high profile transactions can have an undue psychological impact on expectations, potentially creating incentives to manipulate and distort the market. As a result, several steps have been taken to ensure transparency in the sale of uncompleted first-hand flats and increase the disclosure requirements for property transactions.

Box 2: Property Market Measures

October 2009

- lowered the loan-to-value ratio (to 60 percent) for luxury properties over HK$20 million;
- reduced the maximum loan size that could qualify for mortgage insurance (to HK$12 million for coverage up to 90 percent loan-to-value and HK$6 million for coverage up to 95 percent);
- suspended the provision of mortgage insurance for non owner-occupied properties.

2010–11 Budget (February 2010)

- increased the stamp duty on property transactions worth more than HK$20 million (from 3.75 to 4.25 percent) and required stamp duty for such transactions to be paid within 30 days after the signing of a purchase agreement;
- designated six sites on the Application List for government-initiated auction or tender and committed to work with the MTR Corporation and the Urban Renewal Authority to increase land supply.

August 2010

- lowered loan-to-value ratios to 60 percent for residential apartments costing above HK$12 million;
- capped the maximum debt service ratio at 50 percent and required the banks to ensure that this ratio does not exceed 60 percent in the event that interest rates increases by 200 basis points;
- prohibited the resale of new uncompleted flats before the initial sale is completed;
- raised the forfeiture amount for the cancellation of transactions in new flats to 10 percent of the consideration (from 5 percent);
- further tightened the availability of mortgage insurance for properties worth more than HK$7.2 million.

Chief Executive's Policy Address (October 2010)

- establish a new Steering Committee on Housing Land Supply chaired by the Financial Secretary to coordinate building up a sufficiently large land reserve to ensure stable land supply for the residential property market and make sufficient land available to build , on average, 20,000 new units per year in the next 10 years;
- provide land for 15,000 units of new public rental housing per year and strengthen the monitoring of income and asset eligibility criteria for existing public housing tenants;
- the "My Home Purchase Plan" will provide "no frills" rental housing to tenants for a maximum of five years with subsidies for them to purchase property within two years after the termination of tenancy;
- remove real estate from the list of eligible investments under the Capital Investment Entrant Scheme (which offers Hong Kong residency to those investing more than HK$10 millon);
- revitalize the secondary market for Home Ownership Scheme properties by providing loan guarantees to those owners that want to pay the premium needed to sell their property on the open market.

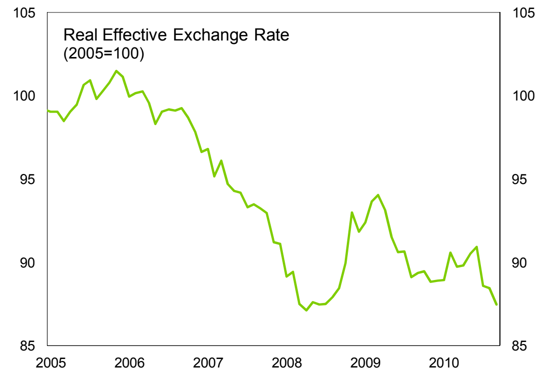
- *Easing the impact of high housing prices on lower income groups*. The government has committed to produce around 15,000 units per year for public rental housing and has introduced a new rent-to-buy scheme for those groups that are not eligible for public rental housing.

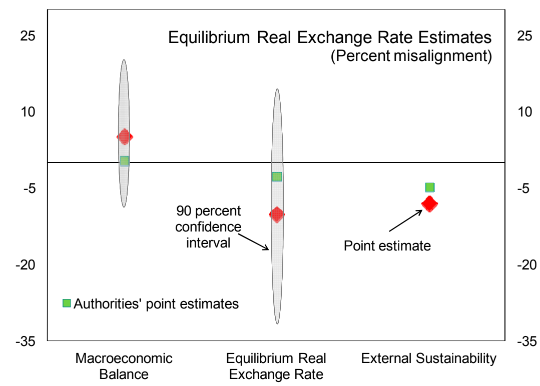
In addition to these measures, to temper demand for luxury properties from nonresidents, the government has suspended the program that offers Hong Kong residency to those investing more than HK$10 million in real estate.

8. ***Potential risks***. Even with these various policy measures, a credit-asset price cycle is now underway and, in the coming months, there is a risk it could accelerate. Rising property values are increasing the availability of collateral that can then be used to support new borrowing. More credit, in turn, boosts the demand for housing, adding to property price inflation and amplifying the cycle through a financial accelerator process. Higher real estate costs are already feeding into rents and, in the coming months, will become an increasing feature of consumer price inflation and possibly wages. A continued rapid increase in property and consumer price inflation could risk pushing the real effective exchange rate somewhat above its equilibrium level (the current level is seen by staff and the authorities as being broadly in line with medium-term fundamentals (Box 3)). Such an adverse scenario would create the conditions for an offsetting, and potentially abrupt, downswing in both the property market and in activity as the current propagation mechanism shifts into reverse. One possible trigger for such a correction is a shift to a tighter monetary policy stance in the United States, which would mean the reversal of the cycle could come at a time when Hong Kong interest rates are beginning to rise. Alternatively, a correction in house prices on the Mainland could also spill over into Hong Kong SAR. Depending on the amplitude of the upswing, the resulting downturn could prove both protracted and painful, necessitating broad-based deflation in goods, labor and asset markets to restore the economy back to equilibrium. The authorities recognized this risk but emphasized that they had put in place a range of policies, on a number of fronts, to tackle the imbalances in the property market and were prepared to take other measures, as needed. They had taken away important lessons from past cycles and were acting preemptively to ensure that exuberance was contained and that marginal borrowers were protected in the event of a downturn. Further, they noted, and staff agreed, that, as a result of policy actions, they were much better prepared now than in any past cycle to deal with housing price pressures and safeguard financial stability.

Box 3: Exchange Rate Assessment[1]

The current value of the Hong Kong dollar continues to be broadly in line with the level suggested by medium-term fundamentals.





Over the past year, the real exchange rate has moved only modestly, depreciating around 2 percent over the last 12 months. The various model-based assessments indicate that the exchange rate is close to its equilibrium level. The *macroeconomic balance approach* would suggest that the real effective exchange rate is around 5 percent above its medium-term value. The *equilibrium real exchange rate and external sustainability approaches* both show the real exchange rate to be modestly below its medium-term value. These estimates are broadly in line with those of the Hong Kong authorities.

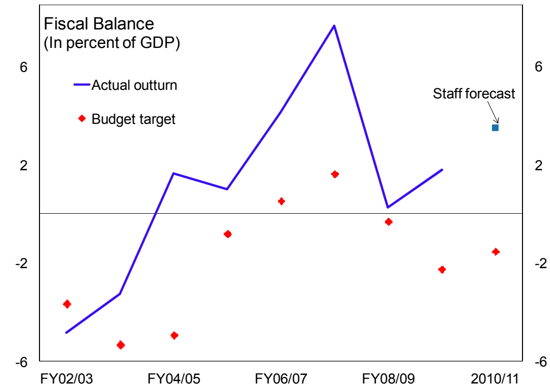
Beyond these model-based estimates, there does not appear to be a clear indication of a fundamental disequilibrium in the balance of payments. Nominal unit labor costs are falling and the stock market has largely moved in line with global trends. The rapid pace of housing price inflation—and its feed through to inflation—does present a concern going forward, but, at present, does not suggest that the current level of the real effective exchange rate is either under- or overvalued.

[1] Staff assessments are based upon panel regressions estimated by generalized method of moments covering six international financial centers (Belgium, Hong Kong SAR, Luxembourg, Netherlands, Singapore, and Switzerland). The authorities' assessments use a similar approach, but with slightly different model specifications.

IV. THE NEED TO WITHDRAW FISCAL STIMULUS

9. ***Developments***. In the 2010/11 Budget the government continued with temporary stimulus measures—including waiving two months' rent for public housing tenants, providing additional social assistance and old age allowances, and reducing or waiving taxes and fees—and forecasted a deficit of 1½ percent of GDP. However, given the revenue trends in the first part of this fiscal year—with strong tax performance and substantially higher land-related revenues—staff considers it likely that the fiscal position will end up with a sizable surplus.

Budget outturns have systematically overperformed



10. ***Policies***. In the context of a strong economic recovery, the case for continued fiscal stimulus is waning. As such, staff considers that the one-off measures that were put in place to provide support to the economy over the past two years should be discontinued in the coming 2011/12 Budget, and that fiscal policy should provide a greater countervailing force on the economy. Staff argued that some consideration could be given to further increasing taxes on property—either through higher stamp duties or an increase in the rates (a small ad valorem tax levied on the rentable value of a property)—although such measures would probably have a relatively small impact on the trajectory for house prices. The authorities indicated that they would carefully consider all the tools at their disposal and, indeed, had already raised stamp duties on luxury properties. However, they noted there was, as yet, no decision to change taxes. Staff supported continuing with the planned increase in infrastructure investment, which will be around 3 percent of GDP per year over the next several years. This spending encompasses large, multi-year projects that will increase transportation linkages with the Mainland and strengthen Hong Kong SAR's longer-term competitiveness. However, even with this higher level of capital spending, given the buoyant outlook for revenues, staff forecasts that the fiscal position is likely to remain firmly in surplus in the coming years.

V. LONGER-TERM ISSUES

11. ***The minimum wage***. The government will soon introduce a new minimum wage with its initial level reportedly to be set somewhere between HK$28–33 per hour (covering around 11−17 percent of the working population). The new minimum wage will go into effect in early 2011 and is expected to remain in place for two years, at which time it will be revisited by the Minimum Wage Commission. There will be no automatic indexing of the minimum wage. Officials indicated that the new system would maintain flexibility and that the minimum wage could be adjusted both up or down, and at a frequency that could be dictated by economic conditions. In addition, companies would be given six months to adjust to the

new law and to put in place systems to track and report data on hours worked for lower wage workers. As a by-product, these reporting systems would also provide useful information as the government initiates a policy study on the possible impact of putting in place a system of standard working hours in Hong Kong SAR.

12. ***Changes in the global regulatory environment***. The authorities' assessment was that Hong Kong SAR was well placed to adopt new regulatory standards implied by Basel III. They noted that there was, however, one complication in meeting the liquidity coverage ratio as defined under Basel III because the local market lacks sufficient supply of the types of Hong Kong dollar debt instruments that are required by the new standards. An alternative approach is being discussed at the Basel Committee on Banking Supervision, and the authorities are actively involved in these discussions. They also indicated that they were coordinating closely with regulators in other jurisdictions on a range of issues. The mission agreed with the authorities that the financial system was generally well placed to absorb the tighter safety and soundness requirements that were now emerging on a global level.

13. ***Internationalizing the renminbi***. Over the past year, important steps have been made to expand the use of the renminbi in offshore markets (Box 4). The strategy has been two-fold:

- *Increasing the offshore use of the renminbi as a unit of account, store of value, and means of payment*. Most recently, this has included an expansion of the pilot program for renminbi trade settlement, as well as allowing Hong Kong financial institutions to undertake interbank settlement in renminbi and sell renminbi financial products.

- *Introducing selective exceptions to China's system of capital controls.* In August, the People's Bank of China changed regulations to allow renminbi accumulated in Hong Kong SAR for trade settlement, renminbi deposits, and foreign central banks to invest in the Mainland interbank bond market, albeit subject to quotas.

The authorities indicated that the recent steps should steadily increase the attractiveness of the renminbi as a settlement currency and as a denominator for financial products available in Hong Kong SAR. They anticipated that there would continue to be steady progress toward broader usage of the renminbi outside of the Mainland in the coming years. As an indication of the increasing interest in using the renminbi for trade settlement, on October 28, the authorities announced that the annual quota for conversion of renminbi for trade settlement had already been depleted. As a result, the Hong Kong Monetary Authority (HKMA) instructed financial institutions participating in the scheme to use their own long renminbi positions to pay trade transactions. In addition, the HKMA has activated its currency swap with the People's Bank of China and indicated that participating institutions without long renminbi positions could approach the HKMA to make use of that swap facility, if needed.

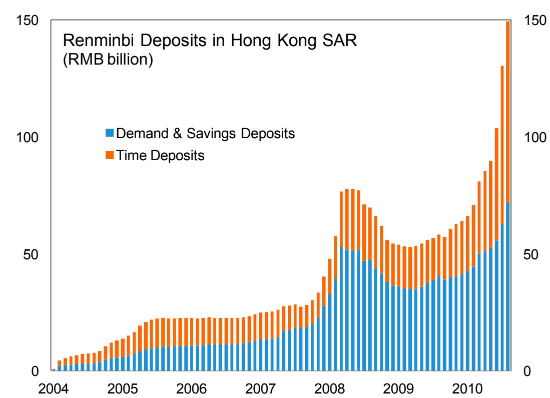
Box 4: Recent Steps Toward Renminbi Internationalization

Trade Settlement. In June, the People's Bank of China (PBC) announced an expansion of the trade settlement scheme to allow transactions between 20 provinces and cities in the Mainland with anywhere in the world to be settled in renminbi. This led to a significant expansion of the use of this scheme, reaching RMB 70.6 billion at end-June.

Renminbi financial products. In July, the PBC and the Hong Kong Monetary Authority signed a supplementary agreement allowing financial institutions—including banks, securities brokerages, and insurance companies—in Hong Kong SAR to open renminbi accounts. Interbank settlement in renminbi was permitted and individuals and corporations were allowed to undertake transfers in renminbi. Financial institutions were also allowed to sell renminbi funds and other renminbi financial products. Then, in August, the PBC opened a window for renminbi accumulated in Hong Kong SAR to be invested in the Mainland interbank bond market, subject to quotas.

Renminbi bonds. Since July 2007, RMB 40 billion in bonds have been issued, predominantly by financial institutions and at yields below that of comparable securities trading on the Mainland. In the third quarter of this year, bonds were issued by a Mainland infrastructure company and by a foreign multinational. In October, the Asian Development Bank issued a 10-year renminbi bond, the longest maturity so far, that will be traded on the Hong Kong stock exchange.

Renminbi deposits. Since 2004, Hong Kong residents have been able to open renminbi accounts in Hong Kong banks and transfer up to HK$20,000 per day to those accounts. The growth of renminbi deposits accelerated markedly in the past few months and now stands at RMB 149 billion at end-September 2010. Nevertheless, renminbi deposits are still a small part of the Hong Kong deposit base, amounting to around 2½ percent of total deposits.



VI. STAFF APPRAISAL

14. ***Outlook***. Thanks in large part to prompt policy action as the global financial crisis unfolded, the Hong Kong economy is now back onto a robust growth trajectory with the key sources of demand firing on all cylinders. As a result, Hong Kong SAR now faces a very different set of challenges from those of the past two years. Given uncertainties about the global recovery, it is likely that the highly accommodative monetary conditions in many industrial countries will persist for some time to come. This will continue to push funds to seek out returns elsewhere. As an international financial center, located in Asia where growth prospects are strong, Hong Kong SAR can expect to continue to be a recipient of such flows. These inflows will tend to push up prices for a range of assets while the re-leveraging of domestic investors will further fuel this updraft.

15. ***Risks from property price inflation***. Supply conditions in the property market are relatively tight, liquidity is abundant, and there is strong demand for housing from both Mainland residents and financial sector professionals. The upward pressures on prices will, therefore, likely continue. As housing prices rise, more collateral will be available to support greater borrowing to finance housing purchases, and the cycle could be amplified through a financial accelerator process. Higher property prices would then lead to higher rents and the ongoing asset price inflation will feed into higher consumer prices. With tightening labor markets, a closing of the output gap, and a higher cost of living, it would be only natural that nominal wages should rise, adding a second-round impact to inflation. If such a dynamic were to unfold, past experience would suggest that the economy will eventually unwind the cycle through broad-based deflation in goods, labor, and asset markets. Predicting the timing of such a reversal is difficult, but a move to a tightening bias in the United States or a slowdown in China could provide a potential catalyst. Depending on the amplitude of the upswing, the resulting downturn could prove both protracted and painful.

16. ***Policies***. The government's graduated response to property price inflation—including the deployment of tighter prudential requirements to safeguard financial stability—is essential and should continue. Consideration could be given to further lowering loan-to-value ratios for a wider share of the property market and proactively tightening further the limits on debt service ratios. Regulators should also continue to ensure that underwriting standards are rigorously complied with. This would be greatly facilitated by expanding the credit reference agency's current information base to include data on all individuals' residential mortgage loans. The recent announcement to discontinue offering Hong Kong residency to those making large investments in real estate was appropriate and the government is also right to seek ways to supply more land to ensure the healthy and stable development of the property market. Should high levels of property price inflation continue, the government could consider further raising the stamp duties on housing and increasing the level of the rates for higher-end properties.

17. ***Housing affordability***. High rates of housing price inflation place a heavy burden on the less affluent members of Hong Kong SAR's society, whose income growth is unable to keep pace with the rising cost of living. It will be important, therefore, to offer continued support for these groups. The government has been clear in its commitment to provide a steady supply of new public rental housing for low-income groups. In addition, the My Home Purchase Plan announced in the Chief Executive's policy address will help. Targeted fiscal support could also be provided to those increasingly priced out of the housing market.

18. ***Guaranteeing financial stability***. Macroprudential tools will help to slow the financial accelerator process but, given the scale of the underlying forces at work—including the strong economic recovery, an improving labor market, and very loose monetary conditions—they will, at best, only be able to mitigate the amplitude of the current upswing. It will be essential, therefore, to guarantee financial stability in the event the cycle shifts into reverse. In this regard, Hong Kong SAR remains in a strong position. The financial system has been prudently managed and is well supervised and regulated. Banks have generally robust internal risk management systems and recent regulatory measures will help insulate the financial system from the effects of a housing downturn. At the same time, the Linked Exchange Rate System has shown itself to be a robust anchor of monetary and financial stability, even in very difficult circumstances, and merits continued support.

19. ***Fiscal policy***. Given the positive prospects for growth, fiscal policy has a role to play in dampening the amplitude of the coming cycle. Over the past two years, fiscal policy has rightly provided support to the economy as the global crisis unfolded. However, those temporary support measures should be discontinued in the 2011/12 Budget. The expansion of infrastructure spending should, however, continue as planned given that these multi-year projects are an integral part of Hong Kong SAR's strategy to increase its integration with the Mainland. Nonetheless, the overall fiscal position should move to adopt a countercyclical policy stance.

20. ***Maintaining flexibility***. Hong Kong SAR's great strength is the flexibility and adaptability of its economy. This has been shown on repeated occasions as Hong Kong SAR has reinvented itself to take advantage of the changing international environment. Preserving such flexibility in Hong Kong SAR's labor markets will now require a careful balancing act as the new Statutory Minimum Wage comes into force. The level of the minimum wage should be calibrated so as to provide effective protection to lower income workers without unduly harming their employment prospects or hampering the ability of Hong Kong SAR's labor market to adjust, particularly to negative shocks. It will, therefore, be important to critically assess the implications of the new minimum wage during the first two years of its introduction. In addition, consideration could be given to enhancing government assistance provided to the working poor, in order to further support lower income groups.

21. ***Integration with the Mainland***. Hong Kong SAR's unique position as an international financial center with strong links to Mainland China provides significant

potential for growth and development. Maximizing those benefits will require continued collaboration with the Mainland authorities to facilitate greater real and financial sector integration. Capitalizing on Hong Kong SAR's pillar industries and developing the six new industries proposed by the Taskforce on Economic Challenges will be crucial. This will be greatly aided by the ongoing improvements being made to transportation linkages with the Mainland. In addition, continued efforts are needed to steadily build on Hong Kong SAR's position as an offshore renminbi center. Opportunities should be sought, in cooperation with the Mainland authorities, to continue to increase the use of the renminbi as a settlement currency for trade and current account transactions and to expand the range of investment vehicles into which offshore renminbi can be invested. This implies both increasing the scope and availability of renminbi denominated instruments in Hong Kong SAR itself but also working with the Mainland to expand the opportunities for offshore renminbi to be reintermediated back into the Mainland in the form of renminbi direct investment, renminbi loans, and portfolio investment to bond and equity markets.

22. It is expected that the next Article IV Consultation discussions with Hong Kong SAR will be conducted in 12 months time.

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

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

Sources: CEIC Database; and staff estimates and projections.

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

2/ Includes Land Fund assets.

3/ IMF Staff estimates.

Table 2. Hong Kong SAR: Consolidated Government Account, 2007/08–2014/15 1/

(In percent of GDP, unless otherwise stated)

	2006/07	2007/08	2008/09	2009/10	2010/11	2010/11	2011/12	2012/13	2013/14	2014/15
					Budget	Staff Projections				
Revenue	19.5	22.2	18.9	19.5	17.1	22.0	21.6	21.2	21.2	21.3
Taxes	12.8	14.2	13.0	12.7	11.4	...	...	...	...	...
Direct taxes	7.8	8.3	8.7	7.5	7.2	...	...	...	...	...
Of which:										
Salaries tax	2.6	2.3	2.3	2.5	2.3	...	...	...	...	...
Profits tax	4.9	5.7	6.2	4.7	4.6	...	...	...	...	...
Indirect taxes	4.9	6.0	4.3	5.2	4.2	…	…	…	…	…
Nontax	6.8	7.9	5.9	6.8	5.7	...	...	...	...	...
Of which:										
Land premium	2.5	3.9	1.0	2.4	2.0	...	...	...	...	...
Investment income	2.0	1.7	2.8	2.1	1.8	1.5	1.5	1.6	1.7	1.9
Expenditure	15.4	14.5	18.6	17.7	18.6	18.6	18.9	18.4	17.7	17.0
Current 2/	13.1	12.7	15.4	14.4	14.7	14.7	14.4	14.2	13.9	13.6
Of which:										
Personnel related	4.2	4.0	4.1	4.4	4.4	...	...	...	...	...
Capital	2.2	1.9	3.2	3.3	3.9	3.9	4.4	4.2	3.8	3.3
Of which:										
Interest	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	4.1	7.7	0.2	1.8	-1.5	3.5	2.7	2.8	3.4	4.3
Memorandum items:										
Operating balance 3/	2.7	4.4	1.4	1.7	-0.2	3.4	2.3	2.8	3.3	3.7
Primary balance 4/	2.2	6.0	-2.5	-0.2	-3.2	2.0	1.3	1.2	1.7	2.5
Structural balance 5/	0.0	1.3	-0.6	-2.8	-4.8	-0.3	0.6	0.7	1.3	1.4
Fiscal reserves	25.0	30.5	29.5	31.9	29.0	32.9	31.9	32.7	34.1	36.0
(Months of spending)	19.5	25.2	19.0	21.6	18.7	21.2	20.3	21.4	23.1	25.5

Sources: CEIC Database; and staff estimates.

1/ Staff projections assume government spending targets in the latest medium-term budget document and staff revenue forecasts. Fiscal year begins on April 1.
2/ This refers to the authorities' measure of operating expenditure.
3/ Operating balance, as defined by the authorities, is akin to the current balance.
4/ Balance excluding investment income.
5/ Staff estimate used to measure the impact of fiscal policy on domestic demand. It excludes asset transactions and cyclical fluctuations.

Table 3. Hong Kong SAR: Medium-Term Balance of Payments, 2007–15

	2006	2007	2008	2009	Projections 2010	2011	2012	2013	2014	2015
					(In billions of U.S. dollars)					
Current account	22.9	25.5	29.3	18.3	18.9	22.8	23.3	25.2	26.7	29.4
Goods balance	-14.0	-19.7	-23.1	-26.9	-35.3	-36.7	-40.8	-44.6	-49.8	-53.9
Services balance	35.7	42.1	45.0	41.9	50.9	54.9	58.8	63.7	69.4	74.0
Income balance	3.5	5.7	10.7	6.4	6.7	8.3	9.2	10.4	11.6	13.8
Transfer balance	-2.2	-2.6	-3.3	-3.2	-3.5	-3.7	-4.0	-4.2	-4.5	-4.5
Capital and financial account	-27.0	-33.2	-29.7	-21.3	-19.0	-22.8	-23.3	-25.2	-26.8	-29.4
Capital account	-0.4	1.3	2.1	4.7	0.7	2.2	2.5	2.8	2.9	3.0
Financial account	-26.7	-34.6	-31.8	-25.9	-19.7	-25.0	-25.8	-28.0	-29.6	-32.5
Net direct investment	0.1	-6.7	9.0	-3.8	-0.5	-0.3	0.3	0.1	-0.2	-0.7
Inflow	45.1	54.3	59.6	48.4	7.8	25.5	30.9	35.9	38.4	41.9
Outflow	-45.0	-61.1	-50.6	-52.3	-8.3	-25.8	-30.6	-35.8	-38.7	-42.6
Portfolio investment	-26.8	-2.7	-37.9	-44.2	-40.6	-45.0	-45.8	-41.0	-40.2	-39.6
Financial derivatives	3.3	5.6	8.1	3.3	0.6	1.9	2.4	3.0	3.5	4.1
Other investment	2.7	-16.0	22.8	89.6	22.3	20.4	20.8	16.2	16.2	15.7
Reserve assets (net change)	-6.0	-14.7	-33.9	-70.9	-1.5	-2.0	-3.5	-6.3	-8.9	-12.0
Net errors and omissions	4.1	7.7	0.4	3.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:					(In percent of GDP)					
Current account	12.1	12.3	13.6	8.7	8.3	9.1	8.7	8.8	8.8	9.0
Goods balance	-7.4	-9.5	-10.7	-12.8	-15.5	-14.6	-15.3	-15.6	-16.3	-16.6
Services balance	18.8	20.3	20.9	19.9	22.4	21.9	22.0	22.3	22.7	22.7
Income balance	1.9	2.8	5.0	3.0	3.0	3.3	3.4	3.6	3.8	4.3
Transfer balance	-1.2	-1.2	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5	-1.4
Capital and financial account	-14.2	-16.0	-13.8	-10.1	-8.3	-9.1	-8.7	-8.8	-8.8	-9.0
Capital account	-0.2	0.6	1.0	2.2	0.3	0.9	0.9	1.0	0.9	0.9
Financial account	-14.0	-16.7	-14.8	-12.3	-8.7	-9.9	-9.6	-9.8	-9.7	-10.0
Net direct investment	0.0	-3.3	4.2	-1.8	-0.2	-0.1	0.1	0.0	-0.1	-0.2
Portfolio investment	-14.1	-1.3	-17.6	-21.0	-17.9	-17.9	-17.1	-14.3	-13.2	-12.2
Financial derivatives	1.8	2.7	3.8	1.6	0.2	0.8	0.9	1.1	1.1	1.3
Other investment	1.4	-7.7	10.6	42.5	9.8	8.1	7.8	5.7	5.3	4.8
Reserve assets (net change)	-3.2	-7.1	-15.8	-33.7	-0.7	-0.8	-1.3	-2.2	-2.9	-3.7
Net errors and omissions	2.2	3.7	0.2	1.4	0.0	0.0	0.0	0.0	0.0	0.0

Sources: CEIC Database; and staff estimates.

Table 4. Hong Kong SAR: Medium-Term Macroeconomic Framework, 2007–15

				Staff Projections					
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real GDP (percent change)	6.4	2.2	-2.8	6.7	5.2	4.4	4.3	4.3	4.3
Contribution									
Real domestic demand	7.0	1.4	0.8	5.4	4.5	3.8	4.1	4.2	4.1
Private consumption	5.1	1.4	-0.2	3.4	2.8	2.5	2.6	2.6	2.4
Government consumption	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Gross fixed capital formation	0.7	0.2	-0.4	1.7	1.5	1.2	1.4	1.5	1.5
Inventories	1.0	-0.3	1.2	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	-0.7	0.7	-3.6	1.3	0.7	0.6	0.1	0.1	0.2
Output gap (in percent of potential)	5.0	2.9	-3.3	-0.6	0.6	0.4	0.2	0.0	0.0
Growth rates									
Real domestic demand	7.9	1.6	0.9	5.8	4.9	4.1	4.5	4.5	4.4
Private consumption	8.5	2.4	-0.4	5.4	4.5	4.0	4.2	4.2	4.0
Government consumption	3.0	1.8	2.4	2.8	2.0	2.0	2.0	2.0	2.0
Gross fixed capital formation	3.4	0.8	-1.8	8.6	7.6	5.7	6.7	6.7	6.8
Saving and investment (percent of GDP)									
Gross national saving	33.3	34.1	31.3	31.4	32.4	32.3	32.8	33.1	33.8
Gross investment	20.9	20.4	22.6	23.1	23.4	23.7	23.9	24.3	24.8
Saving-investment balance	12.3	13.6	8.7	8.3	9.1	8.7	8.8	8.8	9.0
Inflation (percent change)									
Consumer prices	2.0	4.3	0.5	2.7	5.0	3.2	2.5	2.5	2.5
GDP deflator	2.9	1.5	0.2	1.5	4.9	2.1	2.5	2.3	2.2
Employment (percent change)	2.2	1.2	-1.5	3.8	2.1	1.1	1.5	1.5	1.4
Unemployment rate (percent)	4.0	3.5	5.2	4.0	3.5	3.8	3.8	3.8	3.8
Merchandise trade (percent change)									
Export volume	7.0	1.9	-12.7	18.5	7.9	8.6	8.9	8.7	8.6
o/w Re-exports	8.6	2.9	-12.2	19.1	8.2	8.9	9.0	8.8	8.7
Import volume	8.8	1.8	-9.5	18.8	7.6	8.2	8.8	8.4	8.4
Retained import volume	11.7	-1.4	-3.8	-0.5	7.2	6.3	6.8	6.8	6.6
Export value	9.4	5.4	-12.3	23.3	9.9	9.9	9.9	10.0	9.4
Import value	10.7	6.0	-10.6	23.9	9.4	10.0	9.9	10.1	9.3
External balances (in billions of US$)									
Trade balance	-19.7	-23.1	-26.9	-35.3	-36.7	-40.8	-44.6	-49.8	-53.9
In percent of GDP	-9.5	-10.7	-12.8	-15.5	-14.6	-15.3	-15.6	-16.3	-16.6
Exports of goods	346	365	322	396	435	478	525	578	632
Imports of goods	366	388	349	431	471	519	570	627	686
Current account	25.5	29.3	18.3	18.9	22.8	23.3	25.2	26.7	29.4
In percent of GDP	12.3	13.6	8.7	8.3	9.1	8.7	8.8	8.8	9.0
Foreign exchange reserves (end-year)	152.7	182.5	255.8	257.3	259.3	262.8	269.1	278.1	290.0
In percent of GDP	73.7	84.8	121.5	113.2	103.4	98.2	94.1	91.1	89.1

Sources: CEIC Database; and staff estimates and projections.

Table 5. Hong Kong SAR: Vulnerability Indicators

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 Latest
Public sector										
Fiscal surplus (in percent of GDP)	-4.9	-4.8	-3.2	-0.3	1.0	4.1	7.7	0.2	1.8	-3.5
Accumulated fiscal surplus (in percent of GDP)	28.7	24.4	22.3	22.9	22.5	25.0	30.5	29.5	31.9	28.7
External sector										
Total export volume (percent change)	-3.3	8.6	14.0	14.9	10.4	9.3	7.0	1.9	-12.7	20.1
Domestic exports	-10.2	-11.0	-6.9	2.2	6.1	3.0	-19.3	-19.2	-26.6	11.3
Reexports	-2.4	10.9	15.9	15.8	10.7	9.7	8.6	2.9	-12.2	20.4
Total import volume (percent change)	-1.9	7.9	13.1	13.7	8.0	9.2	8.8	1.8	-9.5	23.6
Current account (in billions of U.S. dollar)	9.8	12.4	16.5	15.7	20.2	22.9	25.5	29.3	18.3	0.8
Net equity inflow (in billions of U.S. dollar)	-23.5	-14.4	-4.2	-28.5	-18.0	-1.2	-25.7	-0.8	-34.0	-22.7
Gross official reserves (in billions of U.S. dollar)	111.2	111.9	118.4	123.6	124.3	133.2	152.7	182.5	255.8	266.1
In months of retained imports	20.4	22.6	23.3	21.2	19.8	18.6	19.5	22.1	34.6	30.8
In percent of monetary base	377.0	354.0	314.6	325.8	340.1	349.3	371.6	280.1	196.2	200.1
In percent of broad money 1/	24.4	24.8	24.2	23.1	22.1	20.5	19.5	22.7	30.0	29.6
In percent of Hong Kong dollar M3	43.0	43.6	43.4	43.4	41.2	37.0	36.1	43.4	55.0	52.6
Short-term debt (in billions of U.S. dollar) 2/	300.0	223.8	250.5	308.5	310.5	364.8	539.8	489.8	504.6	509.4
In percent of gross reserves	269.9	199.9	211.6	249.6	249.8	273.9	353.5	268.3	197.2	196.8
One-year forward exchange rate premium (in pips, annual average)	52.7	138.8	33.9	-704.8	-448.9	-599.7	-552.3	-337.4	-163.8	-215.2
Real exchange rate (percent change)	0.3	-4.8	-9.0	-6.7	-2.8	-1.0	-5.2	-5.3	2.3	-2.5
Financial sector										
HIBOR(3M)-LIBOR (3M) (in basis points, per annum)	-3.9	0.6	-25.0	-128.9	-64.6	-102.4	-100.3	-51.9	-27.1	-45.4
Hang Seng index (percent change, end-year) 3/	-24.5	-18.2	34.9	13.2	4.5	34.2	39.3	-48.3	52.0	6.7
Residential property prices (percent change, end-year) 3/	-9.8	-12.2	0.9	27.4	8.2	4.1	25.7	-11.1	28.5	18.9
Banking sector 4/										
Deposit-loans ratio	155.9	159.8	175.3	179.3	175.9	192.8	198.2	184.4	194.0	163.3
Domestic credit growth 5/	-3.8	-2.6	-2.0	4.9	7.7	2.3	15.2	11.0	-1.0	20.7
Real credit growth 5/	-0.3	-1.2	-0.1	4.6	6.2	0.0	11.0	8.8	-2.2	17.8
Capital adequacy ratio 6/	16.5	15.7	15.3	15.4	14.8	14.9	13.4	14.8	16.8	16.2
Nonperforming loans (in percent of total loans) 7/ 8/	6.5	5.0	3.9	2.3	1.4	1.1	0.8	1.2	1.4	1.0
Net interest margin (in percent of interest-bearing assets) 8/	2.0	2.1	1.9	1.7	1.7	1.8	1.9	1.8	1.5	1.3
Return on assets (post-tax) 8/	1.0	1.2	1.2	1.4	1.4	1.4	1.5	0.9	1.0	…
Net open spot position (in billions of U.S. dollar)	24.7	18.2	15.9	28.2	30.7	52.0	78.8	57.1	38.1	24.6
Net open forward position (in billions of U.S. dollar)	-14.6	-6.7	-6.4	-24.5	-25.9	-46.2	-71.8	-44.0	-27.6	-16.4
Exposure to the Mainland (in percent of total assets)	2.4	2.2	2.0	2.3	2.6	5.9	6.5	7.1	8.3	10.0
Exposure to property sector (in percent of domestic credit) 9/	51.0	52.1	51.3	50.6	50.5	51.2	49.3	49.8	52.1	49.0
Deposits (in percent of liabilities)	55.4	55.3	55.0	54.2	56.1	57.3	56.7	56.3	60.0	56.4
Contagion indicator										
Hang Seng-NASDAQ correlation (daily)	0.9	0.8	0.9	0.6	0.8	0.5	0.8	0.9	1.0	0.6

Sources: CEIC Database; Hong Kong SAR authorities; Bank for International Settlements; and staff estimates.

1/ Broad Money refers to M2.
2/ Official statistics on Hong Kong SAR's external debt are available from the first quarter of 2002.
3/ Refers to year-to-date change since end of previous year.
4/ For all authorized institutions, unless otherwise specified.
5/ Domestic credit refers to loans for use in Hong Kong SAR. Latest figures (2010) refer to year-on-year percentage change.
6/ For all locally incorporated authorized institutions.
7/ Refers to total gross classified: "substandard," "doubtful," and "loss."
8/ For retail banks, which comprise all the locally incorporated banks plus a number of the larger foreign banks whose operations are similar to those of the locally incorporated banks, in that they operate a branch network and are active in retail banking.
9/ Exposure to property sector includes loans to finance property investment and development as well as residential mortgage loans.

INTERNATIONAL MONETARY FUND

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

Staff Report for the 2010 Article IV Consultation Discussions—Informational Annex

Prepared by the Asia and Pacific Department

November 5, 2010

Contents Page

ANNEX I: 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 Fund' *Global Financial Stability* 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 IMF Institute 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 Hong Kong Monetary Authority (HKMA) refined the operations of the LERS in May 2005—the first changes since September 1998. For the first time since the introduction of the LERS in 1983, the HKMA explicitly committed to sell Hong Kong dollar at a pre-announced price (set at HK$7.75/US$), which is referred to as the strong-side convertibility undertaking. Previously, the HKMA had only committed to buy Hong Kong dollar at a pre-announced rate (the weak-side convertibility undertaking introduced in October 1998) and could sell Hong Kong dollar at any price. Along with this two-way convertibility undertaking, the HKMA also introduced a symmetric trading band of 0.6 percent around a central parity of HK$7.8/US$. There are no restrictions on current or capital account transactions in Hong Kong SAR, and the Hong Kong dollar is freely convertible. The People's Republic of China accepted the obligations under Article VIII, Sections 2, 3, and 4 of the Articles of Agreement on December 1, 1996.

III. Resident Representative

The Hong Kong SAR sub-office of the Beijing Resident Representative's office was opened on September 23, 2000. Mr. Il Houng Lee is Resident Representative.

ANNEX II: HONG KONG SAR—STATISTICAL ISSUES

Data provision is adequate for surveillance purposes. Hong Kong SAR provides statistics to the Fund on a timely basis for surveillance and publication in the *International Financial Statistics (IFS)*. Hong Kong SAR subscribes to the Fund's Special Data Dissemination Standard and is fully compliant with its requirements.

Hong Kong SAR publishes comprehensive balance of payments data and international investment position statistics for 2000 onwards, and also publishes quarterly external debt statistics according to the recommendations given in the *External Debt Statistics: Guide for Compilers and Users*.

Hong Kong SAR reports both cash and accrual-based annual data for the general government according to the Fund's *Government Finance Statistics Manual* (*GFSM 2001*). No subannual data are provided for publication in the *IFS*.

Hong Kong SAR participated in the IMF's Coordinated Compilation Exercise for Financial Soundness Indicators (FSIs) and its FSI data and metadata for 2005 have been posted on the IMF website.

Work is in progress on the compilation of monetary statistics using the Standardized Report Forms that present data consistent with the *Monetary and Financial Statistics Manual*.

HONG KONG SAR—TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

As of November 5, 2010

	Date of Latest Observation	Date Received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of Publication[5]
Exchange rates	Nov 5, 2010	Nov 5, 2010	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	Oct 2010	Nov 2010	M	M	M
Reserve/base money	Sept 2010	Nov 2010	M	M	M
Broad money	Sept 2010	Nov 2010	M	M	M
Central bank balance sheet	Sept 2010	Nov 2010	M	M	M
Consolidated balance sheet of the banking system	Sept 2010	Nov 2010	M	M	M
Interest rates[2]	Nov 5, 2010	Nov 5, 2010	D	D	D
Consumer price index	Sept 2010	Oct 2010	M	M	M
Revenue, expenditure, balance and composition of financing[3]– central government	Sept 2010	Nov 2010	M	M	M
Stocks of central government and central government-guaranteed debt[4]	Sept 2010	Nov 2010	M	M	M
External current account balance	Q2/10	Sept 2010	Q	Q	Q
Exports and imports of goods and services	Q2/10	Sept 2010	Q	Q	Q
GDP/GNP	Q2/10	Oct 2010	Q	Q	Q
Gross external debt	Q2/10	Nov 2010	Q	Q	Q
International investment position	2009	Nov 2010	A	A	A

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] Including currency and maturity composition.

[5] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

Statement by the Staff Representative on
People's Republic of China—Hong Kong Special Administrative Region
November 22, 2010

The information below, which has become available following the issuance of the staff report, does not alter the thrust of the staff appraisal.

1. Recently published GDP data for the third quarter estimated real growth to be 6.8 percent (year-on-year), in line with staff projections. Growth continues to be broad-based and is being led by private consumption, building and construction, and exports.

2. In the October 2010 report to the Government, released on November 11, the Provisional Minimum Wage Commission recommended that the statutory minimum wage be fixed at HK$28 per hour, which would affect 11 percent of workers. The Commission also recommended that (a) the mechanism for determining the minimum wage should continue to be evidence-based; (b) the statutory minimum wage should be reviewed in a timely fashion based on movements of the indices in the Basket of Indicators (which includes indicators of general economic conditions, labor market conditions, competitiveness, and the standard of living); and (c) an impact assessment of the implementation of the statutory minimum wage should be performed prior to future reviews. The recommendation was consistent with staff appraisal as outlined in the staff report.

Supplement to the Statement by the Staff Representative on People's Republic of China—Hong Kong Special Administrative Region Executive Board Meeting November 22, 2010

1. On November 19, the government announced a series of measures to curb short-term speculative activities and reduce the risk of an asset bubble in the Hong Kong property market. These measures included:

- The introduction of a special stamp duty on residential properties, on top of the existing ad valorem stamp duty, levied at a rate of 15 percent for properties held for 6 months or less; 10 percent if held for 6–12 months; and 5 percent for property held between 12 and 24 months.

- Disallowing the deferral in the payment of stamp duty, including the special stamp duty, for any residential property transaction.

- Lowering the maximum loan-to-value ratio for residential properties with a value at or above HK$12 million from 60 to 50 percent

- Lowering the maximum loan-to-value ratio for residential properties valued at or above HK$8 million and below HK$12 million from 70 to 60 percent, with a maximum loan amount capped at HK$6 million.

- Capping the maximum loan size for properties valued at below HK$8 million at HK$4.8 million.

- Lowering the maximum loan-top-value ratio for all non-owner occupied residential properties to 50 percent.

- Introducing a cap of HK$6.8 million on the value of property that can be covered by the Hong Kong Mortgage Corporation's mortgage insurance program.

The authorities indicated that these initiatives were "extraordinary measures under exceptional circumstances" and would adopt other measures "as and when necessary."

2. Staff fully supports these measures as a proactive and well calibrated response to the current upswing in the Hong Kong property price cycle. These initiatives will have an important impact in shifting the trajectory of the Hong Kong property market to a more sustainable path.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/153
FOR IMMEDIATE RELEASE
December 2, 2010

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2010 Article IV Consultation Discussions with People's Republic of China—Hong Kong Special Administrative Region

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

Background

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

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

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

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

In the 2010/11 (April 1, 2010- March 31, 2011) Budget, the government continued with temporary stimulus measures—including waiving two months' rent for public housing tenants, providing additional social assistance and old age allowances, and reducing or waiving taxes and fees—and forecasted a deficit of 1½ percent of GDP. However, revenue performance in the first part of this fiscal year has been buoyant—with strong tax performance and substantially higher land-related revenues.

Executive Board Assessment

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

Against this backdrop, Directors supported a countercyclical fiscal stance for the 2011/12 budget, which would entail discontinuing the temporary support measures implemented during the global crisis. At the same time, Directors supported the continuation of the multi-year plans for infrastructure spending, which are an integral part of Hong Kong SAR's strategy to increase integration with the Mainland.

Directors considered that the forces behind the recent rapid increase in property prices—relatively tight supply conditions, abundant liquidity, and strong demand from

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

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

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

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

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation Discussions with People's Republic of China — Hong Kong Special Administrative Region is also available

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

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

Sources: CEIC Database; and staff estimates and projections.

1/ Unless otherwise stated, all growth rates are for year-on-year.
2/ Includes Land Fund assets.
3/ IMF Staff estimates.