INTERNATIONAL MONETARY FUND

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

2011 ARTICLE IV CONSULTATION DISCUSSIONS

December 2011

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

- **Staff Report** for the Article IV consultation discusssions, prepared by a staff team of the IMF, following discussions that ended on October 27, 2011, with the officials of 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 14, 2011. 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.

- **Informational Annex** prepared bt the IMF.

- **Staff Statement** of November 30, 2011 updating information on recent developments.

- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its discussion of the staff report that concluded the ArticleIV consultation discussions.

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

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

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION DISCUSSIONS

November 14, 2011

KEY POINTS

Backdrop. The economy has done well, driven by a strong labor market, solid consumption, and a boost from a rising number of Mainland visitors. More recently, growth has slowed, in large part a result of weakening external demand. Inflation has risen during the course of this year (due to higher food and housing costs) but should moderate going forward.

Risks and Spillovers. The principal near-term risks are from a global slowdown, perhaps emanating from a worsening of the economic situation in Europe or a hard landing in the Mainland. If realized, these would spill into Hong Kong SAR, hitting the economy hard through both trade and financial channels.

Credit Growth. Lending by Hong Kong banks has risen rapidly in the past year (particularly foreign currency lending to Mainland entities) outpacing the rate of deposit growth. This combination has created strains on bank funding, although loan-to-deposit ratios remain low by international standards.

Property Market. For the past two consultations, staff have warned of the prospects of an asset bubble forming in Hong Kong SAR's residential property market, creating the potential for macroeconomic volatility. At this juncture, the outlook for the property market is highly uncertain. A slowdown in the local property market is evident in the data but many of the upward drivers to housing prices are still in place.

Renminbi Internationalization. Progress on increasing trade settlement and issuing financial instruments denominated in renminbi has accelerated. This has benefited Hong Kong SAR greatly but the expansion of the offshore renminbi market, along with increased lending to the Mainland, is also increasing the linkages and potential financial spillovers between Hong Kong SAR and the Mainland.

Approved By
Anoop Singh and Tamim Bayoumi

Discussions took place during October 17–27, 2011. The staff team comprised N. Chalk (Head), A. Ahuja, M. Nabar (APD), and S. Craig and A. Meier (Resident Representatives). P. N'Diaye provided significant input and support from headquarters. Mr. Luo and Ms. Szeto (both OED) also participated.

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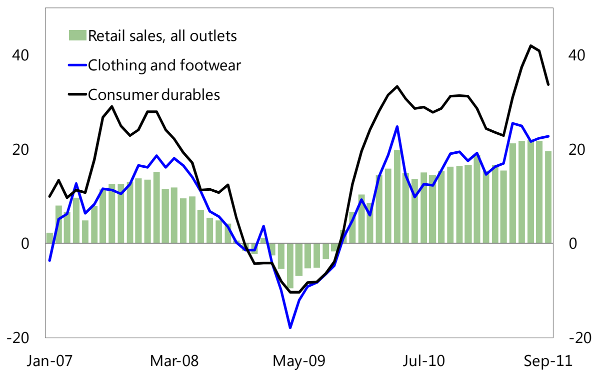
Figure 1. A Dynamic Economy Now Contending with Rising Inflation

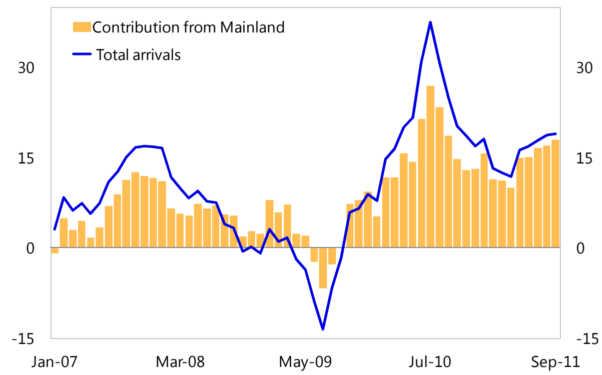
Retail sales volumes have been robust.

Domestic Retail Sales Volumes
(In percent, year-on-year, 3mma)



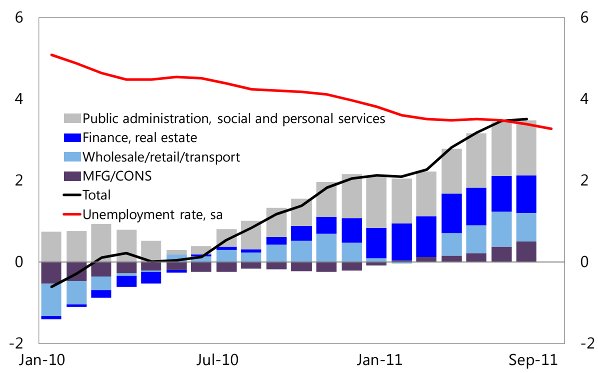
Tourist activity and retail sales continue to benefit from buoyant growth in Mainland visitors.

Tourist Arrivals
(In percent, year-on-year, 3mma)



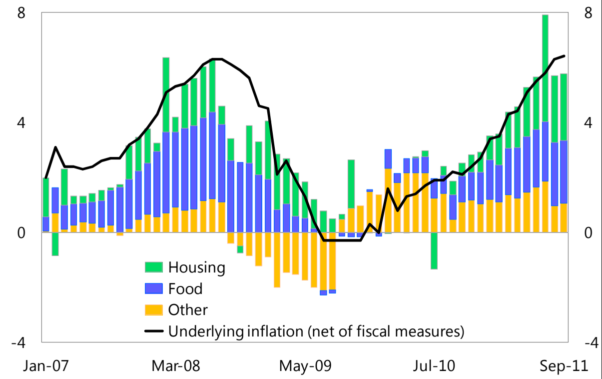
The unemployment rate has declined steadily and payrolls have expanded.

Contributions to Employment Growth
(By sector, in percent, year-on-year, 3mma)



Inflation has increased in recent months, mainly due to housing and food.

Contributions to Inflation
(In percent, year-on-year, monthly frequency)

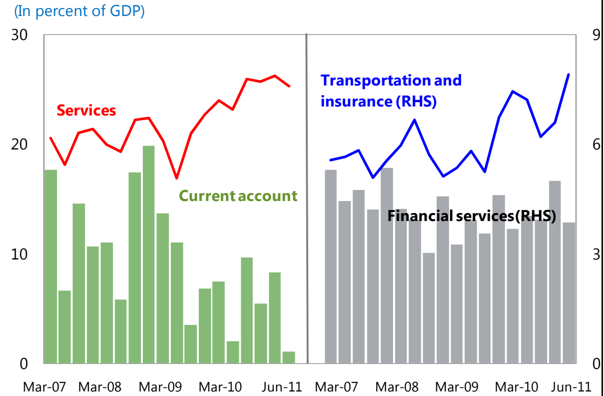


Re-exports have remained buoyant even as global uncertainties have risen…

Re-Exports
(In percent of GDP)

…with added benefits to growth from service exports, particularly in transportation and insurance.

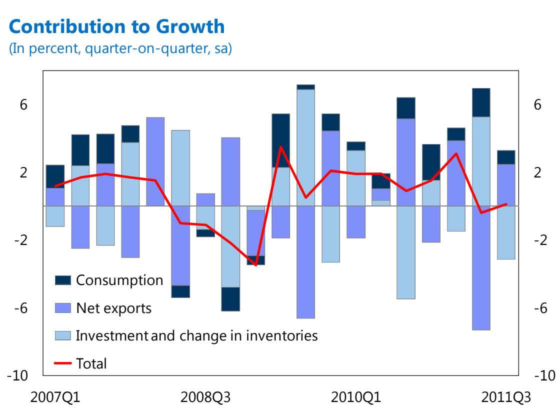
Current Account and Components
(In percent of GDP)



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

THE NEAR-TERM OUTLOOK

1. ***Growth***. The Hong Kong economy has rebounded quickly from the global financial crisis, propelled forward by a solid domestic economy and deepening linkages with the Mainland. Unemployment has fallen, which has supported consumption. Both public construction and private spending on machinery and equipment have added to investment. The contribution to growth from external demand has been relatively modest, although a steadily rising number of Mainland visitors has been a boon to the local economy. Staff expect growth will ease to 5¾ percent this year, slowing further to 4 percent in 2012, with the slowdown driven largely by a weakening in external demand (Figure 1).



2. ***Jobs***. The unemployment rate has been declining steadily (to 3.2 percent in the third quarter of 2011) and total employment has expanded by 4 percent in the 12 months to September. Job growth has been seen mostly in construction and the service sectors. There is little evidence that the introduction of the minimum wage has had a large effect on employment, with any effect being offset by the strong growth in the economy. Real wages for the lowest income groups have, however, risen by 6 percent (year-on-year) in the third quarter of 2011.

3. ***Inflation***. Inflation has been rising, reaching 5.8 percent in September (6.4 percent after netting out the effects of government's relevant one-off relief measures). As labor markets have tightened and the economy has surpassed potential output, price pressures have grown. A rise in food price inflation, largely imported from the Mainland, and the pass-through of higher property prices have added to the cost of living. Inflation is expected to level off for the remainder of the year as the economy slows and food costs wane. Nonetheless, inflation looks set to persist, mostly due to the delayed pass-through to inflation from higher house prices. Staff expect inflation this year to average 5½ percent, remaining in the 4–5 percent range throughout 2012.

4. ***Fiscal Policy***. Fiscal outturns have significantly and systematically outperformed budget targets, mostly due to high collections of profit taxes and asset-related revenues (such as the land premium). The fiscal surplus is certain to exceed this year's –0.5 percent of GDP budget target by a wide margin. Nevertheless, fiscal policy is still likely to exert a modest expansionary effect on the economy due to higher public infrastructure investment, the continuation of various temporary stimulus measures, and a one-time transfer of HK$6,000 to every adult permanent resident. Staff argued that, since the economy is operating above potential and there are concerns about inflation, fiscal policy should seek to provide some countercyclical restraint. In the upcoming budget, in the absence of a major external shock, many of the recent one-off and temporary measures could be discontinued, particularly those taking the form of universal transfers. There is, however, scope for targeted support to lower income groups and the elderly through increases in means-tested social assistance and reductions in public housing rents. The authorities particularly underlined their continuing efforts to aid the most vulnerable in society with the chief executive announcing in his Policy Address the intention to offer two months free rent to those in public rental housing and to provide extra allowances to the elderly, disabled, and those receiving social assistance.

SPILLOVERS AND RISKS

5. ***Spillovers***. The predominant near-term risk to Hong Kong SAR's economy emanates from the shockwaves associated with a renewed global slowdown, a hard landing in Mainland China, or extreme volatility in international financial markets. In particular, both private and public sector counterparts were acutely aware that the risks to Hong Kong SAR from the euro area have risen markedly in recent months as policy uncertainty has interacted with sovereign funding strains and banking sector stress, feeding back into the real economy. Many agreed that Hong Kong SAR's strong fundamentals (including its sizable fiscal reserves, proactive financial regulatory environment, prudently managed banks, and lack of direct exposure to Europe) leave it well placed to handle even very large negative shocks. Nevertheless, as a highly open, international financial center, Hong Kong SAR would be hit hard by a significant shock to external demand that would spill into Hong Kong through both trade and financial channels.

6. ***A European-led downturn scenario***.[1] Using the IMF's Global Integrated Monetary and Fiscal model, staff estimated the financial and trade spillover effects from a crisis in Europe that courses through the global economic and financial system and puts downward pressure on Hong Kong's economy. Under this scenario, the initial

[1] See A. Ahuja and P. N'Diaye, "Trade and Financial Spillover on Hong Kong SAR from a Downturn in Europe and Mainland China," IMF Working Paper (forthcoming).

catalyst is assumed to be a credit loss of 25 percent on the Euro 200 billion of implicit bank losses that have been estimated in the GFSR. As a result of those losses, bank capital would fall and euro area credit spreads would rise by an average of 150 basis points. This would prompt a tightening of financial conditions that would persist for two years and then gradually diminish. There is assumed to be limited room for a monetary and fiscal policy response: the European Central Bank keeps policy interest rates unchanged over the first two years and there will be little discretionary fiscal policy action to offset the decline in growth. In China, on the other hand, there is ample fiscal space and it is assumed the government responds to this negative external shock with a fiscal stimulus package (largely though infrastructure spending) that adds around 3½ percent to growth for the first two years.

7. ***Results***. As a result of the economic losses in Europe and elsewhere, Hong Kong exports weaken which, in turn, dampens future corporate profits and firms' net worth. The cost of financing in Hong Kong SAR also rises and, as the adverse feedback loop takes hold, this further reduces credit, trade, and domestic demand. The end result is that Hong Kong SAR falls back into recession with growth of around 4–4½ percentage points below the baseline forecast for the first two years. This simulation, however, assumes there is no policy response in Hong Kong SAR to offset the impact of this large external shock. Insofar as a policy response is quickly put in place, particularly if there is an effective offsetting fiscal stimulus, the impact from the global tail risk scenario would certainly be mitigated, although not completely offset. The magnitude of these effects looks broadly similar to the experience in 2008–09 where global growth fell by 3½ percentage points and Hong Kong SAR's growth declined by 5 percentage points.

8. ***Mainland hard landing scenario***. While also a low probability scenario, a hard landing in Mainland China would create significant turbulence in Hong Kong SAR's economy. Under this scenario, it is assumed that a portion of credit to local government financing platforms, the real estate sector, and small and medium enterprises become impaired. As a result of those losses, financial conditions tighten in China with credit spreads on the Mainland rising by 450 basis points. This initial shock persists for two years and fades gradually over time. It is also assumed that the Mainland authorities' ability to respond effectively through credit pump priming is limited during the first two years, owing to the deterioration of bank balance sheets. The end-result of these credit losses would be to cause the Mainland economic growth to drop by roughly 4¼ percentage points by the second year.

9. ***Results***. There would be multiple channels of transmission. Trade in goods and services would decline, there would be a reduction in the number of Mainland visitors, and the quality of credit supplied to Mainland corporations would deteriorate. Worsening growth prospects in Hong Kong SAR would depress employment, consumption, investment, and credit demand from households and corporates in Hong Kong SAR and from Mainland entities. Hong Kong corporations' net worth and equity markets would fall, which further depresses private consumption and investment spending. Overall confidence would be negatively affected and economic distress on the Mainland could create a downturn in Hong Kong SAR's real estate sector. Quantitatively, staff find that a halving of growth on the Mainland would put Hong Kong SAR into a sustained downturn with close to zero growth for the next two years. Similar results are obtained from a parallel analysis based on a Global Vector Autoregression model that includes both balance sheet and standard aggregate macroeconomic indicators.

10. ***Policies***. In the unfortunate event that Hong Kong SAR is hit by such a significant external shock the first line of defense should be to provide a significant fiscal stimulus in as rapid a manner as possible. Measures could include reductions in taxation (particularly for salaries and profit taxes), direct transfers to households (especially to the poor, elderly, and other groups most exposed to a deteriorating economy), and fiscal support for smaller enterprises (for example, through loan guarantees, including by temporarily subsidizing the existing SME financing guarantee scheme operated by the Hong Kong Mortgage Corporation). Insofar as is possible, Hong Kong SAR should also aim to accelerate ongoing public sector infrastructure projects. Depending on the severity of the situation, the government might also need to consider extraordinary measures—such as those introduced in 2008—to prevent financial contagion and market dislocation from washing ashore. This would include being ready to provide Hong Kong dollar liquidity through the tools already available to the HKMA and reactivating the contingent backstopping of Hong Kong bank capital using the resources of the Exchange Fund. The recent enhancements to the Deposit Protection Scheme should be sufficient to provide confidence to depositors but, in a very extreme scenario, there may be a case for reintroducing the broad-based guarantee of bank deposits; doing so, though, would best be decided in consultation and coordination with other jurisdictions in the region.

THE EXCHANGE RATE REGIME

11. ***The debate***. Rising property and consumer price inflation has led to a recent upsurge in debate about the appropriateness of the Linked Exchange Rate System. This partly reflects the concern that the current loose monetary conditions are incongruous with Hong Kong's stage in the economic cycle. These low interest rates are likely to persist for some time given the Federal Reserve's announcement that economic conditions warrant exceptionally low levels for the federal funds rate at least through mid-2013. This represents a clear inward spillover from policies in the United States.

12. ***The regime***. Hong Kong SAR has sustained the Linked Exchange Rate System for 28 years through very volatile times including the Asian Financial Crisis, the SARS episode, recession and deflation, and, most recently, the global financial crisis. The regime is supported by several compelling factors:

- *Strong fundamentals*. Hong Kong SAR has shown it has the preconditions to sustain a currency board arrangement. Regulation and supervision are robust and proactive and fiscal reserves have been built up as a result of a long-standing commitment to fiscal discipline. These features are instrumental in supporting the Linked Exchange Rate System.

- *Flexibility*. Hong Kong SAR has some of the most flexible factor, asset, and product markets in the world. This is combined with an economy that is highly open to both trade and capital flows. As a result, any needed adjustment in relative prices is quickly facilitated by domestic markets, rather than by movements in the nominal exchange rate. Indeed, such movements in domestic relative prices are how the economy has successfully adjusted to the dramatic structural changes in domestic and external circumstances that Hong Kong SAR has faced over the years, including the wholesale conversion from an industrial powerhouse to a service economy and the ongoing integration with Mainland China. Throughout this period, there have been repeated episodes where misalignments have been corrected in both directions, through temporary bouts of inflation and deflation.

- *Exchange rate assessment*. Staff analysis does not suggest the currency is out of line with economic fundamentals (Box 1). The Hong Kong authorities share this assessment and their own econometric exercises show the currency to be close to the estimated equilibrium real exchange rate.

- *Policy commitment*. Finally, Hong Kong SAR has demonstrated a long-term and public commitment to the peg. The Linked Exchange Rate System generates substantial benefits in terms of monetary and financial stability, yielding significant advantages to the real economy. Changing the regime would erode this stock of credibility that has been carefully built up over decades.

13. ***Potential alternatives***. Some have claimed that Hong Kong SAR should abandon the Linked Exchange Rate System in favor of a different exchange rate arrangement. In some part this has reflected an uneasiness with the fact that Hong Kong SAR does not have monetary autonomy and is importing its monetary policy from the United States at a time when the Federal Reserve is engaged in very low interest rates and quantitative easing. In this context, what could be potential alternatives for Hong Kong SAR?

- *A step revaluation?* Some argue that Hong Kong SAR should revalue its currency to reduce domestic inflationary pressures. First, this would not give Hong Kong SAR any greater monetary control than it currently has. Second, such a revaluation would undermine the credibility of the exchange rate regime and could create expectations of future adjustments. Third, such an adjustment is unwarranted given there is no strong evidence that the current level of the real exchange rate is out of line with fundamentals.

- *A different peg?* Moving to a crawling peg arrangement or re-pegging to a basket of currencies would again not give Hong Kong SAR any greater monetary policy autonomy, would continue to lead to very low domestic interest rates, and would likely have only modest benefits in curtailing property or consumer price inflation.

- *Floating?* Floating the currency would provide the scope for an independent monetary policy but would be untenable for a very small, very open, international financial center where capital flows dwarf the underlying size of the domestic economy. Indeed, floating the currency could itself expose Hong Kong SAR to even larger and more volatile capital flows, particularly if the Hong Kong dollar were to be viewed as a proxy for the renminbi. This volatility in the nominal exchange rate would be difficult to manage and lead to significant volatility in either domestic prices or in the real exchange rate.

- *The rise of the renminbi?* As an international financial center, Hong Kong SAR has long been a jurisdiction built upon the simultaneous use of multiple

Box 1. Exchange Rate Assessment

While the ongoing structural changes in the Hong Kong economy makes it difficult to draw a definitive conclusion on the presence of misalignment, the available empirical methodologies do not indicate the current level of the Hong Kong dollar is out of line with medium-term fundamentals.

Econometric methodologies

As part of the exchange rate assessment, a number of empirical methodologies were employed. The mission used a Generalized Method of Moments approach to estimate panel regressions for six international financial centers (Singapore, Hong Kong SAR, Switzerland, Netherlands, Luxembourg, and Belgium) and for a broader panel including 55 developed and emerging economies. The subsample of financial centers was included to capture the particular structural features of small international financial centers—service-oriented economies, with generally high savings rates, low dependency ratios, and driven more by investments in human rather than physical capital. In addition, the HKMA provided their own assessment (based upon a methodology adapted from the IMF's CGER); estimates were derived from SPR's exchange rate assessment toolkit, and the IMF Research Department's (RES) estimates are shown based on the CGER methodology.

The Results

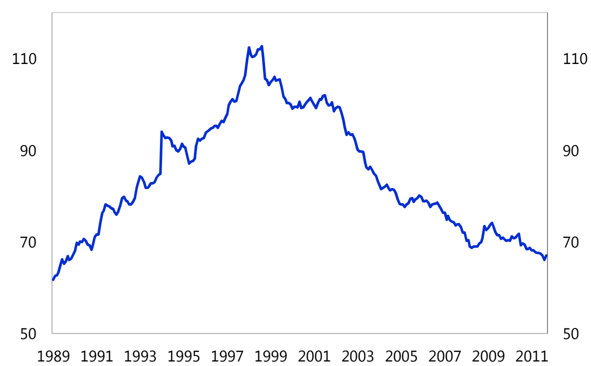
Summary of Empirical Estimates of Misalignment

	Sample	MB	ERER	ES
HK team	6 financial centers	-0.2	-14.7	-1.5
HK team	55 economies	1.0	-9.9	-1.5
HKMA	Hong Kong or 6 financial centers	-1.6	-4.5	5.4
SPR Toolkit	184 economies	2.7	-12.9	8.2
RES	54 economies	-15.0	-16.0	-12.0

- *The macroeconomic balance approach.* Estimates of the equilibrium current account for Hong Kong SAR generally suggest the medium-term current account should be in the 8–11 percent of GDP range. RES, though, estimates a smaller current account norm, which yields an assessment that the currency is undervalued by around 15 percent.

- *The equilibrium real exchange rate approach*. Estimates of the equilibrium real exchange rate generally show the Hong Kong dollar to be undervalued by between 5–16 percent.

Real Effective Exchange Rate
(2000=100)



- *The external sustainability approach.* The range of assessments generated by this approach is much broader going from modestly overvalued to modestly undervalued.

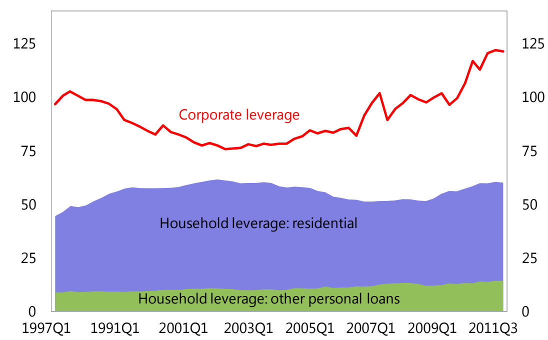
currencies. The recent rise of the renminbi is a new era but it neither undermines the role of the Hong Kong dollar nor creates a compelling argument for changing the currency regime. Linking the Hong Kong dollar to the renminbi in some way would be problematic given the nonconvertibility of the currency and its prospects for appreciation in the coming years (which would create the need for wage and price deflation in Hong Kong SAR to equilibrate the real exchange rate).

14. ***Authorities' views***. The government underlined its commitment to the Linked Exchange Rate System. They noted that the currency board had broad-based support among the public and remained the most appropriate exchange rate arrangement for Hong Kong SAR. They did not see that the exchange rate regime was necessarily a driver of rising property prices, noting that many other economies in the region had seen high property price inflation despite having very different currency regimes. They also agreed with staff's assessment that the potential alternatives for Hong Kong SAR were much less favorable than the current regime. Finally, they reiterated that the Hong Kong government has no intention to change the Link, which has been a source of monetary and financial stability since its introduction in 1983.

A CREDIT BOOM?

15. ***Developments***. Credit has expanded in various areas including trade financing, corporate lending for projects in Hong Kong SAR, and loans to Mainland entities. This growth in lending to the Mainland is not surprising given the very low costs of Hong Kong and U.S. dollar financing and the high levels of liquidity in local banks. This has been further fueled by the strong demand for credit from companies that have been rationed out on the Mainland by administrative limits on loan growth. Both household and corporate leverage in Hong Kong SAR have risen steadily. At the same time, banks' net interest margin continues to fall due to the highly competitive banking environment and rising funding costs.

Household and Corporate Leverage
(In percent of annual nominal GDP, sum of last 4 quarters)



Net Interest Margin
(In percent; local and foreign retail banks)

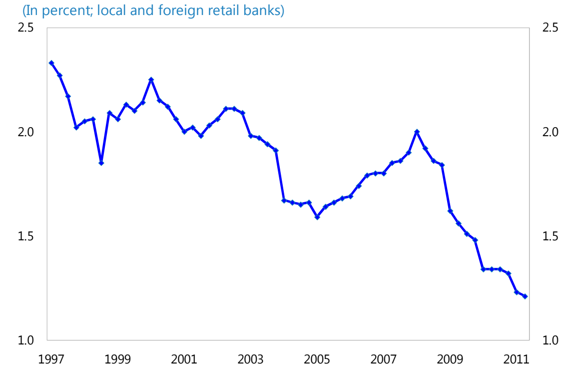
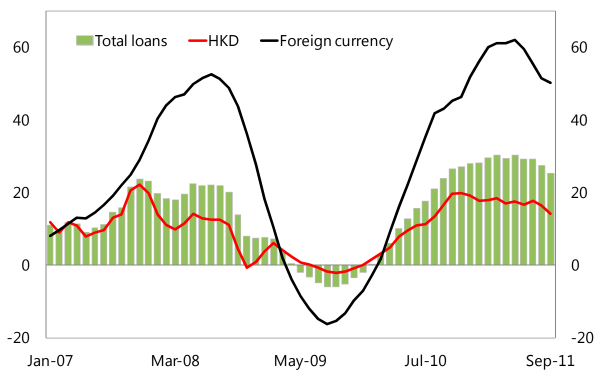


Figure 2. A Credit Boom?

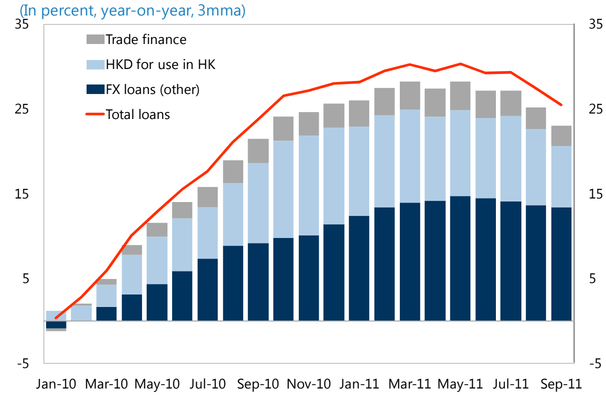
Credit has been growing at a strong pace, particularly for foreign currency denominated loans.

Credit Growth
(In percent, year-on-year, 3mma)



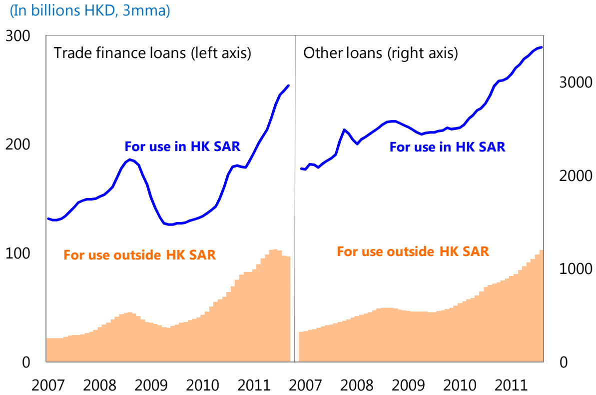
Indeed, foreign currency loans now make up over one-half of overall credit growth.

Contribution to Credit Growth
(In percent, year-on-year, 3mma)



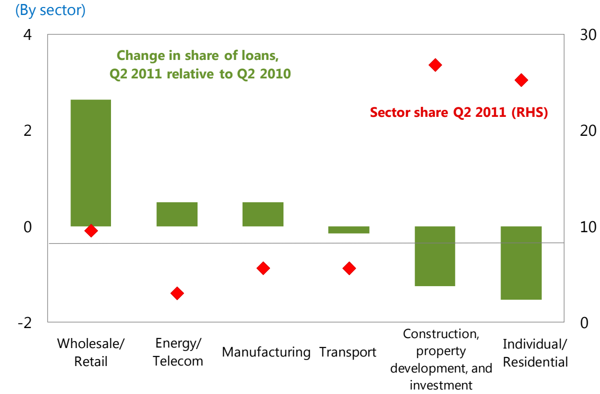
Some part of foreign currency loans categorized as for use in Hong Kong SAR is ultimately funding Mainland projects.

Loans Outstanding
(In billions HKD, 3mma)



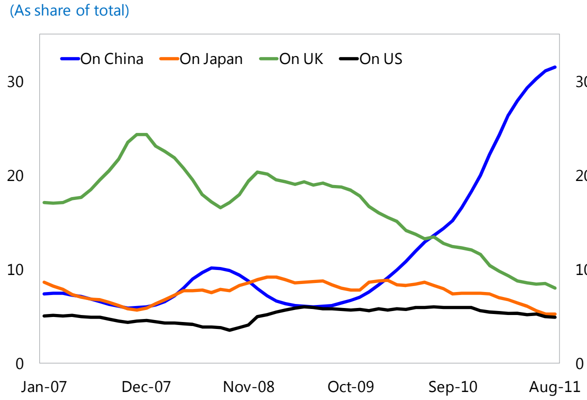
Just under half of the loans for use in Hong Kong SAR are allocated to the property sector, but that share has dropped over the last 12 months.

Loans Outstanding for Use in Hong Kong SAR
(By sector)



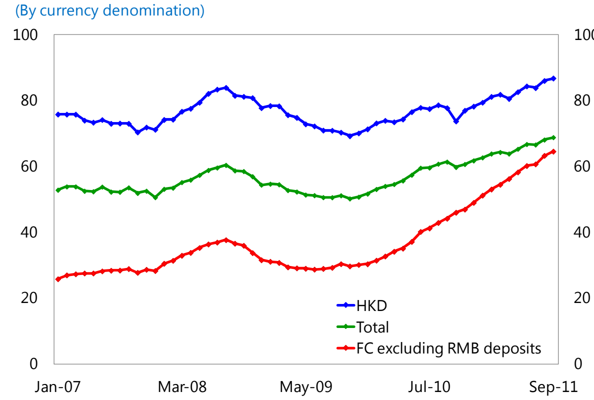
Claims on Mainland banks have been growing particularly rapidly.

External Bank Claims
(As share of total)



Foreign currency loan-to-deposit ratios continue to remain healthy, despite the fast pace of foreign currency lending.

Loan-to-Deposit Ratios
(By currency denomination)



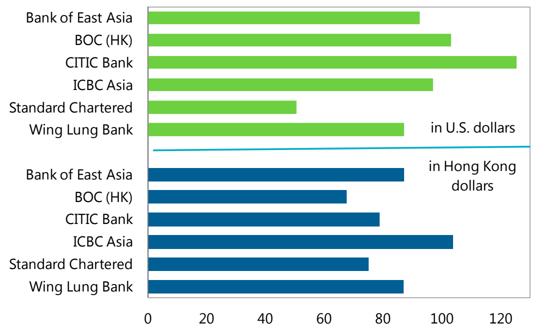
Sources: Bloomberg; CEIC Data Company Ltd.; and staff estimates.

16. ***A credit-asset price cycle?*** For the last two consultations, staff have expressed concern that a credit-asset price cycle could take hold in Hong Kong SAR, with the potential to create future macroeconomic volatility. Since mid-2010 the credit cycle has become increasingly evident with bank lending taking off, particularly loans denominated in foreign currency, fueled by tighter credit conditions on the Mainland (Figure 2). However, this was not the credit-asset price cycle that staff had in mind. Credit to purchases of private residential property has actually grown much slower than overall credit (16 percent in the 12 months to June) and, while property prices have risen, it has not been fueled by leverage. Instead, the bulk of the credit growth over the past year has been much more related to rising cross-border lending to the Mainland rather than the usual financial accelerator driving a credit-property cycle. Market participants indicated that a large part of foreign currency credit classified as for use in Hong Kong SAR was being lent to Mainland subsidiaries that were resident in Hong Kong SAR, but were using the resources for projects on the Mainland. Indeed, the ongoing expansion of credit to the Mainland has actually been tightening domestic financial conditions, leading to a rise in interest rates charged on mortgage loans as banks deploy their resources in other, more highly remunerated, directions.

17. ***Issues***. The rapid pace of credit growth raises two broad questions:

- *Will the surge in credit lead to lower credit quality and, potentially, higher problem loans in the Hong Kong banks?* International experience would suggest that such a rapid pace of credit growth has the potential to lead to a worsening of average credit quality once the business cycle swings into reverse. The authorities indicated that they were aware of this risk and were ensuring that the underwriting and credit standards of the banks were being maintained. They noted that a sizable fraction of the foreign currency lending to Mainland entities carried with it credit enhancements in the form of either guarantees by some of the largest Mainland banks or collateral in the form of deposits deposited at Mainland banks (including the subsidiaries of the Hong Kong bank that undertook the lending). These credit enhancements had been authorized by the Mainland foreign exchange regulator (SAFE) but would still have to be enforced in the Mainland's legal system. As a byproduct of these credit enhancements, Hong Kong banks' cross-border exposure to Mainland banks has risen briskly. In addition, the authorities highlighted their efforts to raise the regulatory reserve ratio as a means to enhance the countercyclical buffers that are already present in the financial system.

Loan-to-Deposit Ratios
(end-2010, in percent)



Source: Fitch Ratings.

- *Is the expansion of credit consistent with the underlying funding positions of the local banks?* The rise in lending is creating strains on bank funding. Average loan-to-deposit ratios in non-renminbi foreign currency have risen to around 63 percent, 20 percentage points higher than a year ago. This is still low by international comparisons and even when compared with Hong Kong SAR's own history but the upswing should not be ignored. The authorities indicated they were concerned about the rising loan-to-deposit ratio and potential funding pressures going forward, particularly given the volatile global outlook. As a result, they had advised banks to ensure that their credit growth is consistent with their funding potential and to stress test their liquidity position in a downside scenario. In some cases, the regulators have also asked foreign bank branches to more closely match the tenor of their loan portfolio with their funding sources in order to provide an additional layer of protection. The authorities expected a sudden stop in U.S. dollar funding would certainly have an impact but noted that the regulatory steps taken would mitigate pressures. Also, Hong Kong banks remained very liquid and continued to be funded predominantly from deposits, relying little on wholesale funding.

A PROPERTY BUBBLE?

18. ***Context***. Since the global financial crisis, property values have been propelled upward by the buoyant economy, cheap financing, a limited supply of new apartments, strong local demand for housing, and purchases by Mainland residents and high net worth individuals working in a resurgent financial industry (Figure 3).

19. ***Policies***. With monetary options limited by the currency board, the authorities have responded to rising property prices with a four-pronged strategy of (i) macroprudential measures—such as limits on loan-to-value and debt service ratios—to contain household leverage in the property sector and protect the financial system; (ii) transaction taxes (particularly the Special Stamp Duty) to discourage speculative, short-term buying-and-selling of residential properties; (iii) increased land supply for the construction of residential real estate to create a pipeline of new apartments in future years and to build out the government's land reserve over the medium term; and (iv) improve market transparency and adopt an effective communication strategy to warn of the risks of households overextending themselves in their mortgage payments and becoming overexposed to the real estate cycle. The evidence suggests that these efforts have helped lower transaction volumes, restrain credit to housing, and protect the financial system in the event of an eventual downturn (Box 2). Over a longer horizon, land supply also appears to have an impact on prices (Box 3).

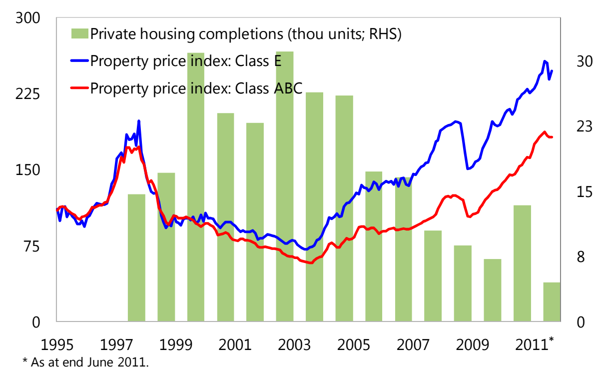
20. ***Recent developments***. While the relative balance of the various forces currently at work in the property market is unclear, over the past few months the dynamic in the residential housing market has clearly shifted. Transaction volumes are falling and there has been a modest decline in prices. In part, this has been due to tighter funding conditions and greater opportunities for lending to Mainland entities, which have caused average mortgage rates to increase (up around 120 basis points from January to 2.3 percent in August). At the same time, sentiment has weakened as domestic equity markets have performed poorly and there is increased concern over the global outlook. Finally, the government has made clear commitments to provide sufficient land to the market to build, on average, 20,000 new private housing units per year in order to meet the expected demand from new households. On the other hand, the near-term supply of apartments remains limited, mortgage rates are still relatively low, and demand for housing is being supported by low unemployment and reasonably strong household income growth.

21. ***Lending to real estate***. So far, the authorities appear to have been effective in protecting the financial system from a property downturn by limiting leverage and requiring banks to undertake careful stress-testing of potential borrowers. Their efforts have been aided by a legal framework of full-recourse mortgages and their active communication strategy to both the lenders and household borrowers. While the property sector (including loans for building, construction, property development and investment, and for purchase of residential property) still makes up around one-half of all loans outstanding, risks are mitigated by a low level of leverage (average loan-to-value ratios for new mortgages are around 53 percent). Indeed, even at the peak in 2001 nonperforming residential real estate loans never exceeded 1½ percent of the total, despite around 16 percent of the borrowers having negative equity in their homes.

Figure 3. A Property Bubble?

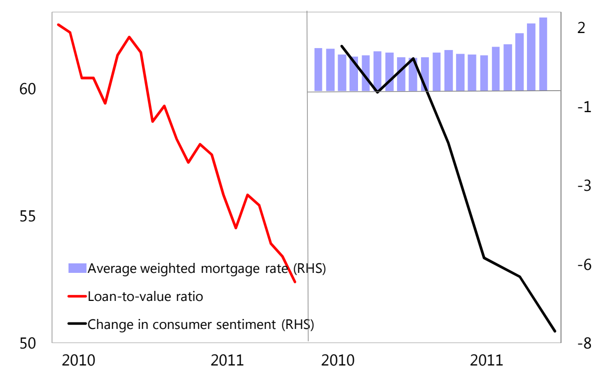
A broad-based residential property boom continued into 2011 and the near–term supply of new flats remains tight.

Property Price
(Index 1999=100)



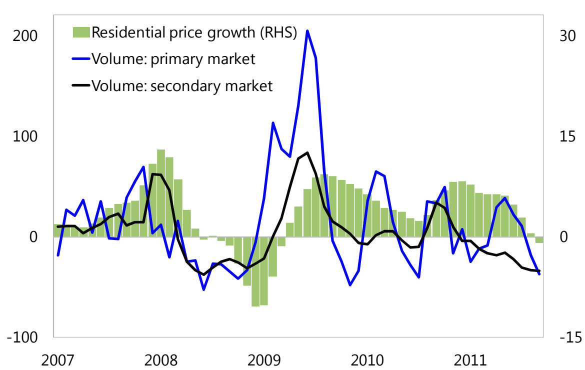
Leverage has been progressively more constrained, mortgage rates have risen, and sentiment has worsened.

Leverage and Interest Rate Conditions



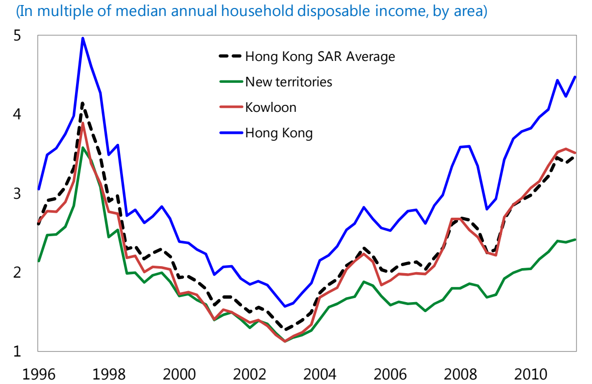
This has led the run up in prices and activity to pause.

Price and Transaction Volume
(In percent, seasonally adjusted, 3m-on-3m, 3mma)



Tighter LTV caps and price hikes have put home ownership increasingly out of reach for the median household.

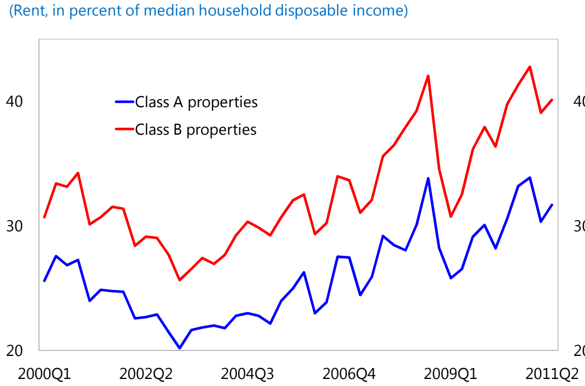
Minimum Down Payment-to-Income
(In multiple of median annual household disposable income, by area)



Note: For 45 sq.m. flat, assuming 70 percent LTV and 5 percent income tax rate.

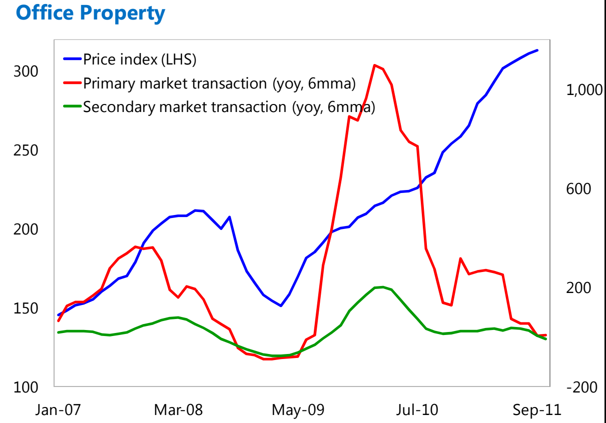
Meanwhile, rent is absorbing a growing portion of household income.

Rent-to-Income
(Rent, in percent of median household disposable income)



The rally in office prices continues unabated, although activity has tapered off somewhat.

Office Property



Sources: Bloomberg; CEIC Data Company Ltd.; Transport and Housing Bureau, Government of Hong Kong SAR; HKMA; and staff estimates.

Box 2. Assessing the Effectiveness of Macroprudential Policies

Macroprudential policies appear to increase bank capital buffers and enhance bank performance, reduce transaction volumes, and can potentially lower property price growth. Land supply appears, however, not to have an empirically significant effect over the short-term on the pace of property price appreciation.

Context. In recent times, a number of economies have used macroprudential policies to protect their financial systems from the ill effects of volatile property prices, rapid portfolio adjustments, and sudden surges in foreign capital. In Hong Kong SAR's case, faced with the onset of a credit-asset price cycle, the authorities have introduced several changes to long-standing loan-to-value (LTV) and debt-service ratio (DSR) requirements as well as changing taxation and land sales policies.

Assessing effectiveness. The analysis assesses the impact of these policies against a number of different indicators. It approaches the issue by looking both in a cross-country context (using a panel data approach estimated by Generalized Method of Moments to control for endogeneity biases) and specifically for the case of Hong Kong SAR (using a VAR approach). [1]

Cross-country results.

- The use of LTV caps tends to have a decelerating effect on property price growth.
- Both LTV and DSR limits appear to slow the growth of lending to the property sector.
- LTV and DSR tools also serve to strengthen bank capital buffers and improve bank performance (as measured by the level of nonperforming loans and return on assets).
- LTV and DSR instruments appear to be used more frequently in those economies that have fixed exchange rates. This may be because, in the broader sample of economies, interest rate tools can also be used to control credit aggregates and affect property prices, making these economies less reliant on macroprudential instruments.

Results for Hong Kong SAR.

- The design of LTV policies appear to be forward looking, with ceilings tightened to counter downward movements in mortgage interest rates, growth in mortgage lending, and rising volumes of transactions.
- More binding LTV limits appear to reduce transaction volumes in both the luxury segment and mass market.
- Over the short term, changes in LTV ratios do not appear to significantly affect the rate of residential property price inflation.
- However, around two years after the change in the LTV ratios, property price inflation appears to fall affecting both the luxury and mass market in a similar way.
- Unlike in the broader cross-country sample, a tightening of maximum LTV limits in Hong Kong SAR appears to have little effect on total mortgage lending.
- Changes in government land supply tend to be countercyclical, with more land provided at times when the market is most exuberant. However, there is little empirical evidence to suggest that changes in government land sales affect either prices or transaction volume growth over the short term.

[1] See A. Ahuja and M. Nabar, "Safeguarding Banks and Containing Property Booms: Cross-Country Evidence on Macroprudential Policies and Lessons from Hong Kong SAR," IMF Working Paper (forthcoming).

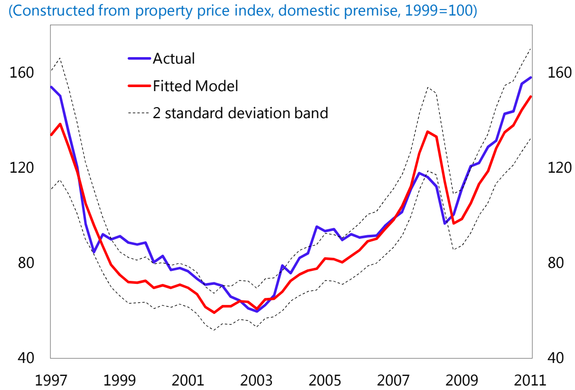
Box 3. Longer-Run Determinants of House Prices [1]

Econometric analysis finds that the rise in property prices can be well explained by economic growth, the tight land supply, low interest rates and broader financial conditions. Land supply appears to be a key long run driver of property prices but affects the market with long lags.

Context. Property prices have undergone a dramatic price cycle over the past few years. A co-integration framework was deployed to examine the longer-term drivers of property prices and whether current price levels are consistent with these economic fundamentals.

Long-term drivers. The model performs well in terms of tracking the behavior of property prices over time.

Real Residential Property Prices
(Constructed from property price index, domestic premise, 1999=100)



The model finds that:

- A one percent rise in real GDP per capita increases real property prices by around 1½ percent.
- A one percentage point fall in the real interest rate adds around 1½ percent to underlying prices.
- Expanding land supply by one percent can reduce property prices by around ¾ percent although the effect shows up with significant lags.
- Increases in construction costs are quickly passed through to higher housing prices, with an elasticity of around one-half.
- Domestic credit also feeds through to higher prices as would be expected from a credit-asset cycle model. A 10 percent rise in credit in real terms adds 2 percent to real housing prices.

Short-term dynamics. In modeling the shorter-term drivers of housing prices, it appears that both loan-to-value ratios and stamp duties have an effect. In particular, model estimation finds a statistically significant but rather temporary influence of both these policy tools on prices. This is in contrast to the findings of the VAR approach (discussed in Box 2).

Interpretation. Overall, the recent rise in property prices is well explained by economic fundamentals and it does not appear that current prices deviate materially from the long-run model. However, that does not mean the market will stay at the current high levels. Real interest rates are extraordinarily low from a historical perspective and will, at some point, move upwards. In addition, the greater land supply should put downward pressure on prices, albeit with a lag.

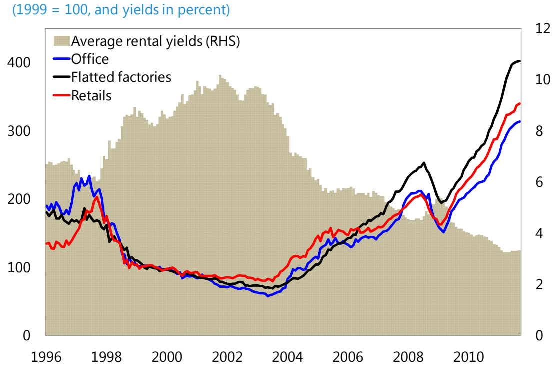
[1] See R. S. Craig and C. Hua, "Determinants of Property Prices in Hong Kong and the Role of Policy," IMF Working Paper (forthcoming).

22. ***Social consequences***. With over half of households owning their home, the majority of Hong Kong residents not in public rental housing have seen a significant wealth gain from the rise in housing prices. However, a substantial segment (around 15 percent of the population) does not currently live in public housing and does not yet own a home. Rents have been rising fast and the combination of higher prices and falling loan-to-value ratios has meant that, for the median household looking to buy a home, the minimum downpayment has reached around 3½ years of disposable income (higher than at any point since mid-1998). Indeed, there is a trade-off between securing financial stability and easing households' difficulty in entering the housing market. Specifically, partly as a side-effect of some of the recent macroprudential measures, the minimum downpayment has risen, making it more challenging for new entrants to purchase a home. Consequently, the rising cost of housing has become an important political and social issue. The authorities indicated they were acutely aware of the social and distributional consequences of rising housing costs. They underlined that they have developed a clear policy to ensure all Hong Kong people have a decent home. To achieve this goal, the government is actively building new public rental housing for low income households with a goal of completing 75,000 units over the next five years. In addition, the government last year launched a new "rent-to-buy" scheme that would ease the burden on eligible households whose incomes were below a certain threshold and who wish to buy a home. This scheme would allow them to live at a fixed rent for up to five years and, at the end of that period, receive a rebate of part of their rent to use to purchase their home. In this year's Policy Address, the chief executive also announced a New Home Ownership Scheme that would be open to low- and middle-income families. The government would build and then sell apartments to eligible, means-tested households at a price that would be linked to the mortgage repayment ability of the household (rather than a function of market prices).

23. ***Commercial real estate***. The non-residential property market has more-than-recovered from the impact of the global financial crisis. Prices have doubled since early 2009 for offices, retail space, and flatted factories (the latter, reportedly increasingly being used as lower grade office space). Unlike the residential market, these markets have not witnessed a slowdown this year and transaction volumes are at the peak levels seen in 1997. Prices are being boosted by favorable business conditions, an expectation of future gains from the conversion of building usage, and increasingly binding supply shortages. Average rental yields for commercial space have fallen below the levels of the early

1990s. The authorities have recognized the risks in this sector and responded by lowering the loan-to-value cap on mortgage lending.

Non-residential Property Price Indices and Rental Yields
(1999 = 100, and yields in percent)



24. ***Risks***. Despite the slowdown in the property market there are still risks. An external shock or even the effect of steadily rising mortgage rates could cause a significant correction in house prices, which would create macroeconomic volatility that is both economically and socially costly. On the other hand, there is a potential that the recent calming of the market could just represent a temporary hiatus in the upward property price dynamic (as Hong Kong SAR has seen periodically over the past couple of years). If true, upward pressures on prices could resume. At this stage, it is exceptionally difficult to gauge future prospects for the housing market. Private sector analysts generally felt that much would depend on the evolution of the global outlook but most were predicting either a leveling out (or even a modest decline) of property prices over the coming year. In addition, there are risks in the commercial real estate sector given the elevated price levels, continued upward dynamic in the market, and low rental yields. However, mitigating the size of these risks is the fact that the commercial real estate market is a relatively small part of the total property sector, making up about 20 percent of total market transactions.

25. ***Policies***. Given the uncertainty, policies will need to remain data-driven and guided by the trajectory of real estate prices, transaction volumes, and property-related lending in the coming months. In particular:

- *If the property market resumes its upward swing* the government should be ready to tighten macroprudential tools, raise the taxation of property, and potentially further increase land sales. They could also consider further expanding the availability of public housing for lower income groups. There are, however, risks in increasing the supply of land. Given the long lags between the initiation of new housing projects and the time when those properties actually reach the market, it is quite possible that government efforts could serve to unintentionally exacerbate the housing cycle rather than dampen it.

- *If an external shock or other force were to cause downward pressures to spread to the property market* the authorities could, as part of their countercyclical toolkit, gradually roll back some of the tightening measures linked to residential real estate that were introduced over the past few years.

In either case, the inherent uncertainty in the market outlook underlines the importance of the policy response continuing to be measured, carefully calibrated, and proportional to the risks and pressures that are emerging in the property market.

THE OFFSHORE RENMINBI BUSINESS

26. ***Progress***. Hong Kong SAR has established itself as the premier offshore renminbi center (Figure 4). Issuance of so-called "dim sum" bonds (traded in Hong Kong SAR and denominated in renminbi) has reached RMB 200 billion; around 10 percent of Mainland trade is now being settled in renminbi; and the renminbi now makes up 10 percent of total Hong Kong deposits. In order to create greater opportunities to deploy offshore renminbi, the Mainland authorities have progressively created avenues through the capital controls for renminbi to flow back to the Mainland for productive use. This has taken the form of recent announcements on renminbi FDI, permitting Mainland banks and nonfinancial corporations to issue dim sum bonds, creating a renminbi–Qualified Foreign Institutional Investors scheme, and allowing limited investment (regulated by quotas) into the interbank bond market. These steps should all facilitate the further expansion, deepening, and maturation of the offshore market.

27. ***Issues***. Hong Kong banks indicated that trade settlement remains one-sided, predominantly being used for the payment of imports heading into the Mainland. However, they also indicated that this imbalance has been steadily falling over time as more Mainland exporters have chosen to settle in renminbi. There is also very little secondary market liquidity in the dim sum bonds (almost all are held to maturity), which has hampered the development of a repo market and, possibly, renminbi derivatives. Also, despite a rapid expansion in the market, the volume of available renminbi assets has not kept up with the amount of renminbi liquidity accumulating in Hong Kong SAR. Finally,

RMB Exchange Rate: Onshore vs. Offshore

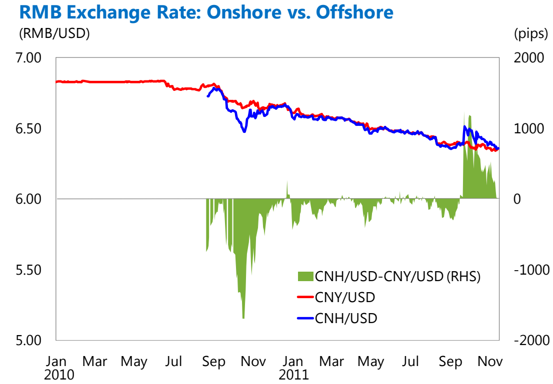
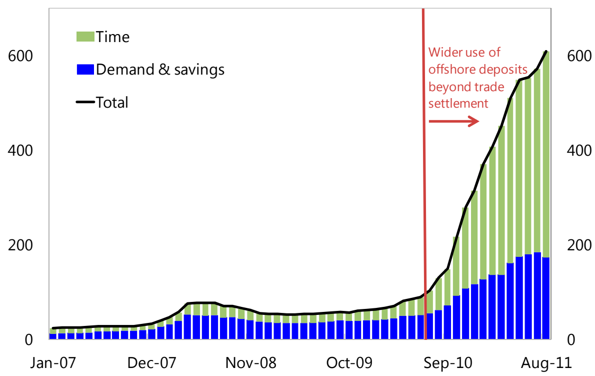


Figure 4. An Upward Trajectory for Offshore Renminbi Markets

Offshore renminbi deposits have grown rapidly, particularly after the Mainland authorities permitted a wider use of offshore deposits beyond trade settlement.

RMB Deposits Outstanding

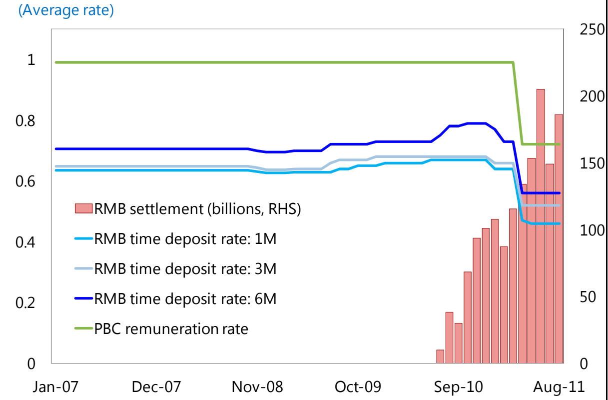
(In billions RMB)



Deposit rates rose with the onset of RMB trade settlement activity, but have since fallen as the People's Bank lowered the remuneration rate at the clearing bank.

Time Deposit Rates and RMB Trade Settlement

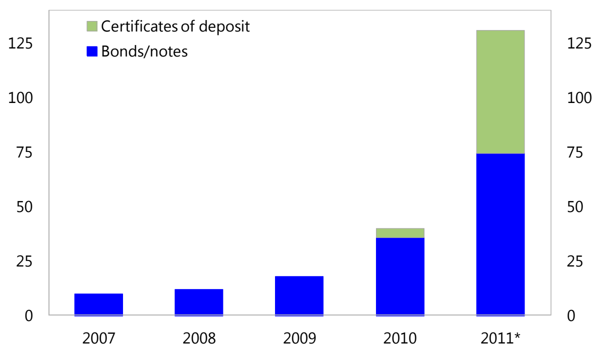
(Average rate)



Offshore renminbi bond and certificate of deposit issuance has more than doubled this year...

CNH Bonds: New Issuance

(By type of security)

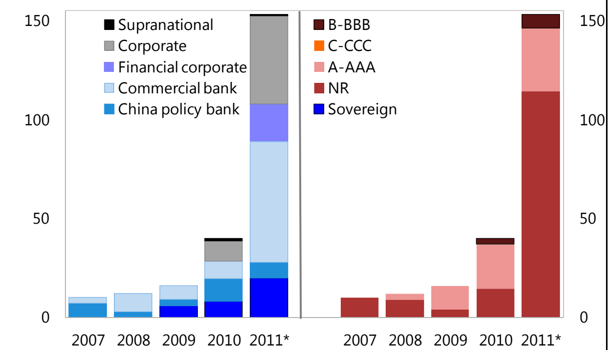


* YTD August, 2011

...and a wider range of issuers has accessed the market...

CNH Bonds: New Issuance

(In billions RMB; by issuer sector & type of rating)

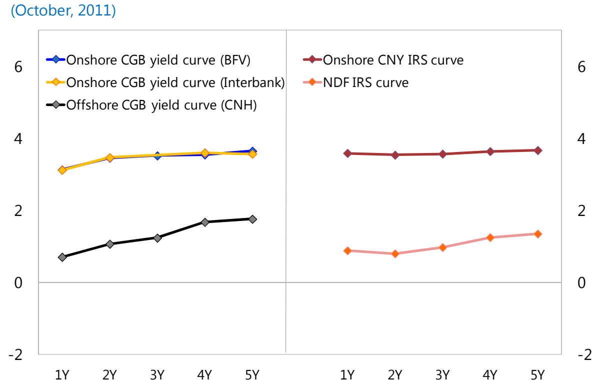


* YTD Sep, 2011

...taking advantage of the lower cost of funding relative to that on the Mainland.

Yield Curve

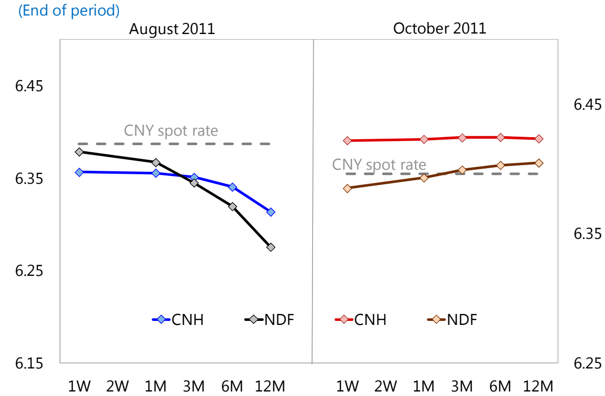
(October, 2011)



Investors have in general priced in appreciation expectations, although the pattern has reversed in the CNH market in the last two months.

Exchange Rate Forwards: RMB/USD

(End of period)



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

Box 4. Key Developments in Renminbi Internationalization

Several significant steps have been taken to expand renminbi offshore intermediation and Hong Kong SAR has emerged as the principal offshore center.

- ***Deposits***. Licensed banks in Hong Kong SAR have offered renminbi deposits and remittances since February 2004. Initially all deposits had to be re-deposited with the People's Bank of China through the Hong Kong clearing bank and the growth of offshore deposits was relatively slow. Since July 2010, corporates have been permitted to open renminbi deposits for purposes beyond trade settlement. As other offshore renminbi products have developed (including bonds, trade finance, CDs, structured deposits, and investment funds), renminbi deposits have grown rapidly and currently stand at around 10 percent of Hong Kong deposits. Corporate deposits constitute around two-thirds of this stock, reflecting the growing use of renminbi for trade settlement purposes. Pricing of deposit rates continues to be driven largely by the PBC's remuneration rate on reserves.

- ***Bonds***. The issuance of offshore renminbi bonds was initially confined to Mainland policy and commercial banks, starting with the China Development Bank listing in July 2007. Sovereign issuance has also been an important driver of the market since September 2009. The most recent Ministry of Finance auction netted RMB 15 billion in August at yields of 0.6 to 2.36 percent. A range of corporate issuers has also tapped renminbi funds in the offshore market, including foreign companies such as McDonald's, Volkswagen and Caterpillar. Bond issuance has more than doubled in the year through September. There is, however, limited secondary market activity as most bonds are held to maturity.

- ***Trade settlement***. Renminbi trade settlement was first introduced as a pilot in June 2009 and extended to all Mainland provinces in August 2011. The use of renminbi for trade settlement purposes has grown rapidly over the past twelve months, reaching around 10 percent of China's overall trade. Data from the People's Bank of China suggests that trade settlement activity continues to be more by renminbi invoicing of Chinese imports than exports.

- ***Other offshore renminbi products***. The steady expansion in the use of offshore renminbi has enabled innovation in other renminbi products including real estate investment trusts.

- ***Capital flows to the Mainland***. In August 2010, the People's Bank allowed (with a quota) some offshore central banks, clearing banks in Hong Kong SAR and Macau SAR, and banks participating in offshore renminbi business access to the Mainland interbank bond market. Beyond this, channels for reinvesting offshore renminbi back to the Mainland were relatively few. However, in August 2011, a new pilot scheme was announced to allow up to RMB 20 billion of portfolio flows into the securities markets (through a renminbi Qualified Foreign Institutional Investor scheme) and, in October, rules were published to allow overseas firms to invest renminbi raised offshore in the Mainland as foreign direct investment.

recent selling pressure—generally perceived to be by international investors—has revealed a lack of liquidity in the offshore renminbi market causing the offshore spot rate to deviate by up to 2 percent from the onshore rate and for that deviation to be rather persistent.

28. ***Credit standards***. Some concerns have been voiced that, because Hong Kong SAR has too much renminbi chasing too few renminbi-denominated assets, investors are willing to put less of a weight and due diligence in assessing the creditworthiness of the borrower. While difficult to assess directly due to the lack of comparable debt in other currencies by the various issuers, available data do not indicate this to be the case. Certainly, financing in renminbi in Hong Kong SAR is cheaper than on the Mainland. However, there does not seem to be a big difference between rates available to borrowers in renminbi and to those who borrow in other currencies and swap the proceeds into renminbi. The government argued that, while some issuers did not have a credit rating, many were listed companies with significant public information available about their operations. In other cases, the underwriting banks had a long customer relationship with the issuer, which helped reduce information asymmetries about the borrower. Market participants were of the view that it may have been the case earlier this year that some high-yield issuers were able to tap the dim sum bond market at unusually low interest rates. However, they suggested that this was possibly a product of the early stage of development of the market (which has been open to corporate issuance for only a few months). More recently, as the dim sum bond market has deepened and as risk aversion has risen, they indicated that investors had become more cautious, particularly for high yield names, and were now more focused on the credit risk profile of issuers. They suggested that high-yield issuers without a sufficient track record or a credit rating were increasingly being rationed out of this market.

29. ***Onshore-offshore comovement***. Until recently, many investors were viewing the offshore renminbi market as a close proxy for the onshore currency. Indeed, some were even hedging positions in the offshore renminbi market with nondeliverable forwards that were priced off the onshore exchange rate fixing. Recent developments have highlighted that these are two separate assets, which move together over a longer horizon but which can diverge significantly over the shorter term. This realization should lead to a healthy realignment of investor expectations and will contribute to the steady maturation of the offshore market.

30. ***Funding***. The ongoing shift of corporate and household deposits into renminbi is creating some knock-on effects to Hong Kong financial conditions. In particular, this growth of renminbi deposits may have reduced the availability of funds that can be lent in other currencies. This comes at a time when lending, particularly in foreign currencies, is expanding rapidly. This, in part, is a factor contributing to greater competition for non-renminbi deposits and higher costs of both funding and credit. Over time, though, as the market develops and as renminbi FDI flows grow, a greater proportion of credit should be provided in renminbi, creating a more balanced situation in terms of offshore renminbi assets and liabilities.

31. ***Information***. Much has been done to help investors better understand the workings of the fast-developing offshore renminbi market, including through a proactive communication strategy by the Hong Kong Monetary Authority. As the offshore renminbi market expands, more information could help facilitate further market development. This could include regular reporting on the direction of renminbi settlement in both goods and services, the nature of renminbi capital flows, and aggregate information on the renminbi assets and liabilities of Hong Kong SAR's financial institutions.

32. ***A hand-off***. To some extent, an expectation of renminbi appreciation over the medium term has aided the rapid development of the offshore market. Going forward, the underlying motivation for this market will have to shift. In particular, for the project to be fully successful, the growing flows of renminbi into the offshore market will have to be supported by an expansion of the conduits by which this renminbi can flow back to the Mainland. This hand-off will need to involve a steady increase in the convertibility of China's capital account. However, particularly where this involves short-term portfolio flows into the Mainland's bond and equity markets, this should be paced in accordance with progress on liberalization and reform of the Mainland's own financial system.

STAFF APPRAISAL

33. ***Growth.*** Hong Kong SAR's rebound from the damage wreaked by the global financial crisis has been dynamic and compelling. Concerted policy efforts, Hong Kong SAR's flexible economic system, and strong up-drafts from Mainland China have all contributed to the growth trajectory. Unemployment has fallen to very low levels, real incomes have grown, and living standards are improving. However, with external demand weakening, the momentum in Hong Kong SAR's economy is set to moderate in the coming year.

34. ***Inflation.*** The government has rightly recognized inflationary pressures as a social concern. Going forward, the slowing economy and waning food prices on the Mainland should take some of the impetus out of inflation. Nevertheless, the delayed pass-through from higher house prices to rents and then on to consumer prices will likely continue for much of 2012. Given the concerns about inflation, fiscal policy should seek to provide some countercyclical restraint. In the upcoming budget, many of the recent one-off and temporary measures could be discontinued, particularly those taking the form of universal transfers.

35. ***Property***. While recent signs of a slowdown in the housing market are encouraging, it would be premature to assume that the prospects for a property bubble have dissipated. The difficulty now is to gauge whether the current property slowdown is going to endure. Many of the drivers that have pushed the market up over the past years remain in place. On the other hand, mortgage rates are moving up, the supply of land has been increasing, and expectations of future price growth appear to have softened. These countervailing forces may be sufficient to cool down the market but it is too early to declare victory. As a result, future policies will need to continue to be data-driven and proportional to the risks. If the property market continues its upward trajectory, the government should be ready to further draw on macroprudential tools, raise the taxation of property, and expand land sales. On the other hand, if an external shock causes property prices to move significantly lower, these same tools should be used countercyclically, gradually rolling back some of the property-related measures introduced over the past few years.

36. ***Social impact.*** The high cost of housing places a large social burden on renters and new households that do not yet own a property. The redistributive impact of the recent rise in housing should not be underestimated. It is fitting, therefore, that the government has been working to lessen this burden by increasing the availability of public housing, introducing schemes such as the My Home Purchase Plan to help partially overcome the rising barriers to home ownership, and, most recently, reactivating the Home Ownership Scheme.

37. ***Spillovers***. The key risk ahead is from a significant external shock, perhaps emanating from Europe. Given the large consequences, such a low probability tail event should be factored into policymakers' contingent planning. In particular, the government should be ready to deploy a significant and immediate fiscal stimulus and, depending on the severity of the shock, consider extraordinary measures to support the financial system or gradually rolling back some of the property-related measures introduced over the past few years.

38. ***Credit.*** Bank lending has been growing fast, particularly that to Mainland-related entities. The regulatory authorities have continued to be forward-looking and proactive in protecting the financial system from an eventual turn in the credit cycle. The regulators have issued instructions to banks to ensure that future lending plans are consistent with the availability of funds. They are also conducting more intensive on-site examinations to check that underwriting standards are not being weakened and are asking banks to increase their countercyclical buffers—including through higher regulatory reserves—in order to offset potential risks. These steps are the right response given the uncertainty in the global outlook and the potential for global foreign currency funding strains to emerge if risk aversion again intensifies.

39. ***The Linked Exchange Rate System***. Proposals to abandon the currency board and re-peg the Hong Kong dollar to a basket of currencies or pursue some form of crawling peg are not compelling. Such changes to the currency regime would give Hong Kong SAR no more monetary autonomy than it has today but would sacrifice the benefits of monetary and financial stability that have been hard-won over the past 28 years. Hong Kong SAR has made the clear social choice to have an economic system that adjusts to the changing environment through movements in nominal wages and prices. The preconditions to sustain such a system are fully in place and the economy is highly flexible which facilitates a quick and effective adjustment of the real exchange rate so as to avoid sizable or persistent misalignments. All in all, the Linked Exchange Rate System is a simple, credible, transparent, and widely understood exchange rate regime that merits continued support.

40. ***Offshore renminbi.*** The offshore renminbi business in Hong Kong SAR has developed quickly with generally positive results. As a consequence, the channels of financial spillovers between the Mainland and Hong Kong SAR are widening. As the Hong Kong and Mainland economies and financial markets become ever more interconnected, there will be greater avenues for both real sector and financial spillovers between Hong Kong SAR and the Mainland. Going forward, the offshore market will need to be supported by a progressive opening to renminbi capital flows and an improvement in the provision of information to the market.

41. It is recommended that the next Article IV consultation takes place on the standard 12-month cycle.

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 2006–12 1/

						Staff projections	
	2006	2007	2008	2009	2010	2011	2012
Real GDP (percent change)	7.0	6.4	2.3	-2.7	7.0	5.7	4.0
Contribution							
Domestic demand	5.3	7.0	1.5	0.7	6.6	5.4	3.9
Private consumption	3.5	5.0	1.4	0.4	3.9	4.1	2.9
Government consumption	0.0	0.3	0.2	0.2	0.2	0.2	0.2
Gross fixed capital formation	1.5	0.7	0.2	-0.8	1.6	1.1	0.8
Inventories	0.3	1.0	-0.4	0.9	0.9	0.0	0.0
Net exports	1.6	-0.6	0.8	-3.4	0.3	0.4	0.1
Inflation (percent change)							
Consumer prices	2.0	2.0	4.3	0.5	2.4	5.5	4.0
GDP deflator	-0.3	2.9	1.5	-0.6	0.5	4.0	3.7
Employment (percent change)	1.9	2.4	1.0	-1.1	0.4	1.5	1.0
Unemployment rate (percent, period average)	4.8	4.0	3.6	5.4	4.4	3.5	3.7
Real wages	-0.1	0.7	0.7	-1.5	-0.4	...	...
Government budget (percent of GDP)							
Revenue	19.5	22.2	18.9	19.6	21.6	22.3	22.1
Expenditure	15.5	14.5	18.8	18.0	17.3	19.8	18.1
Consolidated budget balance	4.0	7.7	0.1	1.6	4.3	2.5	4.0
Fiscal reserves as of March 31	25.0	30.5	29.5	32.1	34.1	33.5	35.1
Money and credit (percent change, end-period)							
Narrow money (M1)	13.1	25.4	4.7	39.6	12.8	...	...
Broad money (M3)	15.5	20.6	2.6	5.2	8.0	...	...
Loans for use in Hong Kong SAR (not including trade financing)	2.3	15.2	11.0	-2.1	21.7	...	...
Interest rates (percent, end-period)							
Best lending rate	7.8	6.8	5.0	5.0	5.0	...	...
Three-month HIBOR	3.8	3.3	0.9	0.1	0.3	...	...
Asset prices							
Hang Seng stock index (end of period, 1964=100)	19,965	27,813	14,387	21,873	23,035	...	...
Hang Seng stock index (percent change)	34.2	39.3	-48.3	52.0	5.3	...	...
Residential property prices (end of period, percent change)	4.1	25.7	-11.1	28.5	21.0	...	...
Merchandise trade (percent change)							
Export volume	9.3	7.0	1.9	-12.7	17.3	6.7	6.8
Import volume	9.2	8.8	1.8	-9.5	18.1	7.3	7.0
External balances (percent of GDP)							
Merchandise trade balance	-7.4	-9.5	-10.7	-12.8	-19.1	-21.9	-21.8
Domestic exports	9.4	7.3	6.1	4.7	4.7	4.5	4.2
Re-exports	157.8	159.8	163.5	149.1	170.8	177.6	177.8
Imports	174.6	176.6	180.3	166.6	194.7	204.1	203.8
Current account	12.1	12.3	13.7	8.6	6.2	5.4	5.6
Foreign exchange reserves 2/							
In billions of U.S. dollars, end-of-period	133.2	152.7	182.5	255.8	268.7	269.9	271.3
In months of retained imports	18.6	19.5	22.0	34.6	28.7	24.5	23.0
In percent of broad money (M3)	20.3	19.4	22.5	29.9	29.2	...	...
Exchange rate							
Linked rate (fixed)			HK$7.80/US$1				
Market rate (HK$/US$1, period average)	7.768	7.801	7.787	7.752	7.769	...	...
Real effective rate (period average, 2000=100) 3/	78.1	74.1	70.2	71.9	70.0	...	...

Sources: CEIC Database; and staff estimates.

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, 2006/07–2016/17 1/

(In percent of GDP, unless otherwise stated)

						Staff projections					
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Revenue	19.5	22.2	18.9	19.6	21.6	22.3	22.1	21.9	21.9	21.9	21.8
Taxes	12.8	14.2	13.0	12.8	13.9	14.2	...	...	...		
Direct taxes	7.8	8.3	8.7	7.6	8.2	8.1	...	...	...		
Of which:											
Salaries tax	2.6	2.3	2.3	2.5	2.5	2.5	...	...	...		
Profits tax	4.9	5.7	6.2	4.7	5.3	5.3	...	...	...		
Indirect taxes	4.9	6.0	4.3	5.2	5.6	6.1	...	...	...		
Nontax	6.8	7.9	5.9	6.8	7.7	8.2	...	...	...	...	...
Of which:											
Land premium	2.5	3.9	1.0	2.4	3.8	3.9	3.3	3.1	3.0	2.8	2.7
Investment income	2.0	1.7	2.8	2.1	1.9	1.7	1.9	2.0	2.1	2.3	2.4
Expenditure	15.5	14.5	18.6	17.8	17.3	19.8	18.1	17.9	17.6	17.3	17.3
Current 2/	13.1	12.7	15.4	14.4	13.7	15.9	13.6	13.6	13.5	13.5	13.5
Of which:											
Personnel related	4.2	4.0	4.1	4.4	4.2	...	...	...	...	...	...
Capital	2.4	1.9	3.2	3.4	3.6	3.9	4.5	4.3	4.1	3.9	3.9
Of which:											
Interest	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	4.0	7.7	0.1	1.8	4.3	2.5	4.0	4.0	4.3	4.5	4.5
Memorandum items:											
Operating balance 3/	2.7	4.4	1.4	1.8	3.5	0.9	3.5	3.8	4.1	4.5	4.9
Primary balance 4/	2.1	6.0	-2.7	-0.2	2.5	0.8	2.1	2.0	2.1	2.3	2.1
Structural balance 5/	0.5	1.6	0.3	-2.3	-1.3	-3.3	-1.3	-1.3	-1.0	-0.8	-0.8
Fiscal reserves	25.0	30.5	29.5	32.1	34.1	33.5	35.1	36.7	38.1	40.2	42.0
(Months of spending)	19.8	25.2	18.8	21.3	23.7	20.3	23.2	24.6	26.0	27.8	29.1

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, 2006–16

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
						Staff projections					
					(In billions of U.S. dollars)						
Current account	22.9	25.5	29.5	18.0	13.9	13.3	14.8	16.7	19.1	21.9	27.1
Goods balance	-14.0	-19.7	-23.1	-26.9	-43.0	-54.0	-57.8	-61.8	-64.2	-68.4	-70.9
Services balance	35.7	42.1	45.2	42.5	55.6	65.0	69.5	74.7	78.6	83.3	88.3
Income balance	3.5	5.7	10.7	5.5	4.7	5.9	7.0	8.0	9.2	11.4	14.0
Transfer balance	-2.2	-2.6	-3.3	-3.2	-3.4	-3.6	-3.9	-4.2	-4.4	-4.4	-4.4
Capital and financial account	-27.0	-33.2	-29.7	-20.0	-17.7	-13.3	-14.8	-16.7	-19.1	-21.9	-27.1
Capital account	-0.4	1.3	2.1	4.7	5.2	5.1	4.5	5.1	5.3	5.6	6.4
Financial account	-26.7	-34.6	-31.8	-24.7	-22.9	-18.4	-19.2	-21.9	-24.4	-27.5	-33.5
Net direct investment	0.1	-6.7	9.0	-11.6	-7.2	-7.7	-10.2	-5.1	-4.9	-3.5	-2.1
Inflow	45.1	54.3	59.6	52.4	68.9	83.0	81.8	88.2	92.5	97.7	105.3
Outflow	-45.0	-61.1	-50.5	-64.0	-76.1	-90.7	-92.0	-93.3	-97.4	-101.1	-107.4
Portfolio investment	-26.8	-2.7	-37.9	-42.9	-60.9	-65.1	-70.4	-74.1	-78.1	-81.9	-94.8
Financial derivatives	3.3	5.6	8.1	3.2	3.8	8.9	8.8	8.7	10.1	11.3	12.1
Other investment	2.7	-16.0	22.8	97.5	50.5	46.6	54.0	50.1	51.5	52.2	60.0
Reserve assets (net change)	-6.0	-14.7	-33.9	-70.9	-9.1	-1.2	-1.4	-1.5	-2.9	-5.7	-8.7
Net errors and omissions	4.1	7.7	0.4	2.1	3.8	0.0	0.0	0.0	0.0	0.0	0.0
					(In percent of GDP)						
Current account	12.1	12.3	13.7	8.6	6.2	5.4	5.6	5.9	6.3	6.7	7.8
Goods balance	-7.4	-9.5	-10.7	-12.8	-19.1	-21.9	-21.8	-21.7	-21.1	-21.0	-20.3
Services balance	18.8	20.3	20.9	20.3	24.8	26.4	26.2	26.2	25.8	25.6	25.3
Income balance	1.9	2.8	5.0	2.6	2.1	2.4	2.6	2.8	3.0	3.5	4.0
Transfer balance	-1.2	-1.2	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5	-1.4	-1.3
Capital and financial account	-14.2	-16.0	-13.8	-9.6	-7.9	-5.4	-5.6	-5.9	-6.3	-6.7	-7.8
Capital account	-0.2	0.6	1.0	2.2	2.3	2.1	1.7	1.8	1.7	1.7	1.8
Financial account	-14.0	-16.7	-14.8	-11.8	-10.2	-7.5	-7.2	-7.7	-8.0	-8.5	-9.6
Net direct investment	0.0	-3.3	4.2	-5.5	-3.2	-3.1	-3.8	-1.8	-1.6	-1.1	-0.6
Portfolio investment	-14.1	-1.3	-17.6	-20.5	-27.1	-26.4	-26.5	-26.0	-25.6	-25.2	-27.2
Financial derivatives	1.8	2.7	3.8	1.5	1.7	3.6	3.3	3.1	3.3	3.5	3.5
Other investment	1.4	-7.7	10.6	46.6	22.5	18.9	20.3	17.6	16.9	16.0	17.2
Reserve assets (net change)	-3.2	-7.1	-15.7	-33.9	-4.1	-0.5	-0.5	-0.5	-1.0	-1.8	-2.5
Net errors and omissions	2.2	3.7	0.2	1.0	1.7	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, 2007–16

					Staff projections					
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Real GDP (percent change)	6.4	2.3	-2.7	7.0	5.7	4.0	4.3	4.3	4.3	4.3
Contribution										
Real domestic demand	7.0	1.5	0.7	6.6	5.4	3.9	4.1	3.8	3.8	3.7
Private consumption	5.0	1.4	0.4	3.9	4.1	2.9	2.9	2.8	2.8	2.7
Government consumption	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Gross fixed capital formation	0.7	0.2	-0.8	1.6	1.1	0.8	1.0	0.8	0.8	0.8
Inventories	1.0	-0.4	0.9	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	-0.6	0.8	-3.4	0.3	0.4	0.1	0.3	0.5	0.5	0.6
Output gap (in percent of potential)	2.8	1.2	-4.4	-1.2	0.9	0.7	0.6	0.4	0.2	0.0
Growth rates										
Real domestic demand	7.9	1.6	0.8	7.2	5.8	4.2	4.4	4.1	4.1	4.0
Private consumption	8.5	2.4	0.7	6.2	6.6	4.7	4.6	4.5	4.4	4.3
Government consumption	3.0	1.8	2.3	2.7	2.3	2.0	2.0	2.0	2.0	2.0
Gross fixed capital formation	3.4	1.0	-3.9	7.8	5.4	3.9	5.0	4.2	4.2	4.2
Saving and investment (percent of GDP)										
Gross national saving	33.3	34.1	29.9	29.9	29.2	29.1	29.3	29.5	29.8	30.6
Gross investment	20.9	20.4	21.3	23.7	23.8	23.6	23.4	23.2	23.1	22.8
Saving-investment balance	12.3	13.7	8.6	6.2	5.4	5.6	5.9	6.3	6.7	7.8
Inflation (percent change)										
Consumer prices	2.0	4.3	0.5	2.4	5.5	4.0	3.0	3.0	3.0	3.0
GDP deflator	2.9	1.5	-0.6	0.5	4.0	3.7	2.8	2.7	2.3	2.9
Employment (percent change)	2.4	1.0	-1.1	0.4	1.5	1.0	1.2	1.2	1.1	1.1
Unemployment rate (percent, period average)	4.0	3.6	5.4	4.4	3.5	3.7	3.9	4.1	4.2	4.3
Merchandise trade (percent change)										
Export volume	7.0	1.9	-12.7	17.3	6.7	6.8	8.6	8.6	8.5	8.5
o/w Re-exports	8.6	2.9	-12.2	17.8	6.9	7.0	8.8	8.7	8.6	8.6
Import volume	8.8	1.8	-9.5	18.1	7.3	7.0	8.5	8.1	8.2	8.2
Retained import volume	11.7	-1.4	-3.8	19.7	-10.0	6.1	6.5	6.1	6.0	5.9
Export value	9.4	5.4	-12.3	22.7	14.1	7.8	9.4	9.5	9.5	9.2
Import value	10.7	6.0	-10.6	25.6	15.3	7.7	9.2	8.9	9.2	8.7
External balances (in billions of US$)										
Trade balance	-19.7	-23.1	-26.9	-43.0	-54.0	-57.8	-61.8	-64.2	-68.4	-70.9
In percent of GDP	-9.5	-10.7	-12.8	-19.1	-21.9	-21.8	-21.7	-21.1	-21.0	-20.3
Exports of goods	346	365	322	394	449	483	529	579	634	693
Imports of goods	366	388	349	437	503	541	591	643	703	764
Current account	25.5	29.5	18.0	13.9	13.3	14.8	16.7	19.1	21.9	27.1
In percent of GDP	12.3	13.7	8.6	6.2	5.4	5.6	5.9	6.3	6.7	7.8
Foreign exchange reserves (end-year)	152.7	182.5	255.8	268.7	269.9	271.3	272.8	275.7	281.4	290.1
In percent of GDP	73.7	84.8	122.2	119.7	109.6	102.2	95.8	90.4	86.5	83.1

Sources: CEIC Database; and staff estimates.

Table 5. Hong Kong SAR: Vulnerability Indicators, 2001–11

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Latest 2011
Public sector											
Fiscal surplus (in percent of GDP)	-4.9	-4.8	-3.2	-0.3	1.0	4.0	7.7	0.2	1.8	4.3	…
Accumulated fiscal surplus (in percent of GDP)	28.7	24.4	22.3	22.9	22.5	25.0	30.5	29.5	32.1	34.1	33.8
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	17.3	-2.2
Domestic exports	-10.7	-11.0	-6.9	2.2	6.1	3.0	-19.3	-19.2	-26.6	-0.1	-5.5
Reexports	-2.4	10.9	15.9	15.8	10.7	9.7	8.6	2.9	-12.2	17.8	-3.1
Total import volume (percent change)	-1.9	7.9	13.1	13.7	8.0	9.2	8.8	1.8	-9.5	18.1	1.4
Current account (in billions of U.S. dollar)	9.8	12.4	16.5	15.7	20.2	22.9	25.5	29.5	18.0	13.9	0.6
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	-16.2	-43.7	-7.6
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	268.7	279.6
In months of retained imports	20.4	22.6	23.2	21.1	19.8	18.6	19.5	22.0	34.6	28.7	24.4
In percent of monetary base	376.9	354.0	313.6	325.1	339.0	349.6	371.6	278.8	196.3	200.9	206.4
In percent of broad money 1/	24.4	24.8	24.1	23.1	22.0	20.5	19.5	22.6	30.1	29.3	28.0
In percent of Hong Kong dollar M3	43.0	43.5	43.3	43.3	41.1	37.0	36.1	43.4	55.0	53.9	55.6
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	496.5	626.5	702.3
In percent of gross reserves	269.9	200.0	211.6	249.6	249.8	273.9	353.5	268.3	194.0	233.1	253.4
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	-212.1	-234.8
Real exchange rate (percent change)	0.3	-4.8	-9.0	-6.6	-2.8	-1.0	-5.2	-5.3	2.4	-2.5	-4.0
Financial sector											
HIBOR(3M)-LIBOR (3M) (in basis points, period average)	-11.1	6.8	-17.1	-116.6	-50.5	-93.4	-96.8	-57.8	-26.3	-9.1	-10.9
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	5.3	-21.3
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	21.0	17.6
Banking sector 4/											
Loan-to-deposit ratio	64.1	62.6	57.1	55.8	56.8	51.9	50.5	54.2	51.5	61.6	68.7
Domestic credit growth 5/	-3.8	-2.6	-2.0	4.9	7.7	2.3	15.2	11.0	-2.1	21.7	20.0
Real credit growth 5/	-0.3	-1.1	-0.1	4.6	6.3	0.0	11.0	8.7	-3.6	18.2	13.6
Capital adequacy ratio 6/	16.5	15.7	15.3	15.4	14.8	14.9	13.4	14.8	16.8	15.9	15.9
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	0.8	0.6
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	1.2
Return on assets (post-tax) 8/	1.1	1.2	1.2	1.4	1.4	1.4	1.5	0.9	1.0	1.0	1.1
Net open spot position (in billions of U.S. dollar)	24.7	18.2	15.9	28.2	30.7	52.0	78.8	56.8	38.1	39.0	27.2
Net open forward position (in billions of U.S. dollar)	-14.6	-6.7	-6.4	-24.5	-25.9	-46.2	-71.8	-43.8	-27.6	-34.6	-25.2
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	11.6	12.3
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	52.8	51.1	49.1
Deposits (in percent of liabilities)	55.4	55.3	55.0	54.2	56.1	57.3	56.7	56.3	60.0	55.8	52.0
Contagion indicator											
Hang Seng-NASDAQ Composite correlation (daily)	0.9	0.8	0.9	0.6	0.8	0.5	0.8	0.9	1.0	0.8	0.8

Sources: CEIC Database; Hong Kong SAR authorities; Bank for International Settlements; Bloomberg; 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, not including trade finance. Latest figures (2011) 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.

Table 6. Hong Kong SAR: General Government Statistics, 2006–11

	2006	2007	2008	2009	2010	2011
Statement of government operations			(HK$ million)			
Revenue	305,352	368,242	330,289	335,793	...	...
Expense	245,787	263,074	316,293	312,157	...	...
Gross operating balance	68,961	114,504	23,924	34,219	...	...
Net operating balance	59,565	105,168	13,996	23,636	...	...
Net acquisition of nonfinancial assets	2,394	-2,362	3,302	5,501	...	...
Net lending/borrowing	57,171	107,530	10,694	18,135	...	...
Net acquisition of financial assets	72,333	124,151	26,027	49,370	...	...
Net incurrence of liabilities	15,162	16,621	15,333	31,235	...	...
Statistical discrepancy	...	...	...	...	...	...
Balance sheet						
Net worth	435,832	531,017	551,584	568,345	...	...
Nonfinancial assets	291,922	289,781	297,621	305,254	...	...
Financial assets	614,177	738,305	764,337	814,325	...	...
Liabilities	470,267	497,069	510,374	551,234	...	...
Revenue						
Revenue	305,352	368,242	330,289	335,793	...	...
Taxes	187,699	230,137	217,201	207,400	...	...
Social contributions	17	17	16	14	...	...
Other revenue	117,636	138,088	113,072	128,379	...	...
Expense						
Expense	245,787	263,074	316,293	312,157	...	...
Compensation of employees	63,919	67,090	70,866	70,494	...	...
Uses of goods and services	70,698	78,831	82,314	86,933	...	...
Consumption of fixed capital	9,396	9,336	9,928	10,583	...	...
Interest	1,038	1,015	901	874	...	...
Subsidies	216	182	277	451	...	...
Grants	61	314	2,352	7,036	...	...
Social benefits	33,883	35,859	40,702	42,561	...	...
Other expense	66,576	70,447	108,953	93,225	...	...
Transactions in assets and liabilities						
Change in net worth from transactions	59,565	105,168	13,996	23,636	...	...
Net acquisition of nonfinancial assets	2,394	-2,362	3,302	5,501	...	...
Fixed assets	3,162	2,490	6,475	6,616	...	...
Change in inventories	-768	-4,852	-3,173	-1,115	...	...
Net acquisition of financial assets	72,333	124,151	26,027	49,370	...	...
Net incurrence of liabilities	15,162	16,621	15,333	31,235	...	...

Sources: Hong Kong SAR authorities; Government Finance Statistics.

Note: Accrual-based data. Figures for 2010 will be available in 2012 Q1.

INTERNATIONAL MONETARY FUND

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

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION DISCUSSIONS—INFORMATIONAL ANNEX

November 14, 2011

Prepared By

The Asia and Pacific Department
(In consultation with other departments)

CONTENTS

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. Messrs. Sean Craig and .Andre Meier are Resident Representatives.

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.

In late 2009, the HKMA began reporting quarterly monetary data using Standardized Report Forms (SRFs) that present data consistent with the *Monetary and Financial Statistics Manual*. However, the SRF data for Hong Kong SAR have not been published in *IFS,* which uses monthly data periodicity.

HONG KONG SAR—TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

As of October 25, 2011

	Date of Latest Observation	Date Received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of Publication[5]
Exchange rates	Sept. 2011	Oct. 2011	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	Aug. 2011	Oct. 2011	M	M	M
Reserve/base money	Aug. 2011	Oct. 2011	M	M	M
Broad money	Jul. 2011	Oct. 2011	M	M	M
Central bank balance sheet	Aug. 2011	Oct. 2011	M	M	M
Consolidated balance sheet of the banking system	Jul. 2011	Oct. 2011	M	M	M
Interest rates[2]	Sept. 2011	Oct. 2011	D	D	D
Consumer price index	Aug. 2011	Oct. 2011	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	Q1/11	Oct. 2011	Q	Q	Q
Exports and imports of goods and services	Q1/11	Oct. 2011	Q	Q	Q
GDP/GNP	Q2/11	Sept. 2011	Q	Q	Q
Gross external debt	Q2/10	Nov 2010	Q	Q	Q
International investment position	Q1/11	Oct. 2011	A	A	A

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[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 IM Staff Representative on
People's Republic of China—Hong Kong Special Administrative Region
November 30, 2011

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 preliminary GDP data for the third quarter estimated growth to be 4.3 percent in real terms over a year earlier, moderating from the second quarter. The growth moderation was largely due to a sharp decline in exports towards the end of the quarter, particularly exports of goods, transportation and offshore trade-related services. Domestic demand continued to expand well. On a seasonally adjusted quarter-to-quarter basis, GDP expanded by 0.1 percent in real terms, after a 0.4 percent decline in the second quarter.

Table 1. Gross Domestic Product and Main Expenditure Components (year-on-year, percent)

	2011 Q3*
Private consumption expenditure	8.8
Government consumption expenditure	1.7
Gross domestic fixed capital formation	10.2
Exports of goods	-2.2
Imports of goods	1.4
Exports of services	6.6
Imports of services	2.1
Gross Domestic Product	4.3

Source: Census and Statistics Department, the Government of Hong Kong SAR.
*Preliminary figures.

Taking this information into account, Hong Kong SAR's economic growth for 2011 is likely to come in modestly lower than staff's current projection.

2. The unemployment rate (seasonally adjusted) increased marginally from 3.2 percent in the July–September period to 3.3 percent (provisional figure) in August–October 2011.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 11/155
FOR IMMEDIATE RELEASE
December 8, 2011

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

IMF Executive Board Concludes 2011 Article IV Consultation Discussions with People's Republic of China—Hong Kong Special Administrative Region

On November 30, 2011, 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 has rebounded from the global financial crisis and growth should be 5¾ percent this year. Unemployment has fallen to very low levels and real incomes have grown, supporting consumption. However, external demand is weakening and the sequential growth momentum is slowing. Inflation has risen during the course of this year. Going forward, the slowing economy and waning food prices on the Mainland should take some of the impetus out of inflation.

The fiscal surplus is likely to exceed this year's –0.5 percent of GDP budget target by a wide margin, mostly due to high collections of profit taxes and asset-related revenues (such as the

[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.

land premium). Nevertheless, fiscal policy is still likely to exert a modest expansionary effect on the economy due to higher public infrastructure investment, the continuation of various temporary stimulus measures, and a one-time transfer of HK$6,000 to every adult permanent resident.

Lending by Hong Kong banks has risen rapidly in the past year, particularly foreign currency lending to Mainland entities. At the same time, banks' net interest margins continue to fall due to the highly competitive banking environment and rising funding costs. With loan growth outpacing deposit growth, loan-to-deposit ratios have risen but remain well below international levels.

The housing market has slowed. Mortgage rates are rising, land supply has been increasing, and expectations of future price growth appear to have softened. Credit to property has also grown at a slower rate than overall credit, and average loan-to-value ratio on new mortgage loans have fallen.

Progress on increasing trade settlement and issuing financial instruments denominated in renminbi has accelerated. Issuance of so-called "dim sum" bonds (traded in Hong Kong SAR and denominated in renminbi) has reached RMB 200 billion; around 10 percent of Mainland trade is now being settled in renminbi; and the renminbi now makes up 10 percent of Hong Kong deposits.

Executive Board Assessment

Executive Directors noted that growth has rebounded thanks to the authorities' policy response, highly flexible labor and product markets, and favorable spillovers from Mainland China. However, Directors considered that, with external demand weakening, the forward economic momentum would moderate in the coming year as would underlying inflation, although headline inflation would likely remain elevated from the delayed pass-through of higher housing costs.

Directors agreed that, while the housing market appears to be cooling off, it is difficult to assess whether this trend will continue. They commended the authorities' measures to protect the financial system from a property market reversal. Directors also welcomed efforts to lessen the social burden of higher housing costs through wider availability of public rental housing and targeted programs to increase home ownership within lower income groups.

Directors noted that bank lending has been growing fast over the past year. They were reassured, however, by the regulatory authorities' continued efforts to be forward-looking and proactive in ensuring prudent risk management at financial institutions. Directors agreed that the macroprudential policy framework had supported high underwriting standards. Furthermore, they noted the appropriateness of recent initiatives to boost regulatory buffers and to ensure that bank lending remains in tune with funding availability, given the potential for funding strains if global risk aversion intensifies.

Directors shared the view that the principal risk to economic prospects is from a significant shock to the external environment. In light of the potentially large cost of such an event, they stressed the need for adequate contingency plans. More broadly, Directors agreed that, if the global outlook worsens significantly, fiscal stimulus, extraordinary support to the financial system, and a roll back of recent macropudential measures linked to the property market could be considered.

Directors agreed that Hong Kong SAR's Linked Exchange Rate System remains appropriate. In their view, the high degree of flexibility of the Hong Kong economy underpins the currency regime and can facilitate a real exchange rate adjustment to changing economic circumstances.

Directors viewed the expansion of the offshore renminbi business in Hong Kong SAR as a positive development that could, however, increase the channels for financial spillovers between the Mainland and Hong Kong SAR. They agreed that the deepening of the offshore market would need to be supported by a progressive opening of the Mainland capital account to renminbi flows and by improved provision of information.

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 2011 Article IV Consultation with Hong Kong Special Administrative Region is also available.

Hong Kong SAR: Selected Economic and Financial Indicators, 2006–12 1/

						Staff projections	
	2006	2007	2008	2009	2010	2011	2012
Real GDP (percent change)	7.0	6.4	2.3	-2.7	7.0	5.7	4.0
Contribution							
Domestic demand	5.3	7.0	1.5	0.7	6.6	5.4	3.9
Private consumption	3.5	5.0	1.4	0.4	3.9	4.1	2.9
Government consumption	0.0	0.3	0.2	0.2	0.2	0.2	0.2
Gross fixed capital formation	1.5	0.7	0.2	-0.8	1.6	1.1	0.8
Inventories	0.3	1.0	-0.4	0.9	0.9	0.0	0.0
Net exports	1.6	-0.6	0.8	-3.4	0.3	0.4	0.1
Inflation (percent change)							
Consumer prices	2.0	2.0	4.3	0.5	2.4	5.5	4.0
GDP deflator	-0.3	2.9	1.5	-0.6	0.5	4.0	3.7
Employment (percent change)	1.9	2.4	1.0	-1.1	0.4	1.5	1.0
Unemployment rate (percent, period average)	4.8	4.0	3.6	5.4	4.4	3.5	3.7
Real wages	-0.1	0.7	0.7	-1.5	-0.4	...	...
Government budget (percent of GDP)							
Revenue	19.5	22.2	18.9	19.6	21.6	22.3	22.1
Expenditure	15.5	14.5	18.8	18.0	17.3	19.8	18.1
Consolidated budget balance	4.0	7.7	0.1	1.6	4.3	2.5	4.0
Fiscal reserves as of March 31	25.0	30.5	29.5	32.1	34.1	33.5	35.1
Money and credit (percent change, end-period)							
Narrow money (M1)	13.1	25.4	4.7	39.6	12.8	...	...
Broad money (M3)	15.5	20.6	2.6	5.2	8.0	...	...
Loans for use in Hong Kong SAR (not including trade financing)	2.3	15.2	11.0	-2.1	21.7	...	...
Interest rates (percent, end-period)							
Best lending rate	7.8	6.8	5.0	5.0	5.0	...	...
Three-month HIBOR	3.8	3.3	0.9	0.1	0.3	...	...
Asset prices							
Hang Seng stock index (end of period, 1964=100)	19,965	27,813	14,387	21,873	23,035	...	...
Hang Seng stock index (percent change)	34.2	39.3	-48.3	52.0	5.3	...	...
Residential property prices (end of period, percent change)	4.1	25.7	-11.1	28.5	21.0	...	...
Merchandise trade (percent change)							
Export volume	9.3	7.0	1.9	-12.7	17.3	6.7	6.8
Import volume	9.2	8.8	1.8	-9.5	18.1	7.3	7.0
External balances (percent of GDP)							
Merchandise trade balance	-7.4	-9.5	-10.7	-12.8	-19.1	-21.9	-21.8
Domestic exports	9.4	7.3	6.1	4.7	4.7	4.5	4.2
Re-exports	157.8	159.8	163.5	149.1	170.8	177.6	177.8
Imports	174.6	176.6	180.3	166.6	194.7	204.1	203.8
Current account	12.1	12.3	13.7	8.6	6.2	5.4	5.6
Foreign exchange reserves 2/							
In billions of U.S. dollars, end-of-period	133.2	152.7	182.5	255.8	268.7	269.9	271.3
In months of retained imports	18.6	19.5	22.0	34.6	28.7	24.5	23.0
In percent of broad money (M3)	20.3	19.4	22.5	29.9	29.2	...	...
Exchange rate							
Linked rate (fixed)			HK$7.80/US$1				
Market rate (HK$/US$1, period average)	7.768	7.801	7.787	7.752	7.769	...	...
Real effective rate (period average, 2000=100) 3/	78.1	74.1	70.2	71.9	70.0	...	...

Sources: CEIC Database; and IMF staff estimates.

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

2/ Includes Land Fund assets.

3/ IMF staff estimates.