



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

2012 ARTICLE IV CONSULTATION DISCUSSIONS

January 2013

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 2012 Article IV consultation discussions with Hong Kong SAR, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 16, 2012, 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 December 19, 2012. 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 by the IMF.
- **Public Information Notice (PIN)** summarizing the views of the Executive Board.

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

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION DISCUSSIONS

December 19, 2012

MAIN ISSUES

Recent developments and outlook. The economy has slowed, pulled down by the weak external environment. Domestic demand, however, has been resilient, buoyed by a healthy labor market and supportive fiscal policy. In line with the cooling economy, inflation and credit growth have declined. In 2013, growth is expected to rebound and inflation to remain moderate.

Property sector. The real estate sector is the main source of domestic risk. Housing prices have doubled from their trough of 2008, raising concerns about affordability, demand-supply imbalances, and the potential for a sharp price correction. Appropriate measures to safeguard the banking system have been taken and should continue to be fine-tuned in line with evolving risks. Improving affordability and stability of the property market ultimately hinges on ensuring a sufficient supply of new housing.

External risk. Hong Kong SAR is susceptible to global shocks. This follows by virtue of being a small economy that is highly open to trade, maintains a currency peg, and serves as a global financial center. The economy could be hard hit by a European, U.S., or Mainland shock. In such an event, the authorities should deploy fiscal policy to mitigate the impact on growth and vulnerable households, while using the existing liquidity facilities and deposit insurance schemes to ensure financial stability.

Financial sector. Hong Kong SAR's banking system is well-capitalized and prepared for Basel III. The authorities have acted preemptively to contain risks, such as those arising from real estate lending and growing Mainland credit exposures. Policies should continue, as needed, to be deployed proactively to safeguard the financial system.

External assessment. The currency and external position are assessed to be broadly in line with fundamentals. The Linked Exchange Rate System remains the best arrangement for Hong Kong SAR.

Approved By
**Anoop Singh and
 Tamim Bayoumi**

Discussions took place during November 7–16, 2012. The staff team comprised S. Barnett (Head), P. N'Diaye, M. Nabar (all APD), X. Wu (MCM), and S. Craig and A. Meier (Resident Representatives). M. Rodlauer joined the final discussions. Mr. Sun and Ms. Szeto (both OED) also participated.

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DEVELOPMENTS AND OUTLOOK

1. Context. Hong Kong SAR is a small economy that is highly open to trade and capital flows and serves as an international financial center. As such, the economy is susceptible to regional and global shocks. Trade, tourism, and financial services are key: gross trade flows amount to some 450 percent of annual GDP, annual tourist arrivals are equivalent to some 600 percent of the population, and for three of the past four years the equity market has ranked number one globally in terms of money raised through public offerings. The economic framework is anchored by the combination of a currency board, flexible markets, a commitment to fiscal discipline, and a strong emphasis on safeguarding financial stability. This setup has continued to serve Hong Kong SAR well in cushioning the impact of external shocks and adapting to changes such as rapid growth in the Mainland.

2. Growth. Recent weakness in the global economy is impacting Hong Kong SAR, and real GDP growth is projected to slow to 1¼ percent this year (Figure 1). The slowdown is being driven by trade developments, with net exports expected to subtract 1¾ percentage points from growth. However, domestic demand is proving resilient owing to a supportive fiscal stance and continued strength in the labor market. Unemployment is expected to remain low, especially in the low-skilled segment, reflecting buoyant activity in tourism-related sectors and construction. Next year, GDP growth is expected to recover to around 3 percent as the drag from net exports abates.

3. Inflation. In line with the cooling economy, consumer price pressures have eased. This has been helped by declining food inflation, tracking developments in the Mainland. Inflation is expected to remain moderate, averaging 3¾ percent this year and 3½ percent next year, despite continued upward pressure from higher housing costs. After a short respite late last year, the run-up in property prices has resumed, defying the general slowdown in economic activity (see below). The rental component accounts for 29 percent of the consumer price index and tends to track the 24-month moving average of housing rent.

4. Fiscal policy. The 2012/13 Budget has provided some counter-cyclical support to the economy. Measures include waiving rates for each rateable property, reductions of public housing rents, increased transfers, additional capital spending, tax relief, and reductions in fees. Given the economic outlook, the 2013/14 Budget should continue to be tilted toward supporting growth, consistent with a

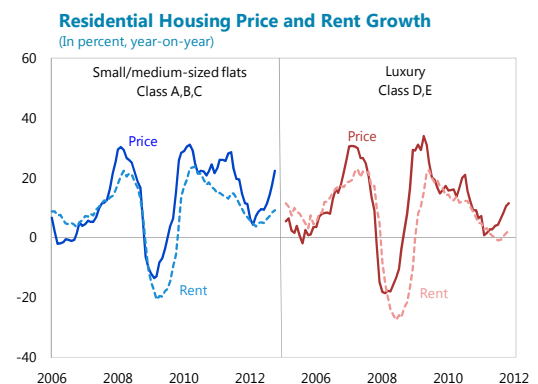
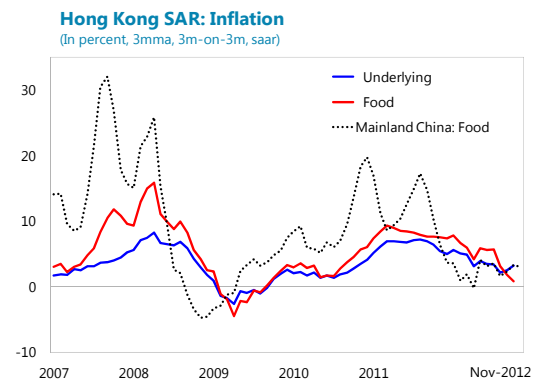
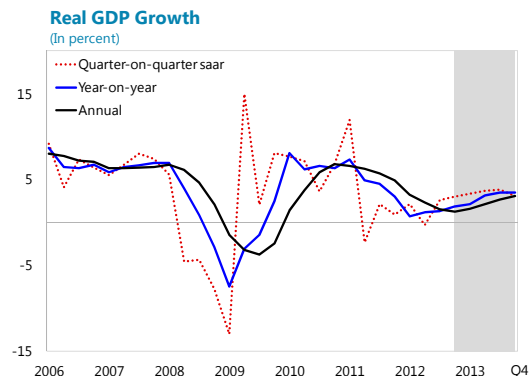
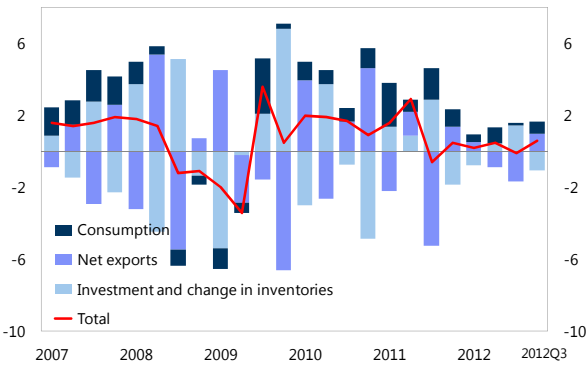


Figure 1. Macroeconomic Developments

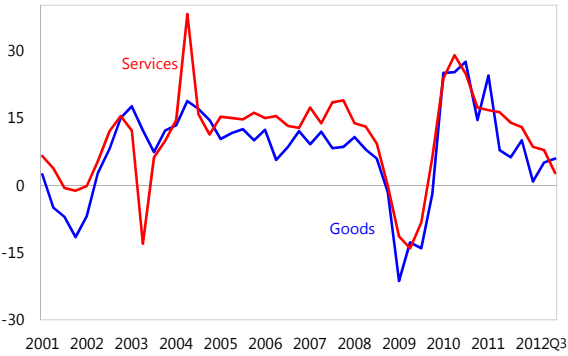
Net exports are pulling down growth, though domestic demand has been resilient so far...

Contribution to Growth
(In percent, quarter-on-quarter, sa)



Both goods and service exports are declining in line with softening global demand.

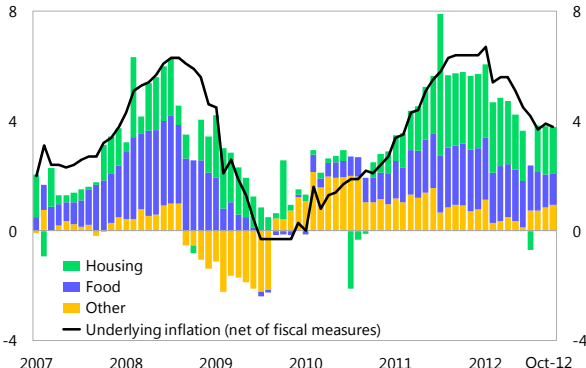
Exports of Goods and Services
(In percent, year-on-year)



Source: CEIC, National Accounts.

Inflation has been slowing and the decline has been fairly broad-based...

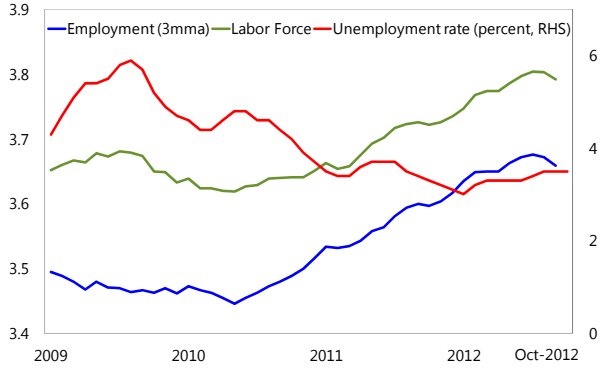
Contributions to Inflation
(In percent, year-on-year, monthly frequency)



Sources: CEIC Data Company Ltd.; HKMA; Haver Analytics; and IMF staff calculations.

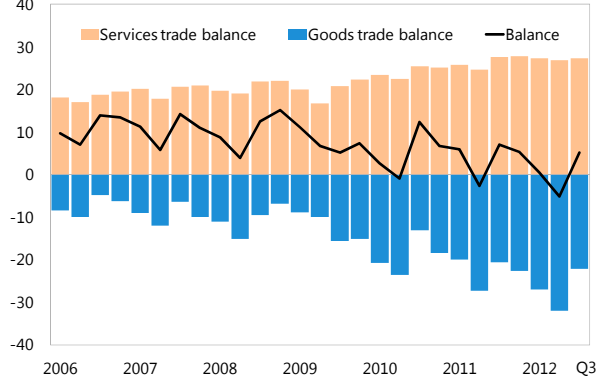
...supported by strength in the labor market.

Labor Market Indicators
(In million)



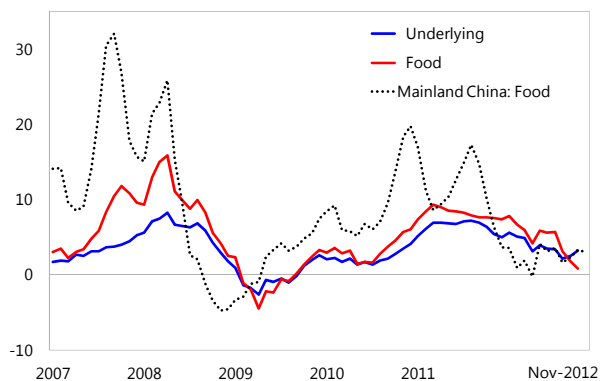
The trade balance has been reduced, led by a trend increase in the goods deficit.

Trade Balance
(In percent of GDP)



...with the fall in food price inflation matching developments on the Mainland.

Hong Kong SAR: Inflation
(In percent, 3mma, 3m-on-3m, saar)



modest positive stimulus. The stimulus should be temporary and could include reductions of public housing rent or tax relief for households. Measures targeted at lower-income households, in addition to supporting growth, also have social benefits.

Table 1: Stimulus and Relief Measures in the 2012/13 Budget (HKD billion and percent of GDP)

	Anticipated Cost	
	HKD billion	Percent of Fiscal Year GDP
Budget speech estimates of total stimulus, relief and investment measures	80	4
Key components 1/		
Increases in recurrent expenditure on education initiatives	1.3	0.1
Increases in recurrent expenditure on health initiatives	2.5	0.1
One-off measures		
SME financing guarantee scheme (anticipated expenditure based on estimated default rates)	11	0.5
Waiving rates	11.7	0.6
Salaries tax reduction and reduction of tax under personal assessment	8.9	0.4
Subsidies on residential electricity accounts	4.5	0.2
Increased transfers	2.1	0.1
Reductions of public housing rent	1.9	0.1

1/ HKD amounts are from the 2012/13 Budget. Percent shares of fiscal year GDP are based on staff estimates. Fiscal year is April 1-March 31.

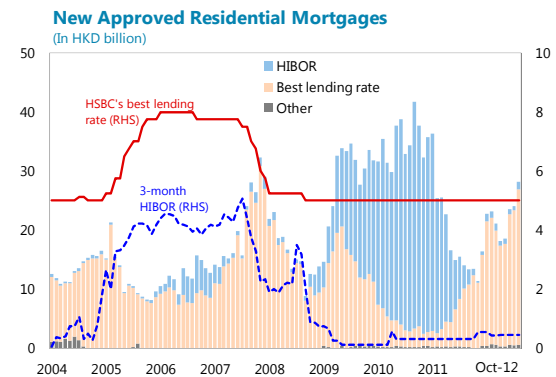
5. Risk of an external shock. A renewed intensification of the euro area crisis and the U.S. fiscal cliff are the main risks, with potentially large spillover effects through the trade channel. A hard landing in the Mainland, although a low-probability risk, could also have a significant impact on Hong Kong SAR's economy. If any of these shocks materialize, Hong Kong SAR should undertake a rapid fiscal stimulus that aims to support domestic demand while helping to shield low-income and vulnerable households. Options include targeted tax relief and increased direct transfers to poor and vulnerable households, extended support for smaller enterprises (which are important for employment), and accelerated public infrastructure spending where possible.

6. Authorities' views. The authorities broadly agreed with staff forecasts. Uncertainty stemming from the euro area crisis and the U.S. fiscal cliff would likely weigh on activity in the near term. The authorities indicated that they had the policy space and the required flexibility to counter these external threats to activity, should they materialize. They noted that the budget process had become more forward-looking in recent years and that the 2013/14 Budget (for which the consultation process has started) would take into consideration the downside external risks.

Hong Kong SAR: Risk Assessment Matrix			
Nature of Threat	Likelihood	Impact	Recommended Policy Response
Strong intensification of the euro area crisis (incomplete delivery of policy commitments leading to yield reversal)	Medium	High. Given Hong Kong SAR's status as a small open economy, financial center, and key trading hub, financial stress would increase and growth would slow significantly in the absence of a domestic policy response.	<i>Deploy fiscal stimulus that aims to support domestic demand while helping to shield low-income and vulnerable households. Options include targeted tax relief and increased transfers to households, support for smaller enterprises, and accelerated public infrastructure. Provide liquidity through existing facilities (such as discount window, foreign exchange swaps, and term repos); if needed as a last resort, the broad-based guarantee of deposits introduced after the fallout of Lehman could be reconsidered, in close coordination with other jurisdictions.</i>
Run-up in property prices that corrects abruptly over the medium term	Medium	High. Falling collateral values and negative wealth effects, which could trigger adverse feedback loop between economic activity, bank lending, and the property market.	<i>Safeguard financial stability by continuing to deploy countervailing macroprudential measures; use fiscal measures to address concerns about demand-supply imbalances; and ensure adequate supply, including public housing.</i>
Large capital inflows trigger a credit-asset cycle	Medium	Medium. Under the currency board arrangement, expansionary U.S. monetary policy could lead to large capital inflows, a renewed credit-asset cycle, inflationary pressures in goods and asset markets, and the build-up of large financial imbalances, which eventually correct rapidly.	<i>Ensure that bank lending standards and risk management practices are sound, while continuing to deploy countervailing macroprudential measures.</i>
U.S. fiscal cliff (political gridlock in early 2013 leading to more austerity than currently planned)	Low	High. Given Hong Kong SAR's status as a small open economy, financial center, and key trading hub, financial stress would increase and growth would slow significantly.	<i>Deploy fiscal stimulus that aims to support domestic demand while helping to shield low-income and vulnerable households. Options include targeted tax relief and increased transfers to households, support for smaller enterprises, and accelerated public infrastructure. Provide liquidity through existing facilities (such as discount window, foreign exchange swaps, and term repos); if needed as a last resort, the broad-based guarantee of deposits introduced after the fallout of Lehman could be reconsidered, in close coordination with other jurisdictions.</i>
Severe dislocation in global financial markets (e.g. from failure of parent bank or global SIFI)	Low	High. In the atmosphere of heightened risk aversion that would follow, the interbank market in Hong Kong SAR would come under stress and bank deleveraging would ensue. Prices of other risk assets (equities, high-yield corporate debt, and property) would decline, triggering further worsening of confidence, negative wealth effects, and depressed consumer and business spending.	<i>Provide liquidity through existing facilities (such as discount window, foreign exchange swaps, and term repos); if needed as a last resort, the broad-based guarantee of deposits introduced after the fallout of Lehman could be reconsidered, in close coordination with other jurisdictions.</i>
Hard landing in China	Low	High. Deterioration of corporate balance sheets, worsening of bank asset quality (related to cross-border exposures and to exposures to firms based in Hong Kong SAR doing business with the Mainland), and drop-off in tourism and Mainland contribution to consumption spending in Hong Kong SAR.	<i>Combination of fiscal stimulus and liquidity support described above. In addition, work closely with Mainland counterparts to facilitate an orderly resolution of distressed assets and address any weaknesses in banks' balance sheets.</i>

PROPERTY SECTOR

7. Recent developments. A combination of limited supply of new housing, strong demand from local and nonlocal purchasers, and low interest rates imported from the United States has been driving up housing prices. Prices have increased 23 percent in the first ten months of 2012 and are now double the trough of 2008 (Figure 2). The rise in mass market prices has been particularly pronounced of late and the rental market is following a similar trend, exacerbating concerns about housing affordability. The supply of new housing units has been relatively small over the last several years, averaging 9,700 private units per year, as compared with the authorities' target of making available land for an average of 20,000 private residential flats each year. Meanwhile, mortgage interest rates have remained low in line with U.S. rates, although they have risen somewhat as banks moved back to using a prime rate (Best Lending Rate), instead of HIBOR, as the dominant basis for pricing mortgages. The Hong Kong Monetary Authority (HKMA) has implemented several rounds of macro-prudential measures (Text Table 1) that have helped to limit the growth in mortgage lending and cap household leverage (the average loan-to-value ratio for new mortgages is around 55 percent). Nonetheless, the low global interest rate environment is making real estate an attractive investment. Mainland buyers have also been active in the market and, in 2011, accounted for nearly 20 percent of primary market transactions (around 50 percent in value terms according to market estimates).



8. Risks. Staff housing price models paint a mixed picture regarding the degree of “froth” in the market (Box 1). Nevertheless, the sharp run-up in house prices raises the possibility of an abrupt correction, with associated risks to the banking system and domestic demand. In past cycles, the banking system has proven resilient to a substantial downswing in real estate prices. From their peak in 1997, housing prices fell by a cumulative 66 percent through mid-2003, yet nonperforming housing loans stayed below 2 percent (though total nonperforming loans peaked at around 8½ percent). Hong Kong SAR has full recourse mortgages, and owners generally continue to service mortgage debt even when they have negative equity. However, the property sector represents half of outstanding loans for use in Hong Kong SAR, with additional risks coming from the use of real estate as collateral. A sharp price correction would lead to falling collateral values and negative wealth effects, which could trigger an adverse feedback loop between domestic demand, bank lending, and the property market. Moreover, mortgage rates were falling in the early 2000s—

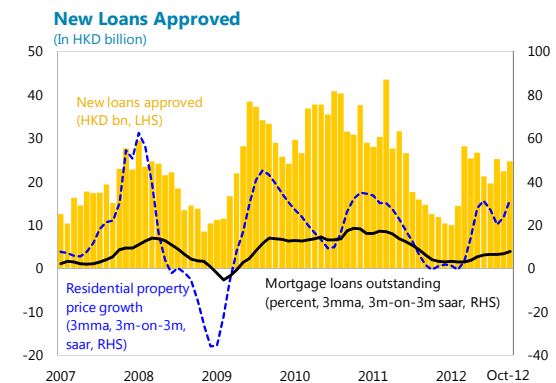


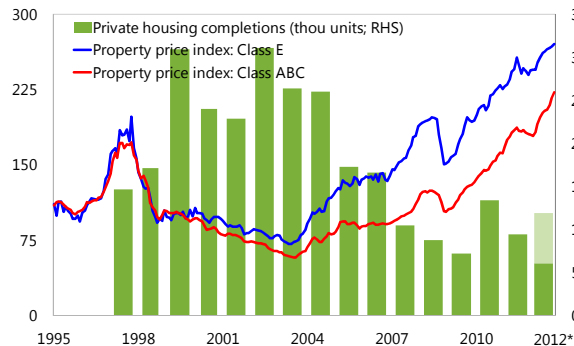
Figure 2. The Property Market

A broad-based residential property boom continued into 2012 after a respite during 2011H2, and the near-term supply of new flats remains tight.

Leverage is above its 2011 trough, mortgage rates have been fallen slightly, and consumer sentiment moved sideways since the beginning of 2012.

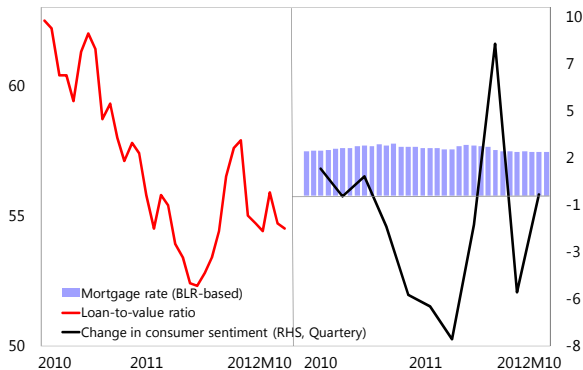
Property Price

(Index 1999=100)



* Actual as at 2012Q3 and forecast completion for 2012.

Leverage and Interest Rate Conditions

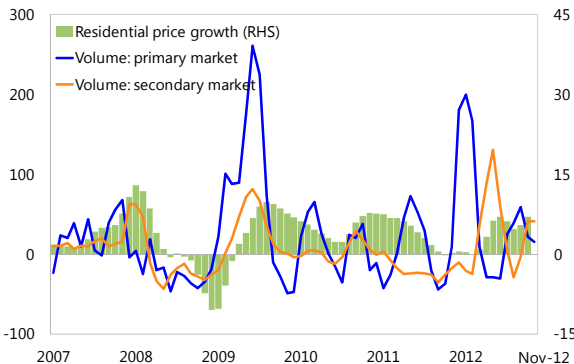


The recent run up in prices is supported by a rebound in activity in the primary market.

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

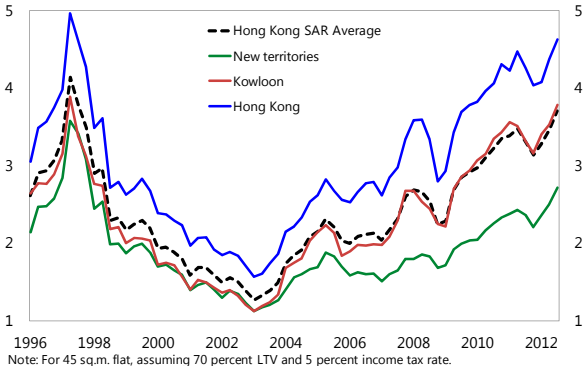
Price and Transaction Volume

(In percent, seasonally adjusted, 3m-on-3m, 3mma)



Minimum Down Payment-to-Income

(In multiple of median annual household disposable income, by area)

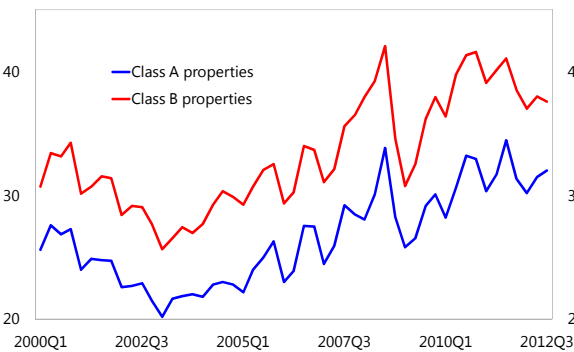


Rent continues to absorb a large portion of household income, though rent-to-income has moderated somewhat.

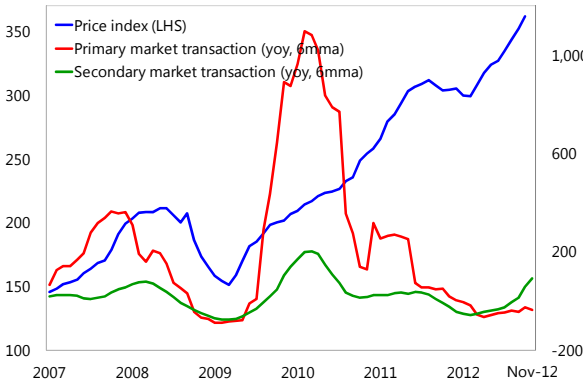
The rally in office prices has also returned, although transaction volumes have tapered off somewhat.

Rent-to-Income

(Rent, in percent of median household disposable income)



Office Property



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

Text Table 1. Hong Kong SAR: Selected Macro-Prudential and Other Property MeasuresAugust 2010

- Loan-to-value (LTV) cap lowered to (i) 60 percent for homes priced at or above HK\$12 million; (ii) and 60 percent (from 70 percent) for non-owner-occupied residential properties.
- Debt-service-to-income ratio cap lowered to 50 percent (for high-income groups had been 60 percent).
- Added stress test to debt-service-to-income ratio, requiring that it stay below 60 percent should mortgage interest rates rise by at least 2 percentage points.

November 2010

- Special Stamp Duty of 15 percent imposed for residential properties resold within 6 months of purchase; 10 percent for properties resold between 6 months and 12 months; and 5 percent for properties resold between 12 months and 24 months.
- LTV cap lowered to (i) 50 percent for homes priced at or above HK\$12 million; (ii) 60 percent for homes priced at HK\$8 million or above, but below HK\$12 million; and (iii) 50 percent for non-owner-occupied residential properties, properties held by companies, commercial and industrial properties, and properties with mortgage loans based on borrowers' net worth.

June 2011

- LTV cap lowered to (i) 50 percent for homes priced at or above HK\$10 million; and (ii) 60 percent for homes priced at or above HK\$7 million, but below HK\$10 million.
- LTV cap lowered by a further 10 percentage points for buyers whose main income comes from outside Hong Kong SAR.
- LTV cap on net-worth-based mortgages lowered to 40 percent (from 50 percent), regardless of property value.

September 2012

- Maximum loan tenor on all new property mortgages limited to 30 years.
- For mortgage loan applicants with outstanding mortgage loans:
 - Maximum mortgage payment reduced to 40 percent (from 50 percent) of monthly income
 - LTV cap lowered by 20 percentage points (previously 10 percentage points) for buyers whose main income comes from outside Hong Kong SAR.
 - LTV cap on net-worth-based mortgages lowered to 30 percent (from 40 percent).

October 2012

- Special Stamp Duty raised to 20 percent for residential properties resold within 6 months of purchases; 15 percent for properties resold between 6 months and 12 months; 10 percent for properties resold between 12 months and 36 months.
- A flat rate of 15 percent of Buyer's Stamp Duty introduced for buyers of residential properties who are not Hong Kong SAR permanent residents.

Box 1. Housing Prices

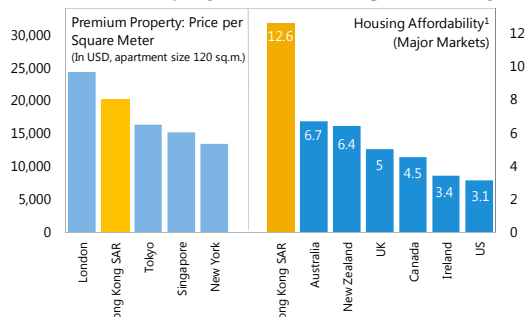
Assessing whether housing prices are out of line with economic fundamentals is an important yet inherently difficult exercise. Two different pricing models are examined, which provide some mild, but on balance inconclusive, evidence that prices are higher than suggested by current fundamentals.

Housing in Hong Kong SAR is expensive. Compared to other regions, house prices in Hong Kong SAR are less affordable as measured by the ratio of median household income to median house price. In absolute terms, U.S. dollars per square meter, prices are also relatively expensive and premium real estate prices are on par or higher than in other high-cost housing.

A regression-based approach indicates prices are about 10 percent above the level suggested by current macroeconomic fundamentals.¹ However, the fundamentals themselves are in some sense abnormal, as loose global monetary conditions have pushed down considerably Hong Kong SAR's real interest rate. The real interest rate, moreover, is a key driver of housing prices in the model. To illustrate the impact of the eventual normalization of global monetary conditions, the regression estimates were used to calculate the price that would prevail if the real interest rate was at its 2003–07 average, with a concomitant change to credit. This exercise suggests that housing prices are some 30 percent higher than they would be if Hong Kong SAR's real interest rate returned to the 2003–07 average.

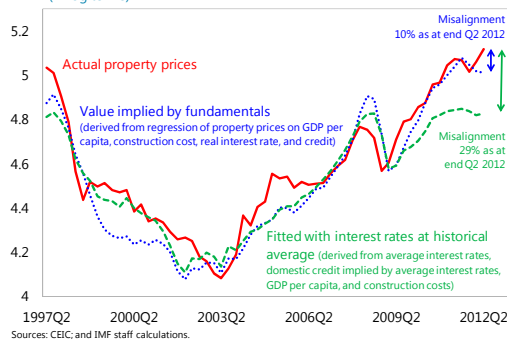
An asset pricing model, however, finds that prices are broadly consistent with fundamentals. The model compares the market price with a benchmark based on an equilibrium relationship between prices, rents, and cost of ownership. The basis for assessing misalignment from fundamentals is that the cost of owning a house (imputed rent) should be the same as the cost of renting a similar house for the same time period. By this measure, smaller-sized flats are found to be some 7 percent above the benchmark while the luxury end of the market is found to be slightly below the corresponding benchmark.²

Premium Property Price and Housing Affordability



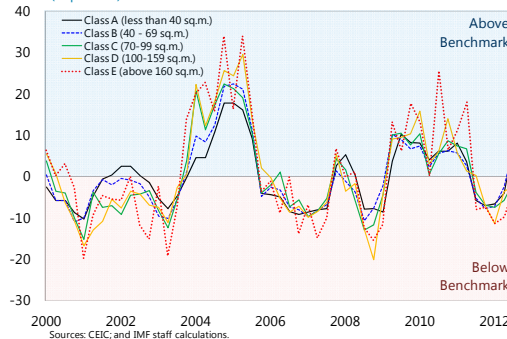
¹ Median house price divided by median household income. Source: Global Property Guide Surveys as of 2012 Q2; Demographia International Housing Affordability Survey; and IMF staff calculations.

Hong Kong SAR: Property Prices and Fundamentals (In log terms)



Sources: CEIC; and IMF staff calculations.

House Price Deviation from Medium-Term (In percent)



Sources: CEIC; and IMF staff calculations.

¹ Craig, R. S. and H. Changchun, "Determinants of Property Prices in Hong Kong SAR," IMF Working Paper No. 11/227 (Washington: International Monetary Fund).

² Ahuja, A. and N. Porter, 2010, "Are Housing Prices Rising too Fast in Hong Kong SAR?" IMF Working Paper 10/273 (Washington: International Monetary Fund).

which provided welcome support to the weak market—whereas during this cycle, a rise in Hong Kong SAR mortgage rates associated with the eventual normalization of U.S. interest rates could exacerbate or trigger a price correction.

9. *Property market policies.* The HKMA has been proactively implementing macro-prudential measures, such as progressively tightening loan-to-value and debt service ratios (Text Table 1). As conditions evolve, these measures can continue to be adapted and potentially complemented by deploying additional tools, including higher risk weights or regulatory reserves. Such macro-prudential measures should remain focused on safeguarding the banking system, while other policies are best suited to fostering the stable development of the housing market, preventing unhealthy price dynamics, and addressing affordability concerns. The management of land supply, which in Hong Kong SAR is mainly provided by the government, is critical for ensuring sufficient availability of housing over the medium term. However, given the 3–5 years needed to develop a housing project, planned increases in land supply will have a limited upfront market impact (mainly through expectations). In the interim, measures to dampen housing demand, such as the recently adopted Buyer's Stamp Duty and extension of the Special Stamp Duty, could help contain unhealthy price dynamics. As the impact is assessed over time, these stamp duties could be adjusted further if needed. Taken together, the government's recent steps to promote demand-supply balance should help improve affordability, while public housing programs—which extend to nearly half of Hong Kong SAR's households—continue to provide a safety net for residents that would otherwise be priced out of the market.

10. *Authorities' views.* The authorities emphasized that they had been actively implementing policies to mitigate property sector risks. They considered boosting land supply as critical to the stable development of the property market over the longer term. However, the lags involved with development created the need for measures (such as the recent stamp duties) to discourage exuberance in the short run. They also placed high priority on ensuring that the financial system would remain resilient to a downturn in prices. The authorities underscored that the five rounds of macro-prudential measures since 2009 had left bank and household balance sheets in a strong position to weather such a downturn. They planned to continue to closely monitor property market developments, and stood ready to take additional macro-prudential steps if needed. The authorities emphasized that affordability was also a critical concern, and that they remain committed to ensuring an adequate supply of public housing and ensuring all eligible families receive an offer of public housing on average within three years of applying.

FINANCIAL SECTOR

11. *Financial developments.* Bank credit growth, a key concern in recent years, has decelerated significantly in line with slowing economic activity, tighter macro-prudential policy, and less new lending to the Mainland (Figure 3). Hong Kong SAR's banking system remains well-capitalized and liquid, while asset quality and profitability have proven resilient to the recent turmoil in the global economy. Although IPO activity has been slow this year, the equity market has rebounded recently and corporate bond issuance has been strong. This includes issuance by local companies who have increasingly used capital markets as the supply of longer-term bank lending has tightened.

Hong Kong Banks (All incorporated banks)		
	2010	2011
Asset quality (percent of total loans)		
Pass loans	97.95	98.28
Special mention loans	1.28	1.13
Classified loans (gross)	0.77	0.59
Classified loans (net)	0.45	0.34
Overdue > 3 months and rescheduled loans	0.60	0.49
Delinquency ratio of residential mortgage loans	0.01	0.01
Delinquency ratio of Credit card lending	0.20	0.19
Profitability		
Bad debt charge as percentage of average total assets	0.03	0.03
Net interest margin	1.32	1.24
Cost to Income ratio	49.9	46.7
Capital adequacy ratio		
Tier 1 capital	15.8	15.8
	12.2	12.4

Source: HKMA Half Yearly Monetary and Financial Stability Report and Fitch.

12. *Macro-prudential measures.* The preemptive use of macro-prudential tools has been effective in protecting the financial system. In addition to the measures deployed to contain real estate risks, the HKMA has set bank-specific regulatory reserves—reserves that banks are required to hold beyond individual and collective impairment allowances—to contain risks such as those arising from rapid credit growth. Macro-prudential measures should continue to be adjusted in line with the evolving credit cycle, and consideration could be given to using additional instruments such as increasing provisioning or risk weights for certain types of lending.

13. *Financial integration with the Mainland.* Hong Kong SAR is benefiting from the ongoing financial integration with the Mainland and should continue to build on its competitive advantage. Over the past few years, claims on Mainland borrowers have grown significantly and accounted for 28 percent of Hong Kong SAR banks' total external claims as of end-June 2012. Some analysts warned about the risks of rapid Mainland portfolio expansion by some banks, especially in an environment where nonresident banks may be effectively subordinated in the case of payment problems and where collateral enforcement procedures are largely untested. To identify emerging risks, the HKMA should continue to stress test and closely monitor banks' exposures, including through close cooperation with the Mainland authorities, and to ensure that banks maintain prudent underwriting standards and hold adequate buffers that reflect the specific risks from Mainland-related exposures.

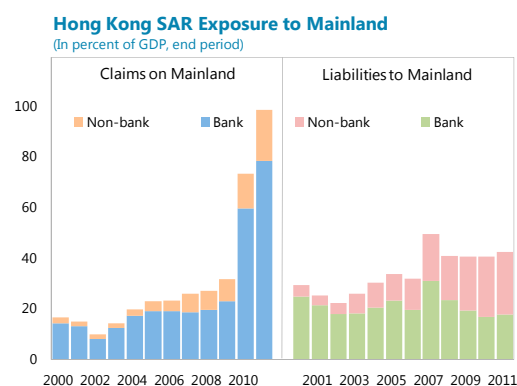
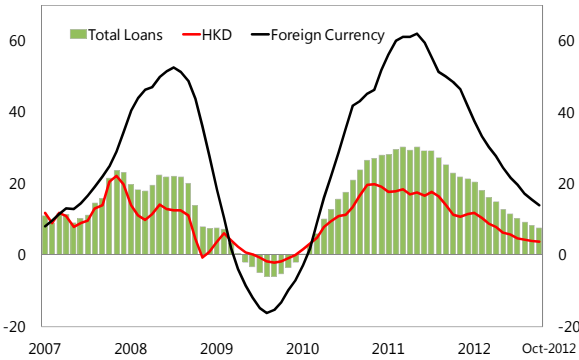


Figure 3. Credit Growth

Credit growth has declined sharply from the peak last year, both in foreign currency denominated loans (mostly U.S. dollar) and loans for domestic use.

Credit Growth

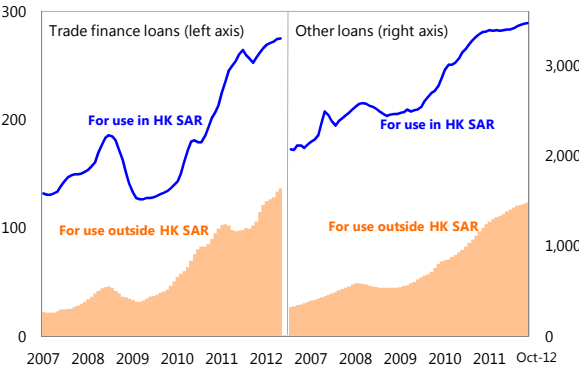
(In percent, year-on-year, 3mma)



Loans for use in Hong Kong SAR are slowing by more than loans for use outside Hong Kong SAR.

Loans Outstanding

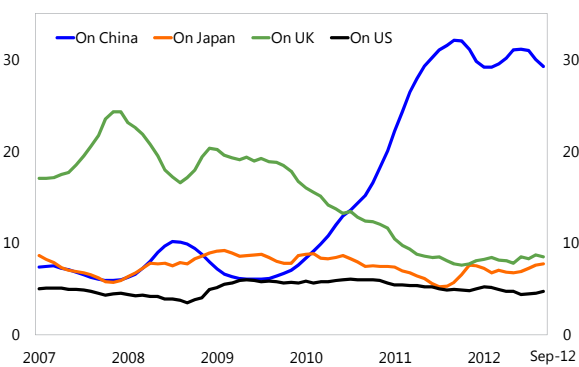
(In billions HKD, 3mma)



The share of claims on Mainland has leveled off at around 30 percent of total external claims.

External Bank Claims

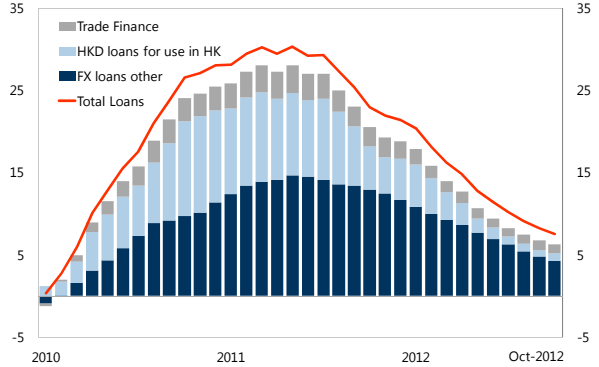
(As share of total)



Foreign currency loans continue to make up over one-half of overall credit growth.

Contribution to Credit Growth

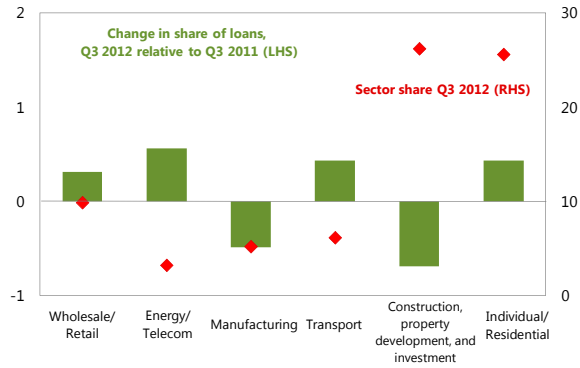
(In percent, year-on-year, 3mma)



The share of loans for use in Hong Kong SAR allocated to the property sector has not increased over the last 12 months.

Loans Outstanding for Use in Hong Kong SAR

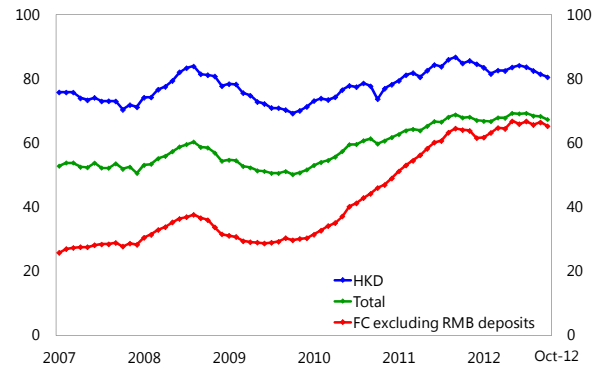
(By sector)



Foreign currency loan-to-deposit ratio has not changed much, despite the sharp decline in foreign currency lending growth.

Loan-to-Deposit Ratios

(By currency denomination)



Sources: CEIC Data Company Ltd.; HKMA; Haver Analytics; and IMF staff calculations.

14. *Cross-border use of renminbi.* Renminbi internationalization continues to benefit Hong Kong SAR, which remains the main offshore renminbi center. After growing rapidly through late 2011, the share of renminbi deposits has stabilized at around 9 percent of total system deposits, which reflects an increase in alternative renminbi assets (especially certificates of deposit), as well as a change in market expectations on renminbi appreciation (Figure 4 and Box 2). The extension of operating hours for the renminbi real-time gross settlement system, introduction of dual-counter equities (issued and traded in both Hong Kong dollar and renminbi), allowing nonresidents to hold unlimited renminbi deposits, and introduction of investment funds providing exposure to Mainland bonds and equities have helped Hong Kong SAR's status as the preeminent offshore renminbi center. To consolidate Hong Kong SAR's first-mover advantage, the authorities should continue to develop the renminbi financial infrastructure.

15. *Financial spillovers.* To gain insights on how a financial shock could reverberate through Hong Kong SAR, staff applied a network analysis to BIS data. The results show that in the event of distress in a foreign banking system, a rise in counterparty risk (similar to that observed after the collapse of Lehman) could lead to a sharp decline in cross-border interbank funding, fire-sale of bank assets, a fall in banks' capital, and a reduction in bank credit (Box 3). In the event of a large shock, the authorities could respond by providing liquidity via the discount window, foreign exchange swaps, term repos, and other suitable tools, such as the renminbi liquidity facility. The existing Deposit Protection Scheme should be sufficient to provide confidence to depositors. If needed as a last resort, the broad-based guarantee of deposits introduced after the fallout of Lehman could be reconsidered, in close coordination with other jurisdictions. The network analysis also illustrates how preventing market dislocation in Hong Kong SAR would help limit contagion arising from a global shock.

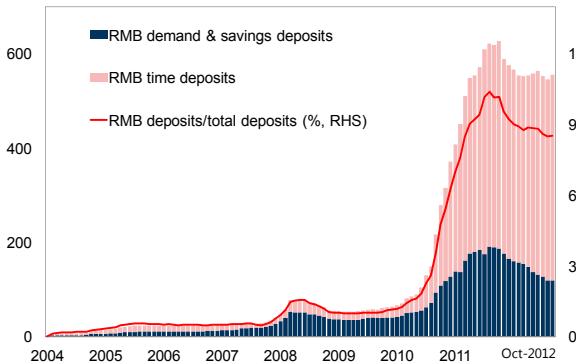
16. *Basel III.* There was a general consensus among officials, private analysts, and staff that Hong Kong SAR banks are well positioned to meet the Basel III standards. Some analysts argued that the capital and liquidity rules are likely to have a larger-than-expected impact on the business models of banks in Hong Kong SAR. For instance, they could discourage trade finance and long-dated (syndicated) loans, and create a heavy demand for liquid assets (such as sovereign debt) that, depending on the eventual rules, may be in short supply in some jurisdictions. Others, however, highlighted that the financial system was highly adaptable and would adjust to the new rules—the recent growth in bond issuance in Hong Kong SAR was cited as an example whereby firms go straight to the capital markets for longer-term funding that under Basel III will be more expensive for banks to provide.

17. *Authorities' views.* The authorities noted that closer financial integration with the Mainland had provided an important growth opportunity for the banking system. At the same time, they were closely monitoring Mainland exposures and highlighted that 60 percent of them were collateralized, often by deposits at a Mainland bank or assets held in Hong Kong SAR. The HKMA, in collaboration with the Mainland bank regulator, has been conducting annual on-site inspections at Mainland subsidiaries of Hong Kong SAR banks to ensure that their underwriting standards are similar to the ones maintained in Hong Kong SAR. In addition, higher regulatory reserves had been imposed on

Figure 4. Offshore Renminbi Market

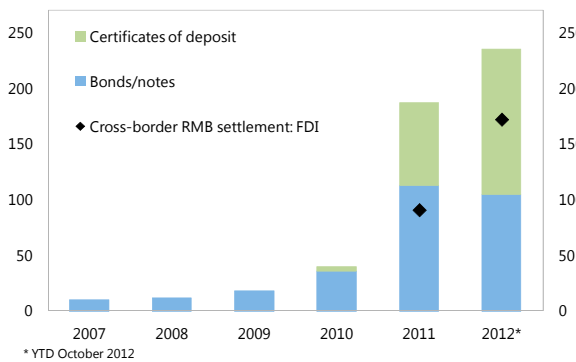
Offshore renminbi deposit growth has slowed, particularly after renminbi appreciation expectation waned.

Renminbi Deposits in Hong Kong SAR
(In RMB billion)



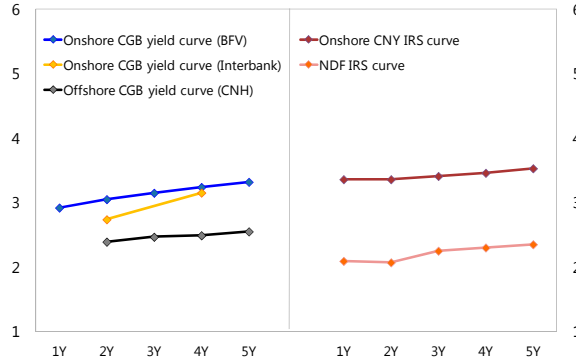
Offshore renminbi bond and certificate of deposit issuance continues to be healthy, after the sharp increase last year...

CNH Bonds: New Issuance
(By type of security)



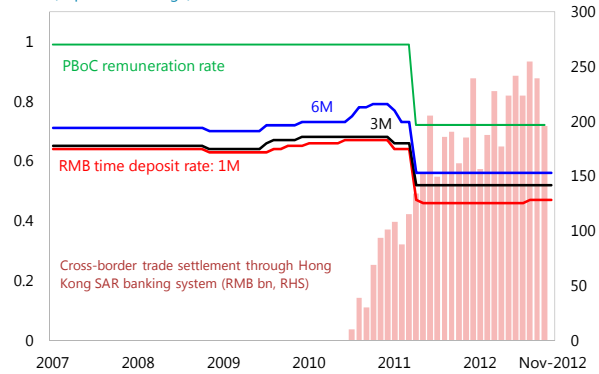
...even as cost of funding is still cheap relative to that on the Mainland.

Yield Curve
(December 17, 2012)



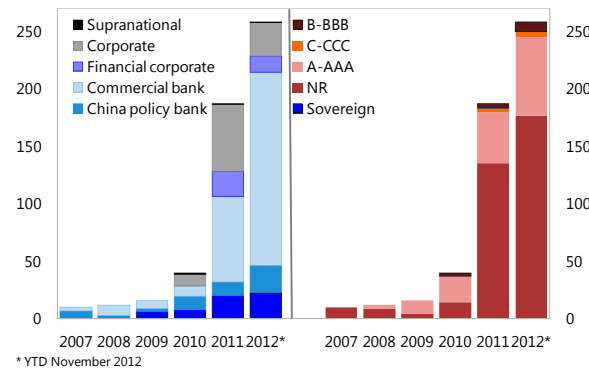
Deposit rates rose with the onset of renminbi trade settlement activity, but have since fallen as the People's Bank of China lowered the remuneration rate at the clearing bank.

RMB Time Deposit Rates and Trade Settlement
(In percent, average)



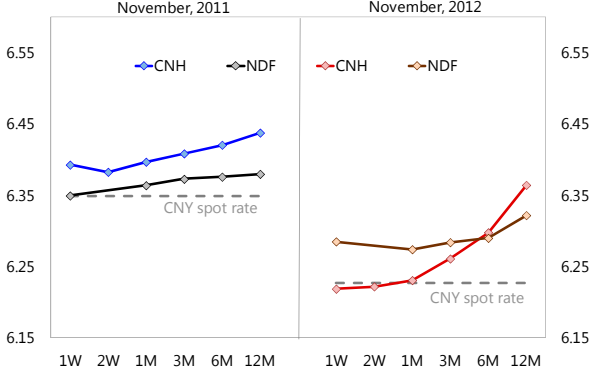
...nonfinancial corporate issuance has declined, offset by banks, other financials, and sovereign...

CNH Bonds: New Issuance
(In billions RMB; by issuer sector and type of rating)



Foreign exchange market expectations have turned toward renminbi depreciation.

Exchange Rate Forwards: RMB/USD
(End of period)

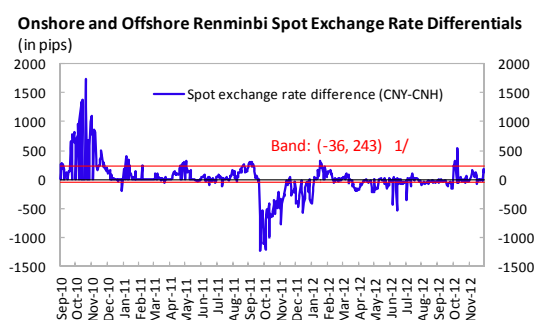


Sources: Bloomberg; CEIC Data Company Ltd.; IMF staff calculations.

Box 2. Has Renminbi Internationalization Led to an Integration of Offshore and Onshore Markets?

Several significant steps have been taken to expand offshore renminbi intermediation in Hong Kong SAR since 2004. The range of renminbi financial products and services offered in Hong Kong SAR has steadily widened to now include deposits, *Dim-Sum* bonds, trade settlement, and structured deposits linked to underlying indices such as property, gold, and equity. Furthermore, the channels that allow offshore renminbi to flow back to the Mainland have been increased and include interbank bond, equity and fixed income markets (subject to quotas) and inward FDI (subject to approval). The expansion in trade settlement in renminbi has contributed to a rapid buildup in offshore renminbi liquidity with renminbi deposits stabilizing more recently at RMB 571 billion. Similarly, measures facilitating FDI in renminbi has supported the expansion of the offshore *Dim-Sum* market to RMB 237 billion at end-November. Also, Hong Kong banks have rapidly increased renminbi lending, which doubled this to RMB 68 billion at end-September 2012.

To assess how effective these developments have been in integrating the offshore renminbi (CNH) and the onshore renminbi (CNY) markets, staff analyzed whether arbitrage opportunities exist between the two exchange rates. The CNY and the CNH trade at different, but generally close, exchange rates against the dollar most of the time. Some divergence within a narrow range defined by transaction costs is consistent with no arbitrage. A key question is whether the flows mentioned above are sufficient to keep the exchange rate within this range.



A Threshold Autoregressive Model (TAR) is used to estimate a “no-arbitrage band” around the CNY-CN H differential.¹ The results show that the differential was within the no-arbitrage band 56 percent of the time, but that there were also extended periods when the differential was large and outside the band. The fact that the differential converges fairly slowly to the band is consistent with the CNH and CNY markets being somewhat segmented, at least enough to prevent financial arbitrage from immediately closing the differential. Nonetheless, the markets are also integrated enough that capital flows work over time to close the differential.

¹ The TAR model estimates a band around a variable (the CNY-CN H differential) such that within the band the variable follows a random walk (meaning arbitrage is not taking place) and outside the band in which the variable mean reverts to the band, consistent with arbitrage. R. S. Craig, C. Hua, P. Ng, and R. Yuen, IMF Working Paper, forthcoming.

Box 3. Analysis of the Spillover Risk of the Domestic Banking System 1/

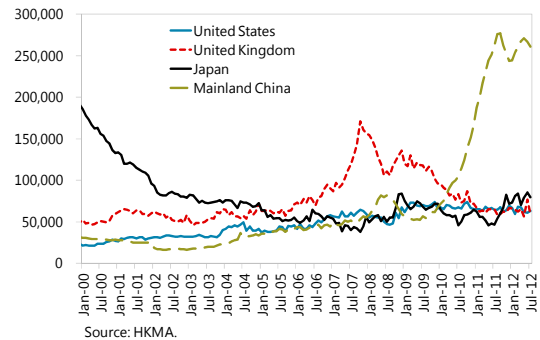
As a hub for global financial intermediation, Hong Kong SAR’s banking system would be impacted by financial distress elsewhere in the world. At the same time, by securing its own financial stability, Hong Kong SAR could help prevent the propagation of financial shocks. This box examines the linkages of Hong Kong SAR’s banking system with the global financial system to assess the potential for such outward and inward spillovers.

Network analysis is used to model how distress could spread from one economy to another. The methodology follows Espinosa-Vega and Sole (2011) and Arslanalp and Lam (2012), which was applied in several FSAP analyses (such as Australia, Japan, and Spain), and uses the same key assumptions and parameters.² It exploits data on cross-border claims and economy-specific measures of banking system resilience. Distress is modeled as a credit shock that causes a banking system to default on its cross-border obligations, a funding shock that results in a liquidity squeeze and fire sale of assets, or a combined credit and funding shock. The analysis considers scenarios that allow for progressively wider spillover channels: Scenario 1 (S1) considers just interbank exposures; Scenario 2 (S2) adds contingent cross-border claims, such as outstanding derivative contracts or contingent liabilities (for example guarantees or credit commitments); and Scenario 3 (S3) adds nonbank and sovereign exposures.

Hong Kong SAR’s banking system is most exposed to shocks from the United States, United Kingdom, and China

(see heat maps). The Mainland has become the most systemically important for Hong Kong SAR in terms of a shock to interbank markets, while U.S. and U.K. banking systems remain more important in terms of potential contingent, nonbank, and sovereign exposures. Credit exposure of Hong Kong SAR banks to Mainland have more than doubled since 2009 and represent the largest exposure. However, the U.S. and U.K. financial systems continue to generally be the more systemically-important for Hong Kong SAR, even though Hong Kong’s cross-border exposures to the Mainland are larger. The U.S. (23 percent of global capital) and U.K. (15 percent of global capital) financial systems have large outward spillovers to other economies that would be infected by a U.S. or U.K. distress, which creates a domino effect of global distress that ultimately has a large impact on Hong Kong SAR. The Mainland, in contrast, is less integrated globally and, in particular, a Mainland funding shock would have fewer repercussions for Hong Kong SAR than a similar shock in the U.S. or U.K. banking systems.

Total Foreign Claims
(in millions of USD)



Likewise, a strong policy response in Hong Kong SAR could help break this domino effect to the benefit of other economies. Safeguarding Hong Kong SAR’s banking system through strong capital and liquidity buffers, providing timely liquidity support, and bolstering confidence would prevent a shock in another economy from propagating through Hong Kong SAR’s banks. For example, in the case of a combined credit and funding shock in China under Scenario 1, a strong policy response by Hong Kong SAR would reduce the impact on the global banking system by an amount equivalent to 1½ percentage points of total global capital (see table, China row, far right two columns).

Global Impact of Banking Distress (percent global capital) 1/

	2008Q2		2012Q1	
	Baseline	Policies 2/	Baseline	Policies 2/
Distress in:				
United States	22.54	20.55	25.79	24.77
United Kingdom	14.98	11.99	11.58	9.76
Germany	7.25	7.25	8.51	8.51
Australia	1.60	1.60	2.21	2.21
China	11.18	9.19	12.35	9.50
Japan	5.83	5.83	8.24	8.24
Singapore	1.99	1.00	1.82	0.80

Source: Staff estimates.

1/ The amount of capital of all failed banking systems in percent of world financial system’s total capital; simulation results refer to credit and funding shocks on cross-border interbank exposures (Scenario 1).

2/ Hong Kong SAR implements policies to be prevent propagation of distress through its banking system.

Spillover impact to Hong Kong banks' capital from a distress in other banking systems

<i>Credit shock only</i> Exposure scenarios	before Lehman-crisis (2008Q2)			Debt crisis in peripheral Europe (2010Q1)			Latest data (2012Q1)		
	S1	S2	S3	S1	S2	S3	S1	S2	S3
	Potential trigger countries:								
United States	Green	Red	Red	Green	Red	Red	Green	Red	Red
United Kingdom	Red	Red	Red	Red	Red	Red	Yellow	Red	Red
Germany	Green	Green	Red	Green	Green	Red	Green	Green	Red
Australia	Green	Green	Green	Green	Green	Green	Green	Green	Green
China	Yellow	Yellow	Red	Yellow	Yellow	Red	Red	Red	Red
Japan	Green	Green	Green	Green	Green	Green	Green	Yellow	Red
Singapore	Red	Red	Red	Yellow	Yellow	Yellow	Red	Red	Red

Spillover impact to Hong Kong banks' capital from a distress in other banking systems

<i>Credit and funding shocks</i> Scenarios	before Lehman-crisis (2008Q2)			Debt crisis in peripheral Europe (2010Q1)			Latest data (2012Q1)		
	S1	S2	S3	S1	S2	S3	S1	S2	S3
	Trigger countries								
United States	Green	Red	Red	Green	Red	Red	Yellow	Red	Red
United Kingdom	Red	Red	Red	Red	Red	Red	Yellow	Red	Red
Germany	Green	Green	Red	Green	Green	Red	Green	Green	Red
Australia	Green	Green	Green	Green	Green	Green	Green	Green	Green
China	Yellow	Yellow	Red	Yellow	Yellow	Red	Red	Red	Red
Japan	Green	Green	Green	Green	Green	Yellow	Green	Yellow	Red
Singapore	Red	Red	Red	Yellow	Yellow	Red	Red	Red	Red

<i>Funding shock</i> Scenarios	before Lehman-crisis (2008Q2)			Debt crisis in peripheral Europe (2010Q1)			Latest data (2012Q1)		
	S1	S2	S3	S1	S2	S3	S1	S2	S3
	Trigger countries								
United States	Green	Red	Red	Green	Red	Red	Yellow	Red	Red
United Kingdom	Red	Red	Red	Yellow	Red	Red	Yellow	Red	Red
Germany	Green	Green	Red	Green	Green	Red	Green	Green	Red
Australia	Green	Green	Green	Green	Green	Green	Green	Green	Green
China	Green	Green	Yellow	Green	Green	Yellow	Orange	Orange	Orange
Japan	Green	Green	Green	Green	Green	Green	Green	Green	Yellow
Singapore	Red	Red	Red	Yellow	Yellow	Yellow	Red	Red	Red

Legend:



¹ Prepared by W. Raphael Lam (APD).

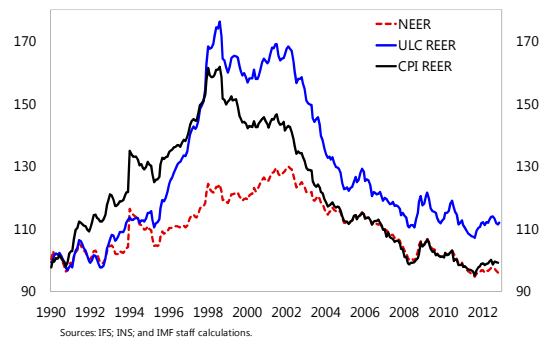
² Espinosa-Vega, M. and J. Solé, "Cross-border Financial Surveillance: A Network Perspective," *Journal of Financial Economic Policy*, vol. 3(3), August 2011; Arslanalp, S. and R. Lam "Financial Spillovers from Cross-border Exposures—A Network Analysis on Asian Banking System," mimeo.

banks whose loan books had expanded more rapidly. More broadly, the HKMA indicated that they would continue to adjust macro-prudential measures as the cycle evolves, and were open to considering additional tools. Regarding international regulatory reform, the authorities reiterated their commitment to Basel III and noted that the implementing regulations had been presented for Legislative Council vetting. More broadly, they considered robust and evenly implemented standards critical for ensuring confidence in the global financial system and flagged the importance of avoiding a watering-down of the standards or delays in implementation.

EXTERNAL ASSESSMENT

18. *Exchange rate regime.* The Linked Exchange Rate System (LERS) has served Hong Kong SAR well for nearly three decades. The system is transparent, well-understood, and credible. The HKMA buys or sells U.S. dollars from licensed banks in a passive and nondiscretionary manner based on what are called convertibility undertakings (HKMA buys U.S. dollars at HK\$7.75/US\$ and sells at 7.85). The recent purchases of U.S. dollars, which mark the first triggering of the convertibility undertaking since 2009, are therefore part of the normal functioning of the LERS. Through December 5, the HKMA had purchased 6.7 billion U.S. dollars, which is significantly less than the 83 billion U.S. dollars purchased in 2008–09 (Figure 5).

Hong Kong SAR: Effective Exchange Rate
(Index, 1990=100)



19. *External assessment.* The REER has appreciated modestly over the past year. Empirical estimates of Hong Kong dollar misalignment show a range from 15 percent undervalued to 7 percent overvalued (Box 4). Hong Kong SAR's current account surplus has fallen substantially since the global financial crisis and is expected to be under 5 percent of GDP this year, compared to 15 percent of GDP in 2008. Over the medium term, as global growth recovers and integration with the Mainland deepens, the current account surplus is projected to rise to around 7 percent of GDP. A structural current account surplus of this magnitude is assessed as consistent with Hong Kong SAR's status as an international financial center. Both external financial assets and liabilities are very high, around 10 times GDP, reflecting Hong Kong SAR's status as a major international financial center with considerable cross-border investment. These assets and liabilities could pose vulnerabilities, including through maturity mismatches, though these risks are mitigated by Hong Kong SAR's large official reserve holdings (of over 100 percent of GDP). The net foreign asset position is expected to rise gradually over time given the persistent current account surplus, and IIP vulnerabilities are low. Overall, the currency and external position are assessed to be broadly in line with fundamentals.

Current Account and Components
(In percent of GDP)

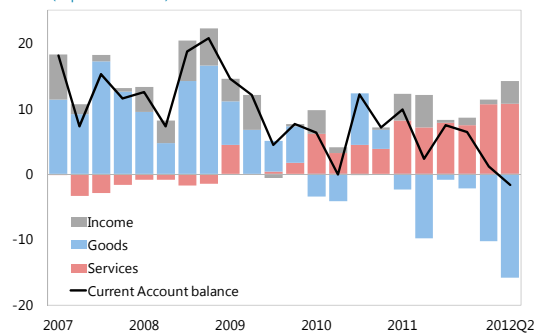
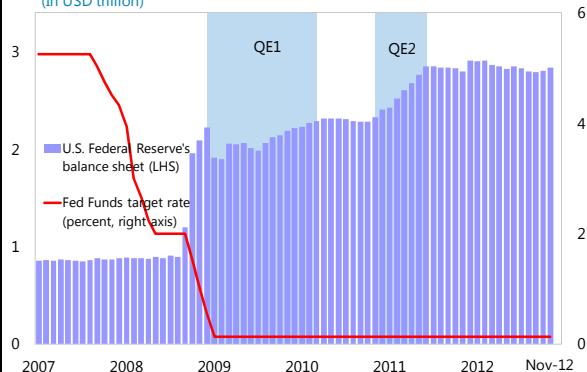


Figure 5. Spillovers from U.S. Quantitative Easing

U.S. interest rates have remained low, thanks to the extraordinary expansion in the Fed's balance sheet.

United States: Federal Reserve's Balance Sheet

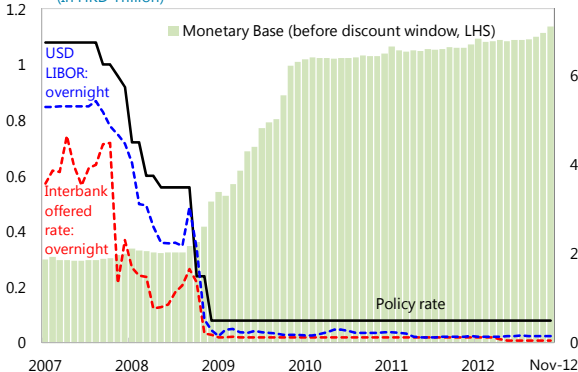
(In USD trillion)



The easy U.S. liquidity conditions have been imported into Hong Kong SAR...

Monetary Base and Policy Rate

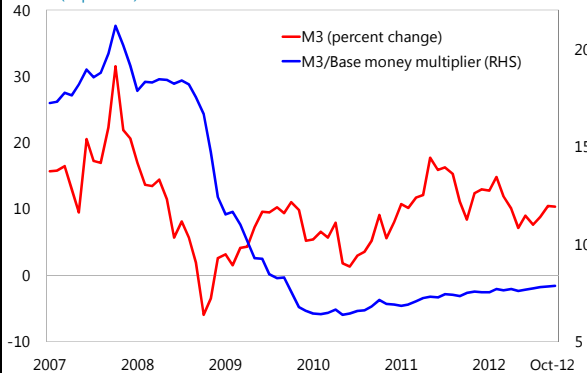
(In HKD Trillion)



...and fueled money growth...

Monetary Aggregates

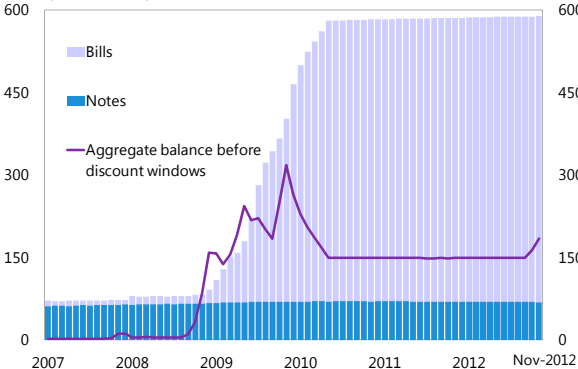
(In percent)



...although the issuance of exchange fund papers has helped limit the expansion in the aggregate balance...

Exchange Fund Paper Outstanding

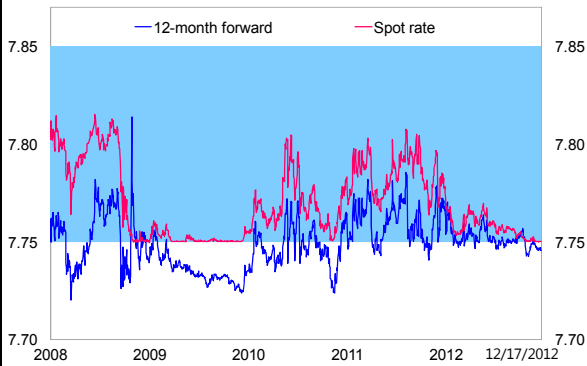
(In HKD billion)



...the currency has recently been leaning on the strong side of the convertibility undertaking...

Bilateral Exchange Rate

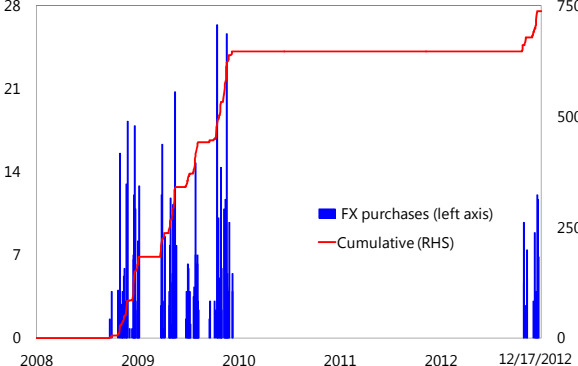
(In USD/HKD)



...and, under the rule-based exchange rate system, the HKMA has purchased U.S. dollars.

Foreign Exchange Purchases

(In HKD billion)



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

Box 4. External Assessment

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

As in previous years, a number of empirical methodologies were employed. The table reports estimates from the macroeconomic balance (MB), equilibrium real exchange rate (ERER), and external sustainability (ES) methodologies. The MB and ERER are based on regressions estimated over a sample of 55 developed and emerging economies, as well as a separate subsample of six international financial centers (Singapore, Hong Kong SAR, Switzerland, Netherlands, Luxembourg, and Belgium). The subsample of financial centers is included to capture the particular features of small international financial centers—service-oriented economies, with generally high savings rates (as wealthy individuals work in these centers and retire elsewhere), low dependency ratios, and driven more by investments in human rather than physical capital. The ES is based on the relationship between the current account, trade balance, the stock of net foreign assets, and the real exchange rate. Hong Kong SAR is not included in CGER or the External Balance Assessment (EBA), in part because these techniques are not well suited for offshore financial centers. However, a CGER-type methodology is also reported along with estimates provided by the HKMA.

Exchange Rate Assessment: 2011 and 2012

Percent misalignment

		2011	2012
MB	Panel reg: 6 financial centers	-0.2	1.8
	Panel reg: 55 economies	1.0	3.2
	CGER-type: 54 economies	-15	-14
	HKMA	-1.6	-1.5
ERER	Panel reg: 6 financial centers	-14.7	-6
	Panel reg: 55 economies	-9.9	-6.6
	CGER-type: 54 economies	-16	-15
	HKMA	-4.5	-2.1
ES	Staff model 1/	-1.5	6.9
	CGER-type	-12	-10
	HKMA	5.4	4.9

1/ Update of "HK Team" estimates from 2011 Staff Report.

- The macroeconomic balance approach compares the projected medium-term current account balance with an estimated equilibrium current account position and assesses the exchange rate adjustment needed to eliminate the gap between the two. Estimates for Hong Kong SAR generally indicate an equilibrium medium-term current account in the range of 6–7 percent of GDP. Consistent with last year's assessment and the pilot External Sector Report, the current account balance is assessed to be broadly in line with fundamentals and estimates of misalignment from the two panel regression approaches are near zero. The CGER-type regression yields a 14 percent undervaluation, with around half of the difference coming from the assumptions on real exchange rate (the panel regressions include some future real appreciation resulting from Hong Kong SAR having somewhat higher inflation than its trading partners, consistent with the medium-term macro-framework, whereas the CGER-type assumes an unchanged real exchange rate).
- The equilibrium real exchange rate approach compares the current level of the real exchange rate with an estimated equilibrium level based on medium-term fundamentals. Estimates of the equilibrium real exchange rate generally show the Hong Kong dollar to be undervalued by 6–15 percent.
- The external sustainability approach calculates the exchange rate adjustment needed over the medium term to bring the current account to a position that would stabilize the net foreign asset position at a benchmark level. The range of assessments generated by this approach is much broader going from modestly overvalued to moderately undervalued, and is largely due to different assumptions regarding the benchmark level, growth, and rates of return on assets and liabilities.

Overall, the results are sensitive to specification and sample coverage, with estimates of misalignment ranging on both sides of zero.

20. Policy discussions. Following the extensive discussion in last year's Article IV consultation, the mission reviewed the exchange rate regime options and concluded that the LERS remains superior to the alternatives. The arguments for maintaining the LERS are compelling, given that it has generated substantial benefits in terms of monetary and financial stability, built up a stock of credibility over the decades, and kept the real exchange rate broadly in line with fundamentals. It works because Hong Kong SAR's economy is highly flexible, with nominal prices and wages adjusting to the changing environment to prevent sizable or persistent misalignments. The additional requisites to sustain the LERS, besides the aforementioned economic flexibility, are in place including a track record of fiscal discipline that is anchored by significant fiscal reserves, and robust financial sector regulation and supervision. As for the alternatives, a step revaluation would undermine the credibility of the system and fuel expectations of future adjustments, and in any event is unnecessary as the exchange rate is not out of line with fundamentals. Moving to a different peg or a crawling arrangement would suffer from similar drawbacks, and in practice would not yield any greater monetary policy autonomy. Regarding the option of linking to the renminbi, it would also prove problematic at this juncture because the renminbi is not convertible, the Mainland has substantial capital account restrictions, and renminbi financial markets are not sufficiently developed to manage a large portfolio of renminbi assets. Moreover, Hong Kong SAR's productivity and competitiveness is likely to evolve more in line with those of the United States than of the relatively less developed and faster growing Mainland. Finally, a floating regime could give some scope for an independent monetary policy, but would be difficult to manage for a very small, very open, international financial center where capital flows dwarf the size of the domestic economy. The nominal exchange rate would be subject to large fluctuations that would lead to significant volatility in domestic prices or the real exchange rate.

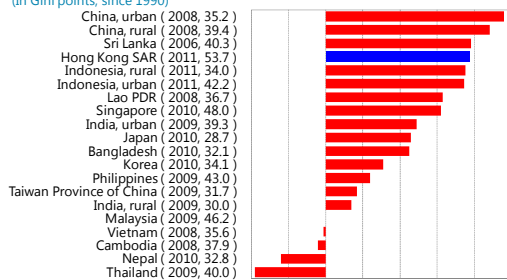
21. Authorities' views. The authorities remained firmly committed to the LERS, which they considered to be the most appropriate arrangement for Hong Kong SAR. They assessed the real exchange rate to be in line with fundamentals, and highlighted that it is through the adjustment of prices and wages that this equilibrium is maintained. This economic flexibility, on top of their firm commitment to fiscal discipline and financial stability, has underpinned the success of the LERS. They noted that the recent triggering of the convertibility undertaking is not a source of concern and that the LERS can accommodate such movement in capital flows.

INEQUALITY AND ECONOMIC VOLATILITY

A. Inclusive growth

22. Social protection. Income inequality in Hong Kong SAR has registered one of the larger increases in the region. This to some extent reflects the skill-based wage premiums inherent in a flexible, open, and free-market economy. Nevertheless, the authorities are concerned with inequality and have taken measures to

Asia: Change in Gini Index, Last Two Decades¹
(In Gini points, since 1990)



Sources: World Bank; national authorities and IMF staff calculations.

¹ In parentheses, the latest available year and corresponding Gini coefficients.

redress it. A minimum wage of HK\$28 (US\$3.6) per hour was introduced in 2011, and the rate is currently undergoing a periodic review as envisaged under the law. The 2012/13 Budget includes tax and other forms of relief for low-income groups, such as reductions of public housing rent. A key area of concern is housing, where rising prices and rent are squeezing many lower and middle income residents out of the private property market. Some observers commented that the absence of an official poverty line makes it difficult to assess developments.

23. *Authorities' views.* The authorities noted that the significant rise in the Gini coefficient over the past decade was not representative of developments and questioned whether Gini comparisons between city-scale financial centers and larger economies were appropriate. Moreover, once government programs were taken into account, inequality had not risen over the past five years. Official data show that a Gini coefficient that takes into account the effect of government programs has remained unchanged at 0.475 between 2006 and 2011. A set of poverty indicators developed by a former Commission on Poverty (in existence during 2005–07) have shown a broad-based improvement over the past decade (some examples include the declining number of recipients of Comprehensive Social Security Allowance (CSSA) and improvements in education enrollment). Moreover, the government recently reinstated the Commission on Poverty and tasked it to establish a poverty line for Hong Kong SAR, examine current poverty situation and causes of poverty, review existing policies, and formulate new policies to improve livelihoods, promote social mobility, and provide a safety net to better help the disadvantaged.

B. Economic volatility

24. *Is Hong Kong SAR' economy more volatile?* Without an independent monetary policy or an exchange rate to absorb shocks, a currency board system could result in higher economic volatility. Staff analysis examined both the average level and volatility of GDP growth, consumer price inflation, and housing price inflation, while controlling for factors such as the exchange rate regime, policy stance, and terms of trade.¹ The results show that GDP growth in Hong Kong SAR has indeed been somewhat more volatile than in other economies (Figure 6). However, the averages of GDP growth and inflation (for both consumer goods and housing prices) have been on par with other economies.

25. *Counter-cyclical fiscal policy.* The absence of an independent monetary policy means that fiscal policy the main tool for managing demand and reducing output volatility. Hong Kong SAR has ample fiscal space for counter-cyclical fiscal policy thanks to a history of prudence, which has built fiscal reserves to over 30 percent of GDP. Since automatic stabilizers in Hong Kong SAR are small, a heavier burden is put on discretionary policy. Staff research indicates that despite smaller automatic stabilizers, Hong Kong SAR's fiscal policy has been effective in reducing output volatility (Box 5).²

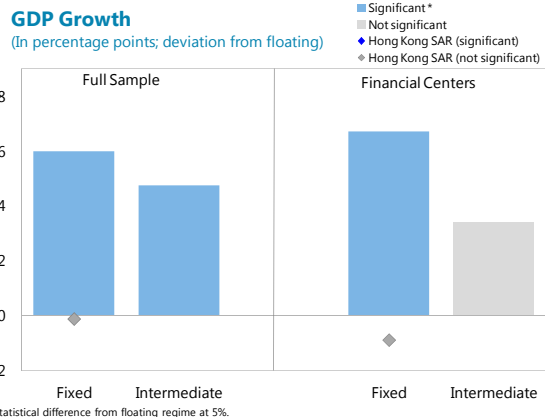
¹ A. Myrvoda and P. N'Diaye, IMF Working Paper, forthcoming. The sample has 48 economies (ranging from developing to advanced, and including financial centers) and uses data from the early 1980s to 2011.

² S. Barnett and M. Nabar, IMF Working Paper, forthcoming.

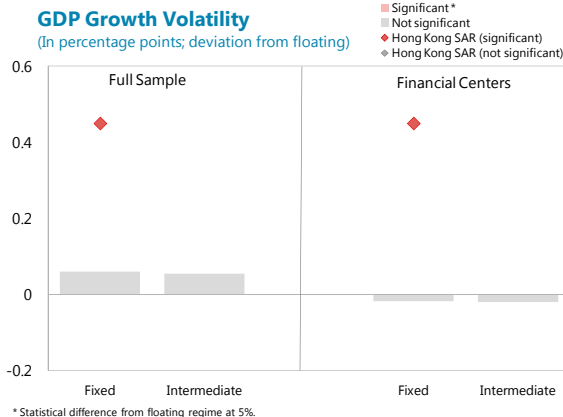
Figure 6. Hong Kong's Macroeconomic Performance: Does the Exchange Rate Regime Matter?

Hong Kong SAR's macroeconomic performance has been on par with that of other economies with fixed or more flexible exchange rate regimes, but its economy seems to be somewhat more volatile. 1/

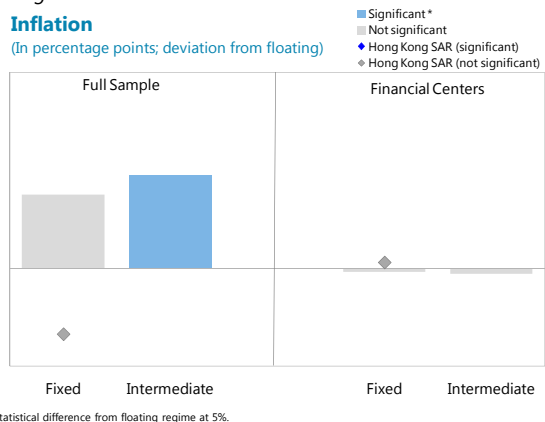
Hong Kong SAR's average growth has been in line with that of economies with flexible exchange rate regimes...



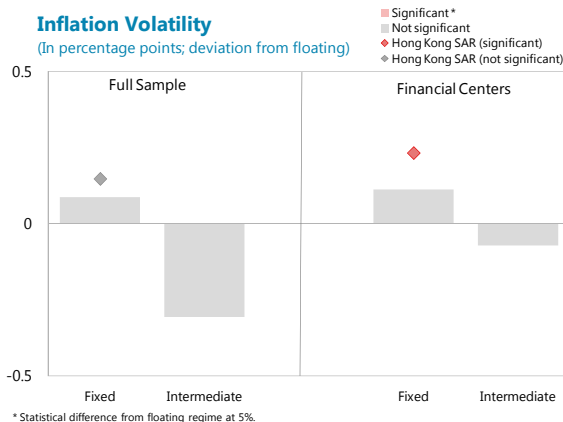
... but growth seems to be more volatile than other economies with flexible exchange rate regimes or financial centers.



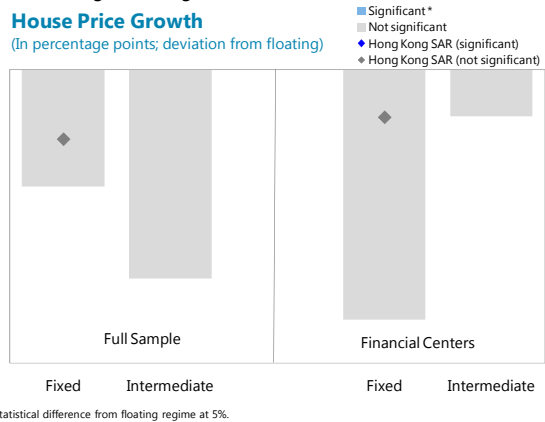
The evidence suggests that inflation in Hong Kong SAR has not been higher than in other economies...



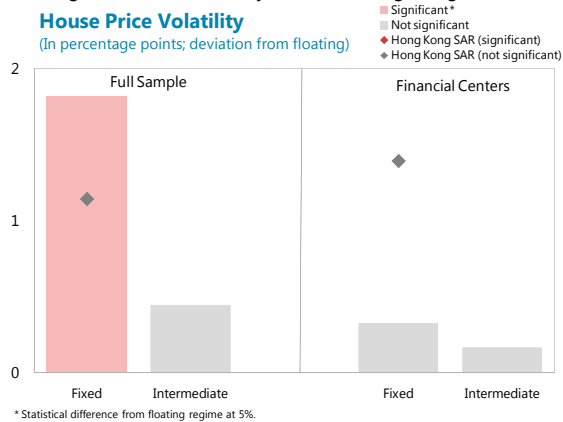
...or more volatile.



Housing prices have on average increased at similar speeds across exchange rate regimes...



...though property price inflation seems more volatile in economies with fixed exchange rates, but volatility is less in Hong Kong SAR.



Sources: CEIC; Haver Analytics; WEO; and IMF staff calculations.

1/ The average performance and volatility are estimated after controlling for a range of macroeconomic fundamentals and exchange rate regimes.

Box 5. Has Fiscal Policy been Counter-Cyclical? A Cross Country Comparison

The nature of Hong Kong SAR’s economy makes it susceptible to external shocks. Moreover, since the currency board takes away the option of using monetary policy, fiscal policy is the main lever for demand management. In comparison with other advanced economies, Hong Kong SAR has been relatively effective in using this lever to reduce output volatility.

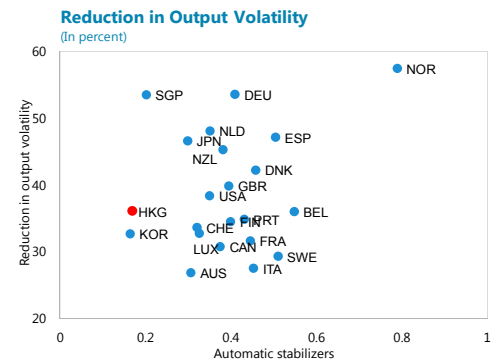
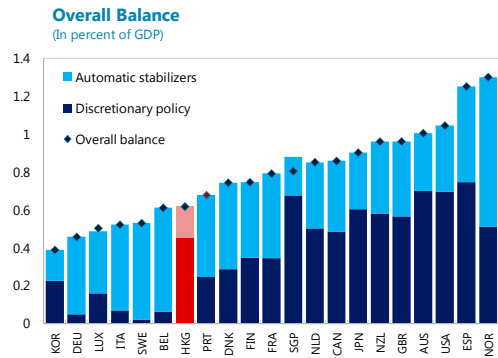
At first sight, budget policy in Hong Kong SAR appears to be counter-cyclical. The surplus tends to decline when the output gap widens and then reverses when the gap closes. A simple regression of the change in the overall balance on the output gap confirms this relationship and suggests that the fiscal surplus is reduced by ½ percent of GDP for each 1 percentage point widening of the output gap.

Still, fiscal policy in Hong Kong SAR seems to be less counter-cyclical than in other advanced economies. One factor is that Hong Kong SAR has small automatic stabilizers, which is a direct reflection of the relatively small size of government (spending averages less than 20 percent of GDP). Indeed, Hong Kong SAR has among the smallest automatic stabilizers in the sample.

However, Hong Kong SAR has been relatively successful in using discretionary fiscal policy—as measured by changes in the cyclically adjusted balance—to help compensate for the small automatic stabilizers. The above regressions provide a simple measure of counter-cyclical, but do not control for the reverse causal impact of fiscal policy on the output gap. This is a potentially significant shortcoming. For example, a government that succeeded in adjusting the deficit to eliminate all fluctuations in the output gap would be found to have no counter-cyclical (the regression coefficient would be zero).

We untangle the impact of fiscal policy on the output gap in an innovative way. The underlying shocks that hit the economy are estimated conditional on the fiscal multiplier, which is assumed to be one rather than estimated. Counter-cyclical is then measured by how much, in percent, fiscal policy succeeded in reducing output gap volatility compared to a counterfactual of no fiscal policy (technically a constant fiscal balance).¹ Using this measure, Hong Kong SAR is about average in the sample in terms of how much fiscal policy reduced output gap volatility.

However, considering that automatic stabilizers are smaller, the results imply that the authorities have been fairly successful in using discretionary fiscal policy. The findings are qualitatively similar using a fiscal multiplier that is smaller (0.5) or bigger (1.5).



¹ Specifically, for a given economy the shocks ϵ_t are derived from the regression:

$$Gap_t = c + \rho * Gap_{t-1} + Multiplier * \Delta Overall\ balance_t + \epsilon_t$$

The reduction in volatility from fiscal policy is equal to: $1 - \frac{\sigma_{gap}}{\hat{\sigma}_{gap}}$, where σ_{gap} is the standard deviation of the

output gap and $\hat{\sigma}_{gap}$ is the standard deviation of the hypothetical no fiscal policy case (constructed as:

$$\widehat{Gap}_t = \hat{c} + \hat{\rho} * \widehat{Gap}_{t-1} + \hat{\epsilon}_t$$

where the "hats" refer to the estimated values from the initial regression.

Staff discussed whether it could be beneficial to make the budget even more responsive to the business cycle, such as by developing a list of “shovel-ready” infrastructure projects or making it easier to adjust policies and spending to changes in the economy. In doing so, it would be critical not to undermine Hong Kong SAR’s hard-won fiscal credibility, by ensuring that any stimulus during economic slowdowns was offset by tightening during economic booms. The openness of Hong Kong SAR suggests that fiscal multipliers are likely somewhat smaller than in other economies since part of fiscal spending leaks abroad via imports. Nonetheless, counter-cyclical fiscal policy would still be warranted given the beneficial social impact, and could usefully focus on shielding the poor and vulnerable from shocks.

26. *Authorities’ views.* The authorities agreed that fiscal policy had been counter-cyclical, and underscored that this reflected their intent. They noted that the existing budget institutions already provided enough flexibility to respond to changing circumstances, including during the fiscal year when necessary. Additional room for maneuver is provided by the possibility of introducing a supplementary, mid-year budget as was done during the 2009/10 fiscal year following the collapse of Lehman Brothers. Infrastructure spending, moreover, was being scaled up in line with medium-term plans, but the size, complexity, and planning involved made it less amenable to being fine-tuned to match the business cycle. They considered other measures they have used to be more effective, such as social spending and support to small businesses. They agreed that multipliers were probably somewhat smaller in Hong Kong SAR given the import leakage. Finally, they emphasized that preserving fiscal discipline was of paramount importance and critical for fostering macroeconomic stability and supporting the LERS.

STAFF APPRAISAL

27. *Macroeconomic context.* Hong Kong SAR is weathering the global economic storms fairly well. Weakening external demand is dragging down growth, but the domestic economy is proving resilient buoyed by supportive fiscal policy and continued strength in construction and tourism-related sectors. Unemployment remains low. Inflation has declined on the heels of the slowing economy and easing of food price pressures in the Mainland. Looking forward, growth is expected to recover in line with the improved global economy while inflation is forecast to remain within a comfortable range. Nonetheless, as a small and highly open economy, Hong Kong SAR remains susceptible to external shocks and would strongly feel the effects of a worsening of the euro area crisis, the U.S fiscal cliff, or a hard-landing in the Mainland.

28. *Fiscal policy.* The absence of an independent monetary policy means that fiscal policy is the main tool for demand management. Overall, Hong Kong SAR’s fiscal policy has been effective in reducing output volatility thanks to the active use of discretionary policies. That includes 2012, with fiscal policy providing timely support to help counter the impact from slowing external demand. The 2013/14 budget should continue to be supportive of demand and, in the event of an external shock, fiscal policy should be deployed to provide further stimulus and protect low-income and vulnerable households. To prevent an erosion of fiscal discipline, it would be critical to ensure that policies are applied symmetrically through the business cycle, with stimulus being withdrawn as the economy

recovers. Hong Kong SAR's history of fiscal prudence, which has built fiscal reserves to over 30 percent of GDP, provides an important backbone to the economy.

29. *Property sector.* While the probability of a correction large enough to generate major macroeconomic and financial consequences is fairly low in the near term, the property sector is the main source of domestic economic risk. Policies on a variety of fronts are needed to contain macroeconomic and financial risks from the housing market. The authorities have taken appropriate macro-prudential measures to help safeguard the banking system. These measures should continue to be fine-tuned in line with evolving risks and, if needed, additional measures could be deployed. Macro-prudential measures should, however, remain focused on safeguarding financial stability, while other policies—such as fiscal measures—can best be used to address broader concerns about demand-supply imbalances and affordability. Improving affordability ultimately hinges on a sufficient provision of new housing. Therefore, the government's efforts to ensure a steady and adequate supply going forward, including through public housing, are welcome, although the impact may be limited in the short run given planning and construction lags.

30. *Financial sector.* Hong Kong SAR's banking system remains well capitalized, putting it in a good place to start implementing Basel III standards in 2013. The authorities have moved proactively to contain risks in the financial system. The slowdown in credit growth is welcome, as are the targeted measures to contain risks in real estate lending and efforts to closely monitor and supervise Mainland exposures. The HKMA should continue to assess evolving risks and, as needed, could deploy additional macro-prudential measures, tighten underwriting standards, and ask banks to increase buffers. As a financial center, Hong Kong SAR would feel the impact of a global financial shock. Bank distress elsewhere in the world could spill over into Hong Kong SAR, with shocks emanating in the United States or the Mainland having the largest potential impact. Hong Kong SAR's existing liquidity facilities and deposit protection scheme should prove sufficient to maintain financial stability, but, in an extreme shock, additional measures could be considered in conjunction

with other jurisdictions. The ongoing opening of the Mainland's capital account and expanded international use of renminbi provide further opportunities for Hong Kong SAR to strengthen its position as an international financial center. The FSAP scheduled for next year will afford an opportunity to explore financial sector issues in greater depth.

31. *Exchange rate regime.* The Linked Exchange Rate System (LERS) is a transparent, credible, and effective exchange rate regime and warrants continued support as the best arrangement for Hong Kong SAR. Hong Kong SAR has an economic system that adjusts to the changing environment through movements in nominal wages and prices. The preconditions to sustain such a system—including a strong fiscal position, robust and proactive financial oversight, and flexible labor, product, and asset markets—are in place. Hong Kong SAR's economic flexibility facilitates a quick and effective adjustment of the real exchange rate so as to avoid sizable or persistent misalignments. The Hong Kong dollar and external position are assessed to be broadly in line with fundamentals.

32. *Income inequality.* Fostering inclusive growth is an ongoing concern. Hong Kong SAR's economic flexibility and reliance on free-market principles are sources of economic strength and resilience which, however, can also result in income inequality given the importance of skill-based wage premiums. Moreover, the high and rising cost of housing is straining the budget of many lower- and middle-income families. The authorities have implemented an array of measures—including the statutory minimum wage and planned increases in public housing—geared toward improving the living standards of lower-income households. Weight should continue to be placed on policies to reinforce the existing social welfare programs and provide support and opportunities to lower-income households.

33. It is recommended that the next Article IV consultation discussions take place on the standard 12-month cycle.

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 2006–13 1/

	2006	2007	2008	2009	2010	2011	Staff projections	
							2012	2013
Real GDP (percent change)	7.0	6.5	2.1	-2.5	6.8	4.9	1.2	3.0
Contribution								
Domestic demand	5.3	7.0	1.3	0.8	6.6	5.7	3.1	3.3
Private consumption	3.5	5.0	1.1	0.5	3.9	5.1	1.8	2.2
Government consumption	0.1	0.3	0.2	0.2	0.3	0.2	0.2	0.2
Gross fixed capital formation	1.5	0.7	0.3	-0.7	1.5	1.6	1.1	0.9
Inventories	0.2	1.0	-0.3	0.9	0.9	-1.2	0.0	0.0
Net exports	1.7	-0.5	0.8	-3.3	0.2	-0.8	-1.8	-0.3
Inflation (percent change)								
Consumer prices	2.0	2.0	4.3	0.5	2.4	5.3	3.8	3.5
GDP deflator	-0.5	3.1	1.3	-0.4	0.3	3.8	3.5	3.1
Employment (percent change)	1.9	2.2	0.9	-1.2	0.2	2.9	1.0	1.1
Unemployment rate (percent, period average)	4.8	4.0	3.5	5.3	4.3	3.4	3.4	3.3
Real wages	-0.1	0.7	0.7	-1.5	-0.4	2.7	...	...
Government budget (percent of calendar year GDP)								
Revenue	19.2	21.7	18.5	19.2	21.2	22.6	20.4	20.8
Expenditure 2/	15.1	14.2	18.3	17.4	17.0	18.8	20.1	19.0
Consolidated budget balance	3.9	7.5	0.1	1.6	4.2	3.8	0.2	1.7
Fiscal reserves as of March 31	24.6	29.9	29.0	31.4	33.5	34.6	33.2	33.0
Money and credit (percent change, end-period)								
Narrow money (M1)	13.1	25.4	4.7	39.6	12.8	10.8	...	...
Broad money (M3)	15.5	20.6	2.6	5.2	8.0	12.9	...	...
Loans for use in Hong Kong SAR (not including trade financing)	2.3	15.2	11.0	-2.1	20.9	12.6	...	...
Interest rates (percent, end-period)								
Best lending rate	7.8	6.8	5.0	5.0	5.0	5.0	...	...
Three-month HIBOR	3.8	3.3	0.9	0.1	0.3	0.3	...	...
Asset prices								
Hang Seng stock index (end of period, 1964=100)	19,965	27,813	14,387	21,873	23,035	18,434	...	...
Hang Seng stock index (percent change)	34.2	39.3	-48.3	52.0	5.3	-20.0	...	...
Residential property prices (end of period, percent change)	4.1	25.7	-11.1	28.5	21.0	11.1	...	...
Merchandise trade (percent change)								
Export volume	9.3	7.0	1.9	-12.7	17.3	3.4	-3.3	6.7
Import volume	9.2	8.8	1.8	-9.5	18.1	4.7	-1.3	6.6
External balances (percent of GDP)								
Merchandise trade balance 3/	16.0	12.7	11.4	5.9	1.0	-3.7	-6.4	-6.0
Domestic exports 4/	9.2	7.1	6.0	4.6	4.6	4.6	3.8	3.6
Re-exports 4/	154.9	156.4	160.6	145.7	167.6	171.7	157.7	158.1
Imports 4/	171.4	172.8	177.1	162.9	191.0	198.9	185.5	185.4
Current account 3/	12.7	13.0	15.0	9.5	6.6	6.5	4.1	4.0
Foreign exchange reserves 5/								
In billions of U.S. dollars, end-of-period	133.2	152.7	182.5	255.8	268.7	285.4	281.9	283.6
In months of retained imports	18.6	19.5	22.0	34.6	28.7	25.9	25.3	24.2
In percent of broad money (M3)	20.4	19.4	22.5	29.9	29.2	27.4	...	...
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	7.784	...	...
Real effective rate (period average, 2000=100) 6/	99.0	93.9	88.9	91.0	88.7	85.7	...	...

Sources: CEIC Database; and staff estimates.

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

2/ In 2006-07, 2008-09, and 2009-10 fiscal years, expenditure excludes bond repayments.

3/ Balance of Payments BPM6 basis.

4/ National Accounts SNA 08 basis.

5/ Includes Land Fund assets.

6/ IMF staff estimates.

Table 2. Hong Kong SAR: Consolidated Government Account, 2006/07–2017/18 1/

(In percent of GDP, unless otherwise stated)

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	Staff projections					
							2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Revenue	19.2	21.7	18.5	19.2	21.2	22.6	20.4	20.8	21.4	22.0	22.4	22.6
Taxes	12.5	13.9	12.8	12.5	13.6	14.2	...	...	...	...	...	...
Direct taxes	7.7	8.1	8.6	7.4	8.0	9.1	...	...	...	...	...	...
<i>Of which:</i>												
Salaries tax	2.6	2.3	2.3	2.5	2.5	2.7	...	...	...	...	...	...
Profits tax	4.8	5.5	6.1	4.6	5.2	6.1	...	...	...	...	...	...
Indirect taxes	4.9	5.8	4.2	5.1	5.5	5.1	...	...	...	...	...	...
Nontax	6.6	7.8	5.7	6.7	7.6	8.4	...	...	...	...	...	...
<i>Of which:</i>												
Land premium	2.5	3.8	1.0	2.4	3.7	4.4	2.1	2.8	3.1	3.3	3.1	2.7
Investment income	2.0	1.7	2.7	2.0	1.9	1.9	1.5	1.5	1.5	1.6	1.6	1.6
Expenditure 2/	15.1	14.2	18.3	17.4	17.0	18.8	20.1	19.0	18.7	20.8	18.0	18.0
Current 3/	12.9	12.4	15.1	14.1	13.5	15.3	16.1	14.4	14.4	16.6	14.4	14.4
<i>Of which:</i>												
Personnel related	4.1	3.9	4.0	4.3	4.1	4.0	...	...	...	...	...	...
Capital	2.2	1.8	3.2	3.3	3.5	3.5	4.0	4.6	4.3	4.2	3.6	3.6
<i>Of which:</i>												
Interest	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	3.9	7.5	0.1	1.6	4.2	3.8	0.2	1.7	2.6	1.2	4.3	4.5
Memorandum items:												
Operating balance 4/	2.7	4.3	1.4	1.7	3.4	2.2	1.4	2.7	2.5	0.1	2.0	1.7
Primary balance 5/	2.1	6.0	-3.0	-0.6	2.4	2.2	-1.2	0.3	1.1	-0.3	2.7	2.9
Structural balance 6/	0.5	1.6	-0.5	-2.8	-1.7	-2.0	-1.8	-0.2	1.0	0.1	4.2	5.8
Fiscal reserves	24.6	29.9	29.0	31.4	33.5	34.6	33.2	33.0	32.9	31.7	33.7	35.6
(Months of spending)	19.3	25.2	18.8	21.3	23.7	22.1	19.8	20.8	21.0	18.3	22.4	23.7

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/ In 2006-07, 2008-09, and 2009-10 expenditure excludes bond repayments.

3/ This refers to the authorities' measure of operating expenditure.

4/ Operating balance, as defined by the authorities, is akin to the current balance.

5/ Balance excluding investment income.

6/ 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, 2006–17

	2006	2007	2008	2009	2010	2011	Staff projections					
							2012	2013	2014	2015	2016	2017
(In billions of U.S. dollars)												
Current account	24.6	27.6	32.9	20.3	15.0	16.2	10.8	11.1	13.2	16.0	19.8	24.7
Goods balance	30.9	26.9	25.0	12.6	2.4	-9.1	-16.6	-16.8	-15.1	-13.1	-10.9	-8.0
Services balance	-9.3	-4.3	-2.7	3.4	10.1	19.0	20.6	20.5	20.8	21.5	22.5	24.0
Primary income balance	4.6	6.8	12.9	6.4	4.8	8.8	9.4	10.1	10.4	10.8	11.7	12.5
Secondary income balance	-1.6	-1.8	-2.4	-2.1	-2.3	-2.5	-2.6	-2.8	-3.0	-3.2	-3.5	-3.8
Capital and financial account	-28.4	-33.4	-32.7	-18.6	-11.4	-11.6	-10.8	-11.1	-13.2	-16.0	-19.8	-24.7
Capital account	-0.1	-0.1	-0.3	-0.4	-0.6	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.4
Financial account	-28.3	-33.3	-32.5	-18.3	-10.9	-11.4	-10.6	-10.8	-12.9	-15.6	-19.5	-24.3
Net direct investment	-2.7	-5.8	10.0	-3.7	-15.7	9.3	1.4	-7.8	-8.8	-9.3	-10.9	-12.2
Liabilities	44.9	62.1	67.0	54.3	82.7	95.4	80.9	86.0	92.7	93.6	101.1	104.8
Assets	-47.6	-67.9	-57.1	-57.9	-98.4	-86.1	-79.5	-93.7	-101.4	-102.9	-111.9	-117.0
Portfolio investment	-26.2	-1.4	-36.1	-40.0	-57.0	0.5	-0.4	-0.7	-1.4	-1.8	-2.0	-2.4
Financial derivatives	3.3	5.6	8.1	3.2	2.4	2.9	3.3	3.6	4.0	4.5	5.0	5.5
Other investment	7.0	-23.5	14.4	101.3	67.0	-13.0	-12.8	-4.3	-4.7	-5.1	-4.5	-3.7
Reserve assets (net change)	-9.7	-8.2	-28.8	-79.0	-7.6	-11.1	-2.0	-1.7	-2.1	-4.0	-7.0	-11.5
Net errors and omissions	3.8	5.8	-0.1	-1.7	-3.6	-4.6	0.0	0.0	0.0	0.0	0.0	0.0
(In percent of GDP)												
Current account	12.7	13.0	15.0	9.5	6.6	6.5	4.1	4.0	4.4	4.9	5.7	6.5
Goods balance	16.0	12.7	11.4	5.9	1.0	-3.7	-6.4	-6.0	-5.0	-4.0	-3.1	-2.1
Services balance	-4.8	-2.0	-1.2	1.6	4.4	7.7	7.9	7.4	7.0	6.6	6.4	6.3
Primary income balance	2.4	3.2	5.9	3.0	2.1	3.6	3.6	3.6	3.5	3.3	3.4	3.3
Secondary income balance	-0.8	-0.9	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital and financial account	-14.7	-15.8	-14.9	-8.7	-5.0	-4.7	-4.1	-4.0	-4.4	-4.9	-5.7	-6.5
Capital account	-0.1	0.0	-0.1	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Financial account	-14.6	-15.7	-14.8	-8.5	-4.7	-4.6	-4.0	-3.9	-4.3	-4.8	-5.6	-6.4
Net direct investment	-1.4	-2.7	4.5	-1.7	-6.9	3.7	0.5	-2.8	-2.9	-2.9	-3.1	-3.2
Portfolio investment	-13.6	-0.7	-16.5	-18.7	-24.9	0.2	-0.2	-0.2	-0.5	-0.5	-0.6	-0.6
Financial derivatives	1.7	2.6	3.7	1.5	1.1	1.2	1.3	1.3	1.3	1.4	1.4	1.5
Other investment	3.6	-11.1	6.5	47.3	29.3	-5.2	-4.9	-1.5	-1.6	-1.6	-1.3	-1.0
Reserve assets (net change)	-5.0	-3.9	-13.1	-36.9	-3.3	-4.5	-0.8	-0.6	-0.7	-1.2	-2.0	-3.1
Net errors and omissions	2.0	2.8	-0.1	-0.8	-1.6	-1.9	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, 2007–17

	2007	2008	2009	2010	2011	Staff projections					
						2012	2013	2014	2015	2016	2017
Real GDP (percent change)	6.5	2.1	-2.5	6.8	4.9	1.2	3.0	4.3	4.3	4.4	4.4
Contribution											
Real domestic demand	7.0	1.3	0.8	6.6	5.7	3.1	3.3	4.2	4.2	4.2	4.2
Private consumption	5.0	1.1	0.5	3.9	5.1	1.8	2.2	3.0	3.0	3.0	3.0
Government consumption	0.3	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Gross fixed capital formation	0.7	0.3	-0.7	1.5	1.6	1.1	0.9	1.0	1.0	1.0	1.0
Inventories	1.0	-0.3	0.9	0.9	-1.2	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	-0.5	0.8	-3.3	0.2	-0.8	-1.8	-0.3	0.1	0.2	0.2	0.2
Output gap (in percent of potential)	5.5	3.6	-1.9	1.2	2.5	-0.3	-1.2	-1.0	-0.6	-0.2	0.0
Growth rates											
Real domestic demand	7.8	1.4	0.9	7.2	6.1	3.2	3.4	4.3	4.3	4.3	4.3
Private consumption	8.6	1.9	0.8	6.3	8.2	2.8	3.4	4.6	4.6	4.6	4.6
Government consumption	3.2	2.0	2.3	3.3	2.2	2.8	2.0	2.2	2.2	2.2	2.2
Gross fixed capital formation	3.2	1.4	-3.5	7.4	7.5	4.7	4.1	4.4	4.4	4.5	4.4
Saving and investment (percent of GDP)											
Gross national saving	34.4	36.0	31.3	30.4	29.1	28.2	28.2	28.4	28.7	29.3	29.9
Gross investment	21.4	21.0	21.8	23.9	23.4	24.1	24.2	24.0	23.8	23.6	23.4
Saving-investment balance	13.0	15.0	9.5	6.6	5.7	4.1	4.0	4.4	4.9	5.7	6.5
Inflation (percent change)											
Consumer prices	2.0	4.3	0.5	2.4	5.3	3.8	3.5	3.5	3.5	3.5	3.5
GDP deflator	3.1	1.3	-0.4	0.3	3.8	3.5	3.1	3.4	3.4	3.4	3.6
Employment (percent change)	2.2	0.9	-1.2	0.2	2.9	1.0	1.1	1.1	1.0	1.0	1.0
Unemployment rate (percent, period average)	4.0	3.5	5.3	4.3	3.4	3.4	3.3	3.2	3.2	3.2	3.2
Merchandise trade (percent change)											
Export volume	7.0	1.9	-12.7	17.3	3.4	-3.3	6.7	8.4	8.4	8.4	8.4
o/w Re-exports	8.6	2.9	-12.2	17.8	3.5	-3.1	6.8	8.5	8.5	8.5	8.5
Import volume	8.8	1.8	-9.5	18.1	4.7	-1.3	6.6	8.1	8.1	8.1	8.1
Retained import volume	11.7	-1.4	-3.8	19.7	7.8	-13.9	5.4	6.5	6.5	6.5	6.4
Export value	9.4	5.4	-12.3	22.7	11.4	-3.9	6.3	8.1	8.5	8.8	9.3
Import value	10.7	6.0	-10.6	25.6	13.3	-2.2	6.1	7.4	7.8	8.2	8.6
External balances (in billions of US\$)											
Trade balance	26.9	25.0	12.6	2.4	-9.1	-16.6	-16.8	-15.1	-13.1	-10.9	-8.0
In percent of GDP	12.7	11.4	5.9	1.0	-3.7	-6.4	-6.0	-5.0	-4.0	-3.1	-2.1
Exports of goods	346	365	322	394	438	404	430	465	504	548	599
Imports of goods	306	388	349	437	494	399	424	456	491	531	577
Current account	27.6	32.9	20.3	15.0	16.2	10.8	11.1	13.2	16.0	19.8	24.7
In percent of GDP	13.0	15.0	9.5	6.6	6.5	4.1	4.0	4.4	4.9	5.7	6.5
Foreign exchange reserves (end-year)	152.7	182.5	255.8	268.7	285.4	281.9	283.6	285.7	289.7	296.7	308.2
In percent of GDP	72.2	83.2	119.5	117.4	114.8	107.8	102.1	95.4	89.6	85.0	81.6

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	2011
Public sector											
Fiscal surplus (in percent of GDP)	-4.8	-4.8	-3.2	-0.3	1.0	3.9	7.5	0.1	1.6	4.2	3.8
Accumulated fiscal surplus (in percent of GDP)	28.2	24.0	21.9	22.5	22.0	24.6	29.9	29.0	31.4	33.5	34.6
External sector											
Total export volume (percent change)	-3.2	8.0	14.0	14.9	10.4	9.3	7.0	1.9	-12.7	17.3	3.4
Domestic exports	-10.1	-11.5	-6.9	2.2	6.1	3.0	-19.3	-19.2	-26.6	-0.1	-1.2
Reexports	-2.3	10.3	15.9	15.8	10.7	9.7	8.6	2.9	-12.2	17.8	3.5
Total import volume (percent change)	-2.0	7.6	13.1	13.7	8.0	9.2	8.8	1.8	-9.5	18.1	4.7
Current account (in billions of U.S. dollar)	10.4	13.1	17.4	16.8	21.6	24.6	27.6	32.9	20.3	15.0	16.2
Net equity inflow (in billions of U.S. dollar)	-23.5	-14.4	-4.2	-28.5	-18.0	-1.2	-25.8	-1.0	-16.3	-28.5	-26.4
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	285.4
In months of retained imports	20.4	22.6	23.3	21.2	19.8	18.6	19.5	22.1	34.6	28.7	25.9
In percent of monetary base	376.9	354.0	313.6	325.2	339.0	349.6	371.6	278.8	196.2	200.9	206.5
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	27.6
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	54.7
Short-term debt (in billions of U.S. dollar) 2/	300.0	225.1	251.8	311.5	312.6	371.4	545.7	485.6	469.6	649.3	716.1
In percent of gross reserves	269.9	200.0	211.6	249.6	249.8	273.9	353.5	268.4	194.1	235.9	249.8
One-year forward exchange rate premium (in pips, annual average)	52.7	138.8	33.9	-704.8	-448.9	-599.7	-552.3	-337.4	-163.8	-212.1	-240.6
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	-3.4
Financial sector											
HIBOR(3M)-LIBOR (3M) (in basis points, period average)	-8.5	7.5	-16.4	-116.1	-50.5	-92.5	-96.5	-57.8	-22.5	-9.4	-6.9
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	-20.0
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	11.1
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	66.9
Domestic credit growth 5/	-3.8	-2.6	-2.0	4.9	7.7	2.3	15.2	11.0	-2.1	20.9	12.6
Real credit growth 5/	-0.3	-1.1	-0.1	4.6	6.3	0.0	11.0	8.7	-3.6	17.5	6.5
Capital adequacy ratio 6/	16.5	15.7	15.3	15.4	14.8	14.9	13.4	14.7	16.8	15.8	15.8
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	1.0
Net open spot position (in billions of U.S. dollar)	24.7	18.2	15.9	28.2	30.7	52.0	78.8	56.8	38.1	39.0	34.6
Net open forward position (in billions of U.S. dollar)	-14.6	-6.7	-6.4	-24.5	-25.9	-46.2	-71.8	-43.8	-27.6	-34.6	-31.7
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	14.9
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	49.6
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	55.2
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.

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, 2006-2011

	2006	2007	2008	2009	2010	2011
Statement of government operations						
	(HKD mln)					
Revenue	305,352	368,242	330,289	335,793	395,879	...
Expense	245,787	263,074	316,293	312,157	309,148	...
Gross operating balance	68,961	114,504	23,924	34,219	96,702	...
Net operating balance	59,565	105,168	13,996	23,636	86,731	...
Net acquisition of nonfinancial assets	2,394	-2,362	3,302	5,501	13,180	...
Net lending/borrowing	57,171	107,530	10,694	18,135	73,551	...
Net acquisition of financial assets	72,333	124,151	26,027	49,370	105,070	...
Net incurrence of liabilities	15,162	16,621	15,333	31,235	31,519	...
Statistical discrepancy	...	...	...	...	...	...
Balance sheet						
Net worth	435,832	531,017	551,584	568,345	644,505	...
Nonfinancial assets	291,922	289,781	297,621	305,254	317,955	...
Financial assets	614,177	738,305	764,337	814,325	958,341	...
Liabilities	470,267	497,069	510,374	551,234	631,791	...
Revenue						
Revenue	305,352	368,242	330,289	335,793	395,879	...
Taxes	187,699	230,137	217,201	207,400	240,496	...
Social contributions	17	17	16	14	13	...
Other revenue	117,636	138,088	113,072	128,379	155,370	...
Expense						
Expense	245,787	263,074	316,293	312,157	309,148	...
Compensation of employees	63,919	67,090	70,866	70,494	71,656	...
Uses of goods and services	70,698	78,831	82,314	86,933	102,437	...
Consumption of fixed capital	9,396	9,336	9,928	10,583	9,971	...
Interest	1,038	1,015	901	874	963	...
Subsidies	216	182	277	451	365	...
Grants	61	314	2,352	7,036	489	...
Social benefits	33,883	35,859	40,702	42,561	43,118	...
Other expense	66,576	70,447	108,953	93,225	80,149	...
Transactions in assets and liabilities						
Change in net worth from transactions	59,565	105,168	13,996	23,636	86,731	...
Net Acquisition of Nonfinancial Assets	2,394	-2,362	3,302	5,501	13,180	...
Fixed assets	3,162	2,490	6,475	6,616	15,682	...
Change in inventories	-768	-4,852	-3,173	-1,115	-2,502	...
Net acquisition of financial assets	72,333	124,151	26,027	49,370	105,070	...
Net incurrence of liabilities	15,162	16,621	15,333	31,235	31,519	...

Source: Hong Kong SAR Authorities, Government Finance Statistics. Accrual-based data. 2011 statistics will be available only in 2013 Q1.



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

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION DISCUSSIONS—INFORMATIONAL ANNEX

December 19, 2012

Prepared By

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

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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's *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. Hong Kong SAR has requested a Financial Sector Assessment Program, which will be undertaken in FY 2014.

II. Exchange Rate Arrangement

The Hong Kong dollar has been linked to the U.S. dollar under a currency board arrangement, the Linked Exchange Rate System (LERS), 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 1986 and GFSM 2001, respectively)*. No subannual data are provided for publication in the *IFS*.

Hong Kong SAR participates in regular reporting of Financial Soundness Indicators (FSIs) to the IMF for dissemination. The reported data are quarterly and cover all core FSIs and 12 additional FSIs for the deposit takers sector.

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 December 17, 2012

	Date of Latest Observation	Date Received	Frequency of Data ⁵	Frequency of Reporting ⁵	Frequency of Publication ⁵
Exchange rates	Nov. 2012	Dec. 2012	D	D	D
International reserve assets and reserve liabilities of the monetary authorities ¹	Oct. 2012	Dec. 2012	M	M	M
Reserve/base money	Oct. 2012	Dec. 2012	M	M	M
Broad money	Oct. 2012	Dec. 2012	M	M	M
Central bank balance sheet	Oct. 2012	Dec. 2012	M	M	M
Consolidated balance sheet of the banking system	Oct. 2012	Dec. 2012	M	M	M
Interest rates ²	Nov. 2012	Dec. 2012	D	D	D
Consumer price index	Oct. 2012	Dec. 2012	M	M	M
Revenue, expenditure, balance and composition of financing ³ —central government	Oct. 2012	Dec. 2012	M	M	M
Stocks of central government and central government-guaranteed debt ⁴	Oct. 2012	Dec. 2012	M	M	M
External current account balance	Q2/12	Oct. 2012	Q	Q	Q
Exports and imports of goods and services	Q3/12	Dec. 2012	Q	Q	Q
GDP/GNP	Q3/12	Dec. 2012	Q	Q	Q
Gross external debt	Q2/12	Oct. 2012	Q	Q	Q
International investment position	Q2/12	Oct. 2012	Q	Q	Q

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).



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

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FOR IMMEDIATE RELEASE
January 17, 2013

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

IMF Executive Board Concludes 2012 Article IV Consultation with People's Republic of China—Hong Kong Special Administrative Region

On January 9, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Hong Kong Special Administrative Region (SAR), and considered and endorsed the staff appraisal without a meeting on a lapse of time basis².

Background

Real GDP growth in Hong Kong SAR is projected to slow to 1¼ percent in 2012, pulled down by the weak external environment. However, domestic demand has been resilient, buoyed by a healthy labor market and supportive fiscal policy. Fiscal measures include waiving rates, reductions of public housing rent, tax relief to households, and increases in social spending. Consumer price pressures have eased, in line with the cooling economy.

After a short respite in late-2011, the rapid run-up in property prices has resumed. Prices increased by 23 percent in the first ten months of 2012 and have doubled from their 2008 trough. The rise in mass market prices has been particularly pronounced of late and the rental market is following a similar trend. The loan-to-value ratio for mortgages has remained at around 55 percent.

Overall bank credit growth, a key concern in recent years, has decelerated significantly in line with slowing economic activity and tighter macro-prudential policy. Hong Kong SAR's banking system asset quality and profitability has proven resilient to the recent turmoil in the global

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.

² The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

economy. Although IPO activity has been slow, the equity market has recently rebounded, and corporate bond issuance has been strong.

Financial integration with the Mainland has continued. Over the past few years, Hong Kong SAR's banking system claims on Mainland borrowers have grown significantly and accounted for 28 percent of Hong Kong SAR banks' total external claims as of end-June 2012. After growing rapidly through late 2011, the share of renminbi deposits has stabilized at around 9 percent of total system deposits.

Executive Board Assessment

In concluding the 2012 Article IV consultation with Hong Kong SAR, Executive Directors endorsed staff's appraisal as follows:

Hong Kong SAR is weathering the global economic storms fairly well. Weakening external demand is dragging down growth, but the domestic economy is proving resilient buoyed by supportive fiscal policy and continued strength in construction and tourism-related sectors. Unemployment remains low. Inflation has declined on the heels of the slowing economy and easing of food price pressures in the Mainland. Looking forward, growth is expected to recover in line with the improved global economy while inflation is forecast to remain within a comfortable range. Nonetheless, as a small and highly open economy, Hong Kong SAR remains susceptible to external shocks and would strongly feel the effects of a worsening of the euro area crisis, the U.S fiscal cliff, or a hard-landing in the Mainland.

The absence of an independent monetary policy means that fiscal policy is the main tool for demand management. Overall, Hong Kong SAR's fiscal policy has been effective in reducing output volatility thanks to the active use of discretionary policies. That includes 2012, with fiscal policy providing timely support to help counter the impact from slowing external demand. Next year's budget should continue to be supportive of demand and, in the event of an external shock, fiscal policy should be deployed to provide further stimulus and protect low-income and vulnerable households. To prevent an erosion of fiscal discipline, it would be critical to ensure that policies are applied symmetrically through the business cycle, with stimulus being withdrawn as the economy recovers. Hong Kong SAR's history of fiscal prudence, which has built fiscal reserves to over 30 percent of GDP, provides an important backbone to the economy.

While the probability of a correction large enough to generate major macroeconomic and financial consequences is fairly low in the near term, the property sector is the main source of domestic economic risk. Policies on a variety of fronts are needed to contain macroeconomic and financial risks from the housing market. The authorities have taken appropriate macro-prudential measures to help safeguard the banking system. These measures should continue to be fine-tuned in line with evolving risks and, if needed, additional measures could be deployed. Macro-prudential measures should, however, remain focused on safeguarding financial stability, while other policies—such as fiscal measures—can best be used to address broader concerns about demand-supply imbalances and affordability. Improving affordability ultimately hinges on

a sufficient provision of new housing. Therefore, the government's efforts to ensure a steady and adequate supply going forward, including through public housing, are welcome, although the impact may be limited in the short run given planning and construction lags.

Hong Kong SAR's banking system remains well capitalized, putting it in a good place to start implementing Basel III standards in 2013. The authorities have moved proactively to contain risks in the financial system. The slowdown in credit growth is welcome, as are the targeted measures to contain risks in real estate lending and efforts to closely monitor and supervise Mainland exposures. The HKMA should continue to assess evolving risks and, as needed, could deploy additional macro-prudential measures, tighten underwriting standards, and ask banks to increase buffers. As a financial center, Hong Kong SAR would feel the impact of a global financial shock. Bank distress elsewhere in the world could spill over into Hong Kong SAR, with shocks emanating in the United States or the Mainland having the largest potential impact. Hong Kong SAR's existing liquidity facilities and deposit protection scheme should prove sufficient to maintain financial stability, but, in an extreme shock, additional measures could be considered in conjunction with other jurisdictions. The ongoing opening of the Mainland's capital account and expanded international use of renminbi provide further opportunities for Hong Kong SAR to strengthen its position as an international financial center. The Financial Sector Assessment Program (FSAP) scheduled for next year will afford an opportunity to explore financial sector issues in greater depth.

The Linked Exchange Rate System (LERS) is a transparent, credible, and effective exchange rate regime and warrants continued support as the best arrangement for Hong Kong SAR. Hong Kong SAR has an economic system that adjusts to the changing environment through movements in nominal wages and prices. The preconditions to sustain such a system—including a strong fiscal position, robust and proactive financial oversight, and flexible labor, product, and asset markets—are in place. Hong Kong SAR's economic flexibility facilitates a quick and effective adjustment of the real exchange rate so as to avoid sizable or persistent misalignments. The Hong Kong dollar and external position are assessed to be broadly in line with fundamentals.

Fostering inclusive growth is an ongoing concern. Hong Kong SAR's economic flexibility and reliance on free-market principles are sources of economic strength and resilience which, however, can also result in income inequality given the importance of skill-based wage premiums. Moreover, the high and rising cost of housing is straining the budget of many lower- and middle-income families. The authorities have implemented an array of measures—including the statutory minimum wage and planned increases in public housing—geared toward improving the living standards of lower-income households. Weight should continue to be placed on policies to reinforce the existing social welfare programs and provide support and opportunities to lower-income households.

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 2012 Article IV Consultation with Hong Kong Special Administrative Region is also available.

Hong Kong SAR: Selected Economic and Financial Indicators, 2006–13 1/								
	2006	2007	2008	2009	2010	2011	Staff projections	
							2012	2013
Real GDP (percent change)	7.0	6.5	2.1	-2.5	6.8	4.9	1.2	3.0
Contribution								
Domestic demand	5.3	7.0	1.3	0.8	6.6	5.7	3.1	3.3
Private consumption	3.5	5.0	1.1	0.5	3.9	5.1	1.8	2.2
Government consumption	0.1	0.3	0.2	0.2	0.3	0.2	0.2	0.2
Gross fixed capital formation	1.5	0.7	0.3	-0.7	1.5	1.6	1.1	0.9
Inventories	0.2	1.0	-0.3	0.9	0.9	-1.2	0.0	0.0
Net exports	1.7	-0.5	0.8	-3.3	0.2	-0.8	-1.8	-0.3
Inflation (percent change)								
Consumer prices	2.0	2.0	4.3	0.5	2.4	5.3	3.8	3.5
GDP deflator	-0.5	3.1	1.3	-0.4	0.3	3.8	3.5	3.1
Employment (percent change)	1.9	2.2	0.9	-1.2	0.2	2.9	1.0	1.1
Unemployment rate (percent, period average)	4.8	4.0	3.5	5.3	4.3	3.4	3.4	3.3
Real wages	-0.1	0.7	0.7	-1.5	-0.4	2.7	...	...
Government budget (percent of calendar year GDP)								
Revenue	19.2	21.7	18.5	19.2	21.2	22.6	20.4	20.8
Expenditure 2/	15.1	14.2	18.3	17.4	17.0	18.8	20.1	19.0
Consolidated budget balance	3.9	7.5	0.1	1.6	4.2	3.8	0.2	1.7
Fiscal reserves as of March 31	24.6	29.9	29.0	31.4	33.5	34.6	33.2	33.0
Money and credit (percent change, end-period)								
Narrow money (M1)	13.1	25.4	4.7	39.6	12.8	10.8	...	...
Broad money (M3)	15.5	20.6	2.6	5.2	8.0	12.9	...	...
Loans for use in Hong Kong SAR (not including trade financing)	2.3	15.2	11.0	-2.1	20.9	12.6	...	...
Interest rates (percent, end-period)								
Best lending rate	7.8	6.8	5.0	5.0	5.0	5.0	...	...
Three-month HIBOR	3.8	3.3	0.9	0.1	0.3	0.3	...	...
Asset prices								
Hang Seng stock index (end of period, 1964=100)	19,965	27,813	14,387	21,873	23,035	18,434	...	...
Hang Seng stock index (percent change)	34.2	39.3	-48.3	52.0	5.3	-20.0	...	...
Residential property prices (end of period, percent change)	4.1	25.7	-11.1	28.5	21.0	11.1	...	...
Merchandise trade (percent change)								
Export volume	9.3	7.0	1.9	-12.7	17.3	3.4	-3.3	6.7
Import volume	9.2	8.8	1.8	-9.5	18.1	4.7	-1.3	6.6
External balances (percent of GDP)								
Merchandise trade balance 3/	16.0	12.7	11.4	5.9	1.0	-3.7	-6.4	-6.0
Domestic exports 4/	9.2	7.1	6.0	4.6	4.6	4.6	3.8	3.6
Re-exports 4/	154.9	156.4	160.6	145.7	167.6	171.7	157.7	158.1
Imports 4/	171.4	172.8	177.1	162.9	191.0	198.9	185.5	185.4
Current account 3/	12.7	13.0	15.0	9.5	6.6	6.5	4.1	4.0
Foreign exchange reserves 5/								
In billions of U.S. dollars, end-of-period	133.2	152.7	182.5	255.8	268.7	285.4	281.9	283.6
In months of retained imports	18.6	19.5	22.0	34.6	28.7	25.9	25.3	24.2
In percent of broad money (M3)	20.4	19.4	22.5	29.9	29.2	27.4	...	...
Exchange rate								
Linked rate (fixed)					HK\$7.80/US\$1			
Market rate (HK\$/US\$, period average)	7.768	7.801	7.787	7.752	7.769	7.784	...	...
Real effective rate (period average, 2000=100) 6/	99.0	93.9	88.9	91.0	88.7	85.7	...	...

Sources: CEIC Database; and staff estimates.

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

2/ In 2006-07, 2008-09, and 2009-10 fiscal years, expenditure excludes bond repayments.

3/ Balance of Payments BPM6 basis.

4/ National Accounts SNA 08 basis.

5/ Includes Land Fund assets.

6/ IMF staff estimates.