Annex

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IMF Concludes 2003 Article IV Consultation with People's Republic of China — Hong Kong Special Administrative Region

On May 16, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with People's Republic of China — Hong Kong Special Administrative Region.[1]

Background

The Hong Kong SAR economy has begun to show some signs of recovery after a prolonged cyclical downturn. The highly open economy experienced a sharp output decline and large capital outflows during the Asian crisis. Before sustained growth could take hold, the global slowdown in 2001 brought on another recession. After four quarters of negative or near zero growth, the economy began to post positive growth in the third quarter of 2002. However, domestic demand has remained weak and the recovery has been driven entirely by robust reexports growth on the back of strengthening the Mainland of China trade. More recently, the outbreak of Severe Acute Respiratory Syndrome (SARS) has significantly weakened activity in the tourism and retail sectors.

Domestic goods and factor prices have continued to undergo significant downward adjustment. Deflation in consumer prices has now entered into a fifth consecutive year. Property prices have continued to drift downwards since the collapse of the property price bubble, and are now about 60 percent below their peak attained in 1997. Nominal wage growth has turned negative and real wage growth has moderated. The adjustment in the labor market has partially taken place through a reduction in employment in certain sectors; and the unemployment rate, although declining from its record high level in mid-2002, has remained above 7 percent.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Real GDP is expected to grow by 2.2 percent in 2003, but the near-term outlook is subject to significant downside risks. The outbreak of SARS is likely to result in a temporary decline in activity in the first half of 2003. Supported by robust growth in the Mainland of China, renewed strength in external demand is projected to enable a gradual recovery of domestic demand in the second half of the year. CPI deflation is expected to ease to 2 percent in 2003 as the one-off effects of administrative factors dissipate, but weak property prices, high unemployment, and other structural factors are likely to continue to dampen both domestic demand and the overall level of prices. This outlook is subject to considerable downside risks related to the possible persistence of the adverse effects of SARS. In addition, further weakening of growth prospects for advanced economies could affect Hong Kong SAR's export performance. Hong Kong SAR's medium-term outlook depends on how well it adapts to integration with the Mainland of China and rising regional competition.

The consolidated fiscal deficit reached 4.9 percent of GDP in FY2002, relative to a budget target of 3½ percent of GDP, largely due to deferred asset sales. The structural budget position has also deteriorated significantly over the last five years, mainly because government expenditures have continued to grow in nominal terms even as the overall price level has declined. In the FY2003 budget proposed in early March, the government reiterated its commitment of achieving budget balance by FY2006. This objective is to be achieved through a three-pronged approach based on cutting expenditures, increasing tax rates and boosting economic growth.

Executive Board Assessment

Directors noted that the Hong Kong SAR economy has been hit by a series of shocks in the last few years, most recently the outbreak of Severe Acute Respiratory Syndrome epidemic in 2003. The economy has begun to show signs of recovery from a prolonged cyclical downturn, mainly on account of robust re-exports, but unemployment is high and rising while deflation persists. Domestic demand contracted in 2002 and weakened further in 2003. Although a revival of exports and domestic demand in the second half of the year could still help maintain growth at over 2 percent in 2003, significant downside risks remain.

Directors noted that the authorities face significant policy challenges in the period ahead — including the short-term difficulties posed by the outbreak of SARS and the medium-term challenges associated with rising integration with the Mainland of China. In this regard, Directors commended the authorities for taking forceful measures to contain the SARS epidemic and welcomed the package of temporary fiscal relief and support measures which would provide much-needed support to economic activity in the short run.

Directors expressed concern that the deflationary trend in Hong Kong SAR appeared to have become more entrenched. They noted that, while temporary and cyclical factors may have triggered the initial phase of deflation, structural factors, including the adjustment to growing integration with the Mainland of China, had become more important over time. Directors agreed that the appropriate policy response to deflation would be to intensify reforms to bolster Hong Kong SAR's competitiveness and long-term growth prospects, including through measures to shift the composition of output towards higher value services, and to strengthen its attractiveness as an international financial center. More broadly, Directors emphasized that

Hong Kong SAR's traditional strengths — flexible labor and product markets and strong legal and institutional frameworks — would need to be complemented by sound macroeconomic policies and productivity-increasing structural reforms.

Directors noted that fiscal policy will need to be managed carefully in order to support the linked exchange rate system. In this context, they observed that the continued deterioration of the fiscal position is a potential source of macroeconomic vulnerability. Directors welcomed the authorities' objective of balancing the budget by FY2006. They agreed that fiscal retrenchment would not be appropriate in FY2003 because of the weak macroeconomic environment and the need for SARS-related spending. However, in order to attain the medium-term objective, they urged that the revenue and expenditure measures announced in the FY2003 budget be fully implemented to make a significant and credible reduction in the budget deficit starting in FY2004. Some Directors also considered that additional measures would be required over the medium term to achieve fiscal consolidation.

Directors considered that significant expenditure reduction will be required for successful fiscal consolidation, which would be consistent with the objective of maintaining a small government. They welcomed the authorities' plans to cut civil service employment and the agreement reached with civil service unions to reduce salaries, and looked forward to the completion of the civil service pay level review by 2004. They believed that the authorities should also de-link the pay system for employees in government-funded agencies from that for civil servants to reduce wage rigidity in the public sector. Directors commended the authorities' initiatives to increase private sector participation in the financing and provision of health and education services, and urged that these efforts be strengthened further. They supported the proposed welfare reforms that would enhance the affordability and effectiveness of the social safety net.

Directors noted that traditional revenue sources, including revenues from land sales, are likely to remain volatile and come under increasing pressure. They believed that the best option for strengthening the revenue base and reducing its volatility in the medium term would be the introduction of a low-rate, broad-based goods and services tax (GST). Some Directors concurred with the authorities' cautious approach and their intention to introduce the tax only as the economic situation permits. However, Directors agreed that, given the long lead time required, preparation for the implementation of a GST should begin soon.

Directors expressed support for the authorities' commitment to the linked exchange rate system. They noted that Hong Kong SAR's strong external position, characterized by zero net external debt and sizable foreign exchange reserves, provides a buffer against short-term external shocks. However, Directors stressed that the long-term sustainability of the system will depend crucially on prudent fiscal policies, maintenance of a sound financial system, and enhanced flexibility of goods and factor markets. Directors noted that the exchange rate regime and supporting conditions should be, as they always have been, kept under review in the medium term.

Directors welcomed the Financial System Stability Assessment's finding that Hong Kong SAR's financial system is resilient, fundamentally sound, and supported by a strong financial stability framework. They noted that the banking system is well capitalized and profitable, notwithstanding the recent economic downturn and the sustained deflation. Directors cautioned that, with profit opportunities shrinking in traditional lending, vigilance will be needed to ensure that higher risk-taking does not undermine the banks' resilience to shocks. Directors believed that the planned introduction of a deposit insurance scheme, and a consumer credit reference agency will further strengthen the banking system. They encouraged the authorities to enhance coordination among regulators of the banking, insurance, and securities industries.

Directors observed that, to enhance its competitiveness as an international financial center, Hong Kong SAR is actively upgrading its financial sector infrastructure and legal environment. They commended the recent enactment of the Securities and Futures Ordinance and the plan to introduce legislation to provide statutory powers for the oversight of important payment and settlement systems. Directors also welcomed the recent initiatives to upgrade the regulatory framework in the area of corporate governance and to enhance accounting and auditing standards. They recommended prompt approval of the proposed reforms to the equity market regulatory system, which would help clarify regulatory roles and strengthen enforcement. Directors commended the authorities for having largely put in place a framework for Anti-Money Laundering and Combating Financing of Terrorism that is in accordance with the Financial Action Task Force (FATF) recommendations.

Directors observed that structural changes have contributed to rising unemployment and income disparities. They supported the authorities' efforts to address these issues by augmenting labor skills —through education and retraining programs —and by providing well-targeted social support to the needy. Directors agreed, moreover, that some restructuring of the Comprehensive Social Security Assistance program might be needed to reduce disincentives to work that may have contributed to rising long-term unemployment.

Directors welcomed recent policy changes that would reduce direct government intervention in the housing and land markets. They also noted the authorities' commitment to the sector-specific approach to competition policy and, in the absence of a comprehensive competition law, urged continued vigilance to competition issues in non-regulated sectors.

Directors commended Hong Kong SAR's compliance with the Fund's Special Data Dissemination Standards and the publication of data on the international investment position and the gross external debt since June 2002, and of production-based quarterly real GDP estimates since August 2002. They looked forward to the presentation of accrual-based fiscal data for Hong Kong SAR in accordance with the Government Finance Statistics manual in November 2003.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with People's Republic of China – Hong Kong Special Administrative Region is also available.

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

	1998	1999	2000	2001	2002	2003
Real GDP (percent change)	-5.0	3.4	10.2	0.6	2.3	2.2
Real domestic demand (contribution)	-9.8	-4.7	9.5	0.8	-1.3	1.0
Foreign balance (contribution)	4.9	8.1	0.6	-0.2	3.6	1.2
Saving and investment (percent of GDP)						
Gross national saving	31.8	32.8	33.6	33.8	34.9	36.0
Gross domestic investment	29.2	25.3	28.1	26.5	24.2	24.3
Inflation (percent change)						
Consumer prices	2.8	-4.0	-3.8	-1.6	-3.0	-2.0
GDP deflator	0.2	-5.9	-6.2	-1.4	-2.8	-0.1
Employment (percent change)	-1.3	-0.3	3.1	1.3	-0.5	1.2
Unemployment rate (percent)	4.7	6.2	5.0	5.1	7.3	7.4
Real wages	0.1	3.8	3.6	3.4	1.3	...
Government budget (percent of GDP) 1/						
Revenue	16.9	18.7	17.5	13.7	14.0	14.9
Expenditure	18.7	17.9	18.1	18.7	18.8	20.1
Consolidated budget balance	-1.8	0.8	-0.6	-5.0	-4.9	-5.2
Reserves at March 31	33.9	35.7	32.9	29.1	24.5	18.7
Money and credit (percent change, end-period)						
Narrow money (M1)	-5.0	13.9	8.3	5.8	14.6	...
Broad money (M3)	10.3	8.4	7.5	-2.7	-0.9	...
Loans for use in Hong Kong SAR 2/	-3.8	-7.2	2.3	-3.8	-2.6	...
Interest rates (percent, end-period)						
Best lending rate	9.0	8.5	9.5	5.1	5.0	...
Three-month HIBOR	5.1	5.7	5.8	1.9	1.4	...
Merchandise trade (percent change)						
Export volume	-4.3	3.7	17.1	-3.3	8.6	6.1
Domestic exports	-7.9	-7.2	7.6	-10.2	-11.2	-6.0
Reexports	-3.7	5.4	18.5	-2.4	11.0	7.3
Import volume	-7.1	0.2	18.1	-2.0	7.8	6.0

Export value	-7.4	0.1	16.6	-5.8	5.4	14.7
Import value	-11.4	-2.5	19.2	-5.3	3.4	14.4
External balances (in billions of US$)						
Merchandise trade balance	-7.8	-3.2	-8.2	-8.3	-5.1	-5.1
In percent of GDP	-4.7	-2.0	-5.0	-5.1	-3.1	-3.1
Current account balance	4.4	12.0	9.1	12.3	17.5	19.3
In percent of GDP	2.7	7.5	5.5	7.5	10.7	11.6
Foreign exchange reserves 2/						
Foreign exchange reserves (in billions of U.S. dollars, end of period)	89.6	96.3	107.6	111.2	111.9	104.0
(In months of retained imports)	17.1	19.8	18.0	20.4	21.9	20.3

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

1/ Fiscal year.

2/ Figures exclude trade financing.