



People's Republic of China—Hong Kong Special Administrative Region Preliminary Conclusions of the 2010 Article IV Mission

October 26, 2010

A resurgent economy...

1. Thanks in large part to prompt policy action as the global financial crisis unfolded, the Hong Kong economy is now back onto a robust growth trajectory with the key sources of demand firing on all cylinders. Net exports have been buoyed by vigorous growth in the Mainland and the ongoing global recovery. Investment has benefited from the implementation of various multi-year public infrastructure projects and private investment in machinery and equipment has picked up. At the same time, consumption bounced back as labor market conditions improved and confidence returned. Growth is likely to reach 6¾ percent this year and moderate to 5-5½ percent in 2011.

...brings a new set of challenges.

2. Hong Kong SAR now faces a very different set of challenges from those of the past two years. As the output gap closes, inflationary pressures are likely to rise in both factor and product markets. At the same time, strong domestic growth prospects and abundant global liquidity have the potential to attract further capital inflows. Finally, accommodative monetary conditions imported from abroad—combined with tight domestic supply conditions for new housing units—are already fueling property price inflation.

Imported monetary conditions are highly expansionary...

3. As a result of the monetary expansion in the United States, the Hong Kong dollar monetary base has tripled over the past two years and there is abundant liquidity in the financial system. Interbank rates remain close to zero and real interest rates are negative and falling. Meanwhile, the Hong Kong dollar has depreciated by 4 percent in nominal effective terms since mid-year, adding to the expansionary conditions.

...which is now translating into faster credit growth...

4. With Hong Kong's economic recovery more entrenched, the monetary transmission mechanism has reactivated and the extraordinary levels of liquidity residing in the domestic banking system are now beginning to translate into a brisk expansion of new credit. Lending has picked up, albeit from a low base, and is now 18 percent higher than the levels reached a year ago. Loan-to-deposit ratios remain low, at less than 80 percent, but forward looking loan officer surveys point to a further expansion of lending in the coming months. Around one-half of the growth in credit for use in Hong Kong has been directed to the property sector. In addition, supply conditions for new housing are unusually tight.

...increasing the prospects for a bubble in the housing market.

5. This combination of factors has manifested itself as strong price growth for housing over the past 18 months. Initially this property price inflation was concentrated in the luxury segment of the market but has now filtered down to the mass market. Prices in the more expensive segments of the market are already around 10 percent above the levels reached in 1997 while, for the mass market, prices are fast approaching their historical peaks. Despite this, low interest rates and the strong growth in household incomes over the past decade have meant that housing still remains more affordable today than it was in the late 1990s.

The upward pressure on property prices will continue...

6. The outlook is for a continuation, and perhaps acceleration, of the credit-asset price cycle. Supply conditions are relatively tight, liquidity is abundant, and there is strong demand from both Mainland residents and financial sector professionals. As housing prices rise, more collateral will be available to support greater borrowing to finance housing purchases, amplifying the cycle through a financial accelerator process. Higher property prices will lead to higher rents and the ongoing asset price inflation will feed into higher consumer prices. With tightening labor markets, a closing of the output gap, and a higher cost of living it is only natural that nominal wages should rise, adding a second-round impact to inflation. These price pressures will become increasingly visible in the coming months with inflation expected to reach around 5 percent by end-2011.

...but, eventually, the equilibrating forces of the Hong Kong economy will pull prices back down to earth.

7. It is the mission's judgment that the current level of the Hong Kong dollar is broadly in line with economic fundamentals. Therefore, absent a coincident weakening in the U.S. dollar, an acceleration of inflation and labor costs would lead to an appreciation of the real exchange rate, potentially pushing it above its equilibrium level. If such a dynamic were to unfold, past experience would suggest that the economy will eventually unwind such an overshooting of the real exchange rate through broad-based deflation in goods, labor, and asset markets. Predicting the timing of such a reversal is difficult, but a move to a tightening bias in the United States or a slowdown in China could provide a potential catalyst. Depending on the amplitude of the upswing, the resulting downturn could prove both protracted and painful.

The authorities should continue to deploy the full range of tools that are at their disposal.

8. The government's graduated response to property price inflation, including the deployment of tighter prudential requirements to safeguard financial stability, is essential and should continue. Consideration could be given to further lowering loan-to-value ratios for a wider share of the property market and proactively tightening further the limits on debt service ratios. Regulators should also continue to ensure that underwriting standards are rigorously complied with. This would be greatly facilitated by expanding the credit reference agency's current information base to include data on all individuals' residential mortgage loans. The recent announcement to discontinue offering Hong Kong residency to those making large investments in real estate was appropriate and the government is also right to seek ways

to supply more land to ensure the healthy and stable development of the property market. Should high levels of property price inflation continue, the government could consider further raising the stamp duties on housing and increasing the level of the rates for higher-end properties.

While taking steps to mitigate the social pressures created by less affordable housing.

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

Despite these efforts, macroeconomic volatility will likely be unavoidable.

10. Macroprudential tools will help to slow the financial accelerator process but, given the scale of the underlying forces at work—including the strong economic recovery, an improving labor market, and very loose monetary conditions—they will, at best, only be able to mitigate the amplitude of the current upswing.

However, the monetary and financial system is well-placed to handle the coming cycle...

11. It will be essential, therefore, to guarantee financial stability in the event the cycle shifts into reverse. In this regard, Hong Kong remains in a strong position. The financial system has been prudently managed and is well supervised and regulated. As a result, Hong Kong banks have significant buffers—capital levels are well in excess of regulatory requirements, average loan-to-deposit ratios are low, and liquidity ratios are very high. Banks have generally robust internal risk management systems and recent regulatory measures will help insulate the financial system from the effects of a housing downturn. At the same time, the Linked Exchange Rate System has shown itself to be a robust anchor of monetary and financial stability, even in very difficult circumstances, and merits continued support.

... and fiscal policy can help provide an offsetting, countercyclical force.

12. Given the positive prospects for growth, fiscal policy has a role to play in dampening the amplitude of the coming cycle. Over the past two years fiscal policy has rightly provided support to the economy as the global crisis unfolded. However, those temporary support measures—including rent waivers for public housing tenants, supplemental social assistance and old age allowances, the one-off reduction in the salaries taxes, and waivers of rates and business registration fees—should be discontinued in the 2011 Budget. The expansion of infrastructure spending should, however, continue as planned given that these multi-year projects are an integral part of Hong Kong's strategy to increase its integration with the Mainland. Nonetheless, the overall fiscal position should move to adopt a countercyclical policy stance.

It will be important to preserve the flexibility of the Hong Kong economy,...

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

... continue to facilitate greater integration with the Mainland,...

14. Hong Kong SAR's unique position as an international financial center with strong links to Mainland China provides significant potential for growth and development. Maximizing those benefits will require continued collaboration with the Mainland authorities to facilitate greater real and financial sector integration. Capitalizing on Hong Kong's pillar industries and developing the six new industries propose by the Taskforce on Economic Challenges will be crucial. This will be greatly aided by the ongoing improvements being made to transportation linkages with the Mainland.

...and further build offshore renminbi markets

15. Over the past year, important steps have been made to expand the use of the renminbi in offshore markets. These efforts should steadily increase the attractiveness of the renminbi as a settlement currency and as a denominator for financial products available in Hong Kong SAR. Opportunities should be sought, in cooperation with the Mainland authorities, to continue to expand the avenues for offshore renminbi use. These efforts should focus on two broad areas. First, on increasing the use of the renminbi as a settlement currency for trade and current account transactions. Second, in order to increase the attractiveness of using the renminbi as a means of payment, expanding the range of investment vehicles into which offshore renminbi can be invested. This implies both increasing the scope and availability of renminbi denominated instruments in Hong Kong itself but also working with the Mainland to expand the opportunities for offshore renminbi to be reintermediated back into the Mainland in the form of renminbi direct investment, renminbi loans, and portfolio investment to bond and equity markets.

In closing, the mission would like to express its sincere gratitude to the Hong Kong authorities for the consistently high quality of our discussions and for their generous hospitality.