

**People's Republic of China—Hong Kong Special Administrative Region: 2002
Article IV Consultation Discussions—Staff Report; and the Public Information Notice
on the Executive Board Discussion**

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 2002 Article IV consultation discussions with People's Republic of China—Hong Kong Special Administrative Region, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation discussions, prepared by a staff team of the IMF, following discussions that ended on **January 24, 2002**, with the officials of **People's Republic of China—Hong Kong Special Administrative Region** on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 25, 2002.** 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.
- the Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 1, 2002 discussion** of the staff report that concluded the 2001 Article IV consultation.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

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

Staff Report for the 2002 Article IV Consultation Discussions

Prepared by the Staff Representatives for the Consultation Discussions Held in 2002
In Respect of the Hong Kong Special Administrative Region¹

Approved by Wanda Tseng and Shigeo Kashiwagi

April 25, 2002

- The consultation discussions were held in the Hong Kong Special Administrative Region of the People's Republic of China during January 11–24, 2002. The staff team comprised M. Rodlauer (Head), D. Iakova, T. Wang, and C. Mendis, P. Schellekens (all APD), and W. Lee (Resident Representative). Mr. Wei, Mr. A. Wong, and Ms. Tong (OED) attended key meetings.
- The mission met with Financial Secretary Mr. Antony Leung, Chief Executive of the Hong Kong Monetary Authority Mr. Joseph Yam, Financial Services Secretary Mr. Stephen Ip, Treasury Secretary Ms. Denise Yue, and a wide range of other senior government officials, labor unions, and private sector representatives.
- In concluding the last Article IV consultation, Executive Directors reiterated their support for the linked exchange rate system; praised progress in enhancing the financial infrastructure; and commended the authorities for their pragmatic approach to fiscal policy which had aided the recovery. To take full advantage of opportunities created by China's WTO accession, Directors believed that Hong Kong SAR would need to strengthen efforts to upgrade the economy's infrastructure and human capital. Directors also noted that pressures on the budget might emerge as health and education spending increased, while revenue growth could slow if asset-related revenues lagged behind GDP growth, and welcomed the authorities' initiative to review these issues.
- The authorities have indicated their intention, as in the past, to publish the staff report.
- The principal authors of this report are Markus Rodlauer and William Lee.

¹The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

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SUMMARY

Key issues:

- **The Hong Kong economy is facing the twin challenges of successive cyclical shocks and structural changes from integration with the Mainland.** A brief recovery from the Asian crisis was aborted by the global slowdown in 2001. While the integration will benefit Hong Kong SAR in the near term, the challenge is to compete successfully in high-end trade, business and financial services as the economy's traditional entrepôt role will diminish.
- **A cyclical rise in the budget deficit has added to a structural weakening of the fiscal position.** The fiscal deficit has risen to over 5 percent of GDP mainly due to a cyclical drop in revenues and a small increase in social spending. More worrisome, the structural balance has worsened in recent years, mainly due to rising expenditures.

Policy Discussions:

- **The authorities' approach to dealing with the current difficulties is to maintain the rules-based and transparent policy framework, while taking some steps to cushion the impact of the downturn.** The staff broadly supported this approach.
- **The staff supported the current (mildly expansionary) fiscal stance, while stressing the need for a comprehensive medium-term fiscal adjustment program.** The authorities agreed, and soon after the mission published two reports by government commissions urging medium-term fiscal adjustment and measures to broaden the revenue base. The FY02 budget proposed in early March outlines medium-term targets toward fiscal balance by FY06.
- **The authorities remain fully committed to the linked exchange rate system.** The staff agreed with them that the link remained the best system for Hong Kong SAR, and that it required prudent fiscal management, flexible goods and factor markets, and a robust financial system.
- **The banking sector remains strong despite the recent slowdown.** Standard indicators suggest continued robust health of the sector, even if the current slowdown were to continue a while longer. The authorities have confirmed their participation in FSAP later this year.
- **The staff supported the authorities' plans for upgrading market infrastructure and human capital as key elements of Hong Kong SAR's long-term growth strategy.** In particular, better education and training is needed to increase productivity and meet the challenges of Mainland integration.

I. BACKGROUND

A. Recent Developments

1. **Over the last five years, the Hong Kong economy has suffered two rounds of external shocks, while also adjusting to growing integration with the Mainland of China.** The highly open economy was hit hard by the Asian crisis, and under the linked exchange rate system, the brunt of adjustment fell on domestic asset and factor markets. Aided by favorable external conditions, a recovery started in 1999, and GDP growth surged to 10½ percent in 2000 (Chart 1, Table 1). However, before adjustment was completed and sustained growth could take hold, the global slowdown in 2001 dealt another blow to the economy. The cyclical shocks have come on top of structural adjustments needs, including from integration with the Mainland, which together pose a challenging policy environment.

2. **Economic growth stalled and financial markets weakened in 2001:**

- **Real GDP growth dropped to almost zero, with a decline in the second half.** The downturn was led by exports, especially those produced in Hong Kong SAR (down by 11 percent in volume terms). Although domestic demand held up initially, it also fell in the course of the year, with a particularly sharp decline of inventories. The unemployment rate rose to 6.8 percent in February 2002, above the Asian crisis peak (Chart 2).
- **Deflation has continued now for over 3 years, bringing consumer prices to their early-1996 level (Chart 3).²** While domestic price flexibility is part of the adjustment process under the linked exchange rate system, the persistent deflation has raised concerns whether more long-term forces may be at work. Staff analysis suggests, however, that most of the deflation is attributable to cyclical factors (Box 1). In particular, the prolonged downward drift in property prices and rentals reflects a slow unwinding of the pre-1998 bubble as well as weak demand conditions.
- **Bank credit has declined further despite lower interest rates and ample liquidity.** Hong Kong interest rates have fallen in line with US interest rates. However, credit (especially property-related lending) has remained weak reflecting the uncertain business outlook and weak asset prices; also, real interest rates, although down, remain quite high reflecting deflation (Chart 4).

² The CPI fell by 2.9 percent (y/y) in January-February 2002, partly due to a one-off cut in the tax on the assessed rental value of properties (accounting for about 1 percentage point of the decline).

Box 1. Deflation: Cyclical or Structural?³

With deflation persisting for over three years, the question arises whether it reflects primarily cyclical factors or more long-term structural forces. The cyclical view posits that, given the linked exchange rate system, prices have had to decline in response to shocks so that competitiveness can be restored. The structural view sees deflation as a process of narrowing price differentials between Hong Kong SAR and the Mainland of China, as a result of growing economic integration.

The staff's analysis suggests that, although structural factors have played a role, deflation has been mainly the result of a process of adjustment to cyclical shocks. Econometric analysis attributes a major part of the inflationary/deflationary process in Hong Kong SAR to cyclical factors, and only a small part to a price equalization process with the neighboring region in the Mainland.

A price equation for Hong Kong SAR finds unemployment, nominal credit, and the nominal effective exchange rate as powerful determinants of inflation/deflation, while the gap between prices in Hong Kong SAR and neighboring Shenzhen has only small explanatory power. Variations in unemployment, nominal credit, and the nominal effective exchange rate contribute 36 percent, 14 percent and 5 percent, respectively, to the explanatory power of the inflation equation. In contrast, the price equalization process contributes only 2 percent. To the extent that there has been price equalization, most of it seems to have come through greater inflation in the Shenzhen region rather than deflation in Hong Kong SAR.

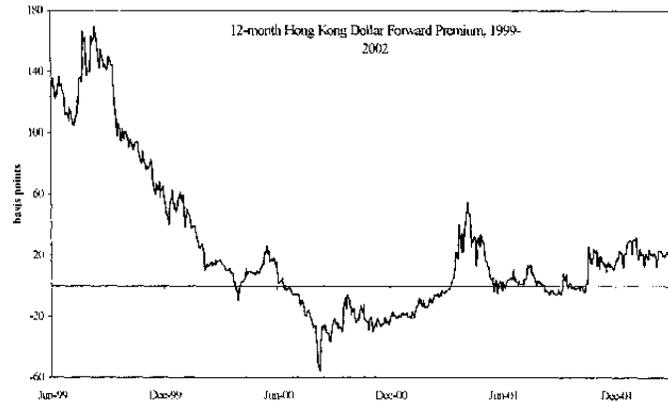
Despite this evidence, the persistence of deflation for more than three years raises the question of why adjustment has taken so long. The persistence of deflation can be explained by the importance of wealth and balance sheet effects in Hong Kong SAR, and the fact that the Hong Kong economy was hit by two subsequent shocks. In particular, the large wealth and balance sheet effects from the fall of property and equity prices (given the large share of household wealth in those assets) have fed back into demand and thus amplified and prolonged the deflationary shock.

Anecdotal evidence from the property market confirms the view that the deflation is mainly cyclical.⁴ Various factors seem to limit price equalization in the residential property market, including commuting time and transportation costs. To the extent that there is increased demand from Hong Kong residents for property in Shenzhen, a large part of it is for second homes (demand creation) rather than relocation (demand displacement). Likewise, the cost of commercial property reportedly plays only a minor role in the location decision of firms. Overall, therefore, the sustained fall in housing prices over the past four years appears to be mainly a prolonged retrenchment from the pre-1998 property price bubble, exacerbated by last year's renewed economic downturn.

³ The issue is explored in greater detail in a forthcoming Selected Issues Paper.

⁴ About half of the decline in the overall CPI since 1998 reflects a decline in the housing component.

- **Contagion from Argentina has been minimal, while equity prices have fallen in line with global markets.** Hong Kong dollar forward rates increased slightly in March-April 2001 and in the last three months, but the increase was much smaller than during previous periods of global market turbulence. The stock market dropped by 24 percent last year; with selling pressures intense after September 11, the authorities cut back scheduled equity disposals to limit market disruptions.⁵



3. **The budget deficit widened sharply in FY2001 (Chart 5).** Although a large part of the deterioration was cyclical (lower asset sales and investment income), there has also been a trend weakening in the structural budget position (Table 2). In addition, a set of measures to cushion the impact of the economic slowdown was announced in October 2001 (totaling about 1 percent of GDP, to be implemented over two years).

Fiscal Balance, Hong Kong SAR, 1997-2001
(in percent of GDP)

	FY1997	FY1998	FY1999	FY2000	FY2001
Overall Balance	6.6	-1.8	0.8	-0.6	-5.2
Structural Balance 1/	0.3	-2.9	-2.9	-4.4	-5.3
Fiscal Impulse	-0.5	3.3	0.0	1.5	0.8

1/ Excludes asset-related transactions, investment income, and cyclical fluctuations.

4. **Growing economic integration with the Mainland has raised structural unemployment and worsened income disparities.** The economy's transformation to a high value-added service-based economy has been accelerated by the growing integration with the Mainland. The resulting high demand for skilled labor has raised the wage premium for better-educated workers and contributed to widening income disparity (Box 2). The labor market imbalance has been exacerbated by immigration from the Mainland that has increased the supply of lower-skilled labor.

⁵ In August 1998, the government bought HK\$118 billion of stocks to stabilize markets against suspected manipulation by speculators. After subsequent increases in market value and sales through the independently managed Tracker Fund, there remain about HK\$37 billion (at end-2001 valuations) to be sold.

Box 2. Income Distribution

As the Hong Kong economy grew rapidly over two decades before the Asian crisis, income disparity in Hong Kong SAR increased and is now one of the highest in the world.⁶ Significant structural change that brought about sustained growth has also led to a sharp rise in income inequality. Looking ahead, the need to continually move up the value-added chain as the economy integrates further with the Mainland may lead to even higher inequality. This trend has increasingly become a concern for the public and policy makers in Hong Kong SAR. Staff analysis of these issues concluded that:

- *Despite rising inequality, rapid economic growth brought higher standards of living for the entire population - real wages rose significantly across the wage distribution.* Hong Kong SAR has highly flexible labor markets, which have allowed the economy to adjust well to the major structural changes of the last twenty years, and as a result of that process the return to advanced skills has increased. This is in contrast, for example, to developments in the United States, where rising income inequality in the 1980s and early 1990s had been accompanied by declining real wages in the lower deciles of the distribution.
- *The structural changes have favored the better-educated.* The premia to higher education are substantial and have increased over the period, despite a rapid increase in the average education level (suggesting that growing demand for skilled labor has outpaced the rise in supply). In addition, unemployment among the low-skilled has been rising much faster than among the skilled, especially in recent years.

The analysis suggests that the most effective policies to address rising income disparity, as well as to support growth, are those which increase the skill levels of the labor force. Hong Kong SAR has relatively low enrollment in post-secondary education compared to OECD and many of the Asian economies, despite the large premium that higher education commands. Government policies to promote higher the education levels and to improve the quality of education should help the economy to sustain growth and adjust to the challenges of integration with the Mainland. In recognition of the importance of this issue, the government has recently adopted a new program for education reform, as well as a number of measures to support education including building of new schools, provision of loans for higher education and for continuous education, and creation of retraining programs. Immigration policy is also being reviewed with a view to easing restrictions on inflow of qualified specialists from the Mainland.

⁶ As measured by standard indicators (see the Selected Issues Paper SM/02/117). These measures do not take into account implicit transfers to low-income households through the public housing program.

B. Outlook and Vulnerabilities

5. **The near-term outlook is for a moderate recovery, depending on a pick-up in external demand.** The staff projects that real GDP will grow by about 1½ percent in 2002, assuming a recovery in global growth. A pick-up in global activity will boost the Hong Kong economy through several channels: exports and re-exports (the latter depending on Mainland exports), tourism, and demand for financial services. Deflation is projected to continue through 2002, although it should moderate during the year as property prices are expected to bottom out and activity recovers.

6. **Standard vulnerability indicators remain robust (Box 3).** The current account surplus is sizable and external reserves exceed US\$100 billion, four times the monetary base. In addition, Hong Kong has no public debt, and fiscal reserves are nearly 30 percent of GDP (Table 3). Although, as a regional financial center, Hong Kong SAR may be exposed to contagion from global and regional financial market disturbances, local financial markets proved resilient after September 11 and during recent events in Argentina.

Box 3. Vulnerability Assessment

Hong Kong SAR's vulnerability to external crises remains small using standard methods of assessment.

- **Relevant standard external indicators are strong (Table 5).** Despite the slowdown in export growth, the current account surplus is large and reserves are high, covering the monetary base four times. Short term debt is low, and forward exchange rates indicate little pressure on the domestic currency.

- **Macro stress testing indicates that further external deterioration would affect Hong Kong SAR, but is very unlikely to cause serious balance of payments strains (Table 1.1).** In the baseline

Table 1.1: Hong Kong SAR - Real Growth Scenarios

	Baseline		Low growth
	2001	2002	2002
Assumptions			
US growth	1.1	2.0	0.5
World growth	2.5	2.8	2.0
Hong Kong SAR growth	0.1	1.5	0.6
Contribution			
Real domestic demand	0.2	1.4	0.7
Net Exports	-0.1	0.1	-0.1
Inflation (percent)	-1.6	-2.5	-3.0
Capital and Financial account (percent of GDP)	-6.8	-7.7	-9.7
Current Account (percent of GDP)	7.4	7.7	6.7
Gross official reserves (US\$ billion)	111.2	112.3	110.4

Source: CEIC Database, Fund Staff estimates

- **Hong Kong SAR has a sound and well-regulated financial system.** The banking system is well capitalized, with adequacy ratios significantly above Basel standards and healthy performance indicators (Table 5). The forthcoming FSAP will further analyze the performance and vulnerability of the financial sector, and suggest areas where vulnerability to shocks could be further reduced.

7. **The longer-term outlook depends on how Hong Kong SAR meets the challenges of Mainland integration (Box 4).** In the next few years, the Hong Kong economy will likely benefit from increased trade in goods and services after China's entry into WTO (Tables 4 and 5). For satisfactory growth in the long run, however, Hong Kong SAR will need to push ahead with the transformation into a center for high value-added financial and business services as the importance of entrepôt trade for the Mainland diminishes.

II. REPORT ON THE DISCUSSIONS

8. **Hong Kong SAR thus faces the twin challenge of a sharp cyclical downturn and structural changes as the economy integrates further with the Mainland.** Since the Hong Kong economy is highly open, focused on intermediating regional trade and capital flows, the role of counter cyclical demand management has been limited, with economic policy emphasizing prudent institutional arrangements and long-term capacity building. Against this background, the discussions focused on how best to cope with the sharp cyclical downturn under the rules-based policy framework embodied in the Basic Law and the linked exchange rate system, and on how to enhance Hong Kong SAR's long-term growth potential and meet the challenges arising from growing integration with the Mainland of China.

A. Fiscal Policy

9. **Near-term fiscal policy is set to remain mildly expansionary.** The authorities explained that most of the FY2001 increase in the budget deficit reflected a cyclical revenue shortfall which they had decided not to counteract, given the economic downturn and the large cushion of fiscal reserves. For FY2002, although the budget presented in March targets an overall deficit of 3.6 percent of GDP (down from 5.2 percent of GDP in FY2001), the improvement reflects mainly the planned privatization of the Mass Transit Railway postponed last year. The structural deficit, however, is projected to rise by 1.0 percent of GDP. A set of one-off reductions in various fees and charges and a significant increase in capital expenditure is partly offset by an assumed 4.75 percent cut in civil service pay (from October 2002) and increased revenues from tobacco and wine duty. The authorities explained that maintaining a mildly expansionary fiscal stance was appropriate in light of the weak demand conditions.

10. **The authorities recognized that structural pressures could threaten the long-term health of the public finances.** A government Task Force on the Review of Public Finances reported in February 2002 that a narrowing revenue base and medium-term spending pressures risked undermining the stability of Hong Kong SAR's long-term public finances (Box 5). Unless corrective measures were taken, persistent fiscal deficits would threaten eventually to exhaust fiscal reserves and force the government into a net debtor position. To ensure medium-term fiscal sustainability, the Task Force advised that priority should be given to controlling the growth of government expenditures, with measures to broaden the tax base to be taken as necessary and when the economic situation permits. A concurrent Advisory Committee on New Broad-Based Taxes concluded, in a report

Box 4. Integration with the Mainland of China: Opportunities and Challenges

Over the coming years, the Hong Kong economy will become increasingly integrated with the Mainland of China, which itself is opening up its economy further following WTO accession.

For Hong Kong SAR, this process will bring major opportunities...

- *Increased trade between the Mainland and the rest of the world will benefit Hong Kong SAR, which now handles about 40 percent of the Mainland's trade.* Mainland's external trade is projected to increase by 80 percent over the next five years.
- *Increased financing needs of the Mainland should help boost Hong Kong SAR's financial sector.* Trade financing, equity listing and corporate bond issuance by Mainland enterprises will increase as will public bond issuance to finance reforms and infrastructure as well as FDI flows. Part of these flows should continue to be channeled through Hong Kong.
- *The opening of China's services market should offer Hong Kong companies a larger market and deepen integration with the Mainland beyond the traditional trade links.* As a services-dominated economy, Hong Kong SAR has a comparative advantage especially in areas such as trade and trade financing, banking, and distribution, which are underdeveloped in the Mainland.

...and challenges:

- *Hong Kong SAR's role as a traditional "middleman" will diminish.* As China's port infrastructure improves, restrictions on trade are lifted, and more foreign businesses operate directly in the Mainland, Hong Kong's entrepôt role will decline.
- *Hong Kong companies will face increased competition from both foreign and Mainland companies.* As the Mainland opens up further, Hong Kong companies will face increased competition from foreign companies who are larger and financially stronger (especially in the financial sector), and from Mainland companies that are gaining efficiency and international experience.
- *Hong Kong SAR will have to sharpen the focus on higher value-added sectors.* As more manufacturing and services activities shift to the Mainland, Hong Kong will need to move from a trade-dominated economy to a regional center for business, trade, and financial services.
- *Hong Kong SAR could suffer from higher structural unemployment and shortage of skilled labor.* The authorities estimate that by 2005, Hong Kong will have a shortage of some 120,000 people with higher education and a surplus of 160,000 with only secondary school education or less.
- *There could be increased pressure on the medium-term fiscal position.* Labor market mismatch, education system upgrades, and infrastructure development will put pressure on spending while the revenue base might erode as businesses shift activities to the Mainland.

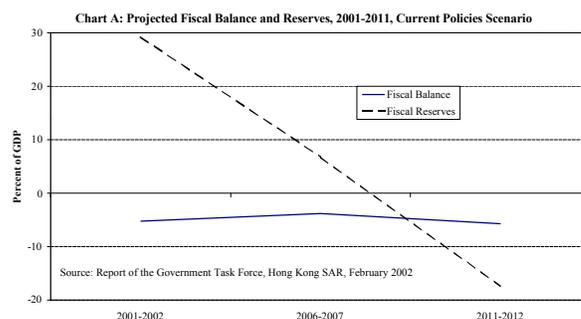
Over the next few years, the benefits are expected to outweigh costs as trade creation dominates trade diversion. The long-term outcome will depend on implementation of appropriate policies to meet the challenges of integration.

Box 5. Medium-Term Fiscal Outlook

While recent budget deficits are partly cyclical, there has also been a structural deterioration in the fiscal position. A government Task Force on the Review of Public Finances has found rising structural deficits in recent years that will continue in the future unless corrective measures are taken:

- Revenues from *land sales and taxes* will remain much lower than during the asset bubble of the mid-1900s. Lower property prices and active competition have also eroded *profit tax revenue*.
- *Investment income* from fiscal reserves has fallen as a share of revenues, and would fall further if fiscal deficits persist.
- *Direct tax revenue* may decline as Hong Kong SAR businesses increase investments abroad, as only Hong Kong SAR-based profits and salaries are subject to tax.
- *The government expenditure deflator has tended to rise faster than the general price level*, raising the expenditure/GDP ratio even if real spending growth has not exceeded real GDP growth.
- *Demographic trends* will put pressure on health and social security expenditures.

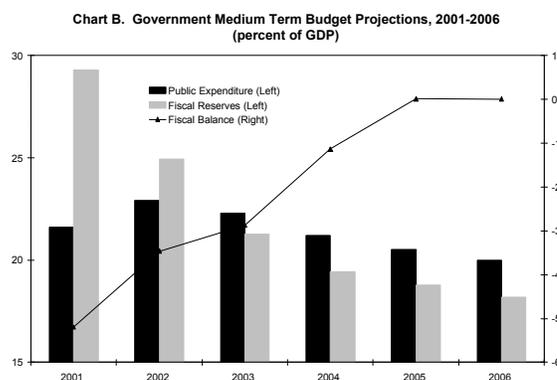
Without measures, continued sizable deficits are projected into the future (Chart A). Assuming unchanged revenue and expenditure policies and a return to a trend growth of about 3-3.5 percent, fiscal deficits of 4-5 percent of GDP are projected in the medium term. This would exhaust fiscal reserves by 2008/09, followed by a rising debt burden.



The FY2002 budget proposed in March outlines the government's strategy for returning to a balanced budget over the next four years (Chart B). It envisages to eliminate the overall budget deficit as well as that on current operations; reduce the public expenditure/GDP ratio to 20 percent or lower; and stabilize fiscal reserves at the level of one year's expenditures.

To achieve these goals, measures averaging about 1 1/2 percent of GDP per annum will be required. The government's medium-term plan emphasizes expenditure restraint, limiting real spending growth to 1.5 percent per year starting in FY2003.

The authorities intend to review the entire public administration for possible cost savings (with an up-front 4.75 percent cut of civil service pay assumed in late 2002). On revenues, an Advisory Committee on New Broad-Based Taxes has concluded that a low-rated broad-based goods and services tax (GST) is the best choice for broadening the tax base, with higher taxes on the assessed rental value of properties, lower personal income tax deductions, and a land and sea departure tax cited as additional options (albeit with significantly smaller yields than GST). The government proposed to introduce a land departure tax in FY2003 and explained that it would consider the other options carefully, for implementation if necessary.



published in early March, that a low-rate broad-based goods and services tax (GST) would be the best option to broaden the tax base. The staff noted that while the strong fiscal track record provided a cushion to absorb temporary deficits, a comprehensive medium-term deficit reduction plan was needed to address the underlying structural fiscal problem.

1. **The FY 2002 budget spells out the government's commitment to balance the budget over the next four years.** This is to be achieved by reducing, from FY2003 onward, the growth of public expenditure and modestly raising revenue, with a view to stabilizing fiscal reserves at around one-year's expenditures level (from 1.3 times expenditures currently—Table 2). While this plan does not contain further specific measures (beyond the FY2002 budget) in support of those goals, the authorities emphasized their commitment to taking the necessary steps, including a comprehensive review of the public administration for possible cost savings and careful consideration of all the options proposed by the Advisory Committee on broadening the tax base. The staff agreed with the authorities that the current cyclical juncture was not propitious for introducing a GST, but stressed that because of the substantial lead time required, preparations for it should start as soon as possible.

A. Exchange Rate Policy

2. **The authorities remain firmly committed to the linked exchange rate system, which has served Hong Kong SAR well.** They noted that the record of strong fundamentals, including prudent fiscal management and large reserves, flexible markets, and a strong financial system had enabled the economy to adjust well to shocks under the link. In turn, they agreed with the staff that keeping those conditions in place was critical to the continued smooth operation of the link in the future. The authorities also observed that the link underpinned confidence in Hong Kong SAR as a stable financial center, and provided a transparent anchor for economic decision-making and market expectations.

3. **The linked exchange rate system is likely to remain the best option for Hong Kong SAR, even with growing integration with the Mainland.** The authorities explained that the conditions in favor of a link with the U.S. dollar were likely to remain, including the high correlation of cyclical movements between the two economies (given the importance of entrepôt trade with the United States); the different stages of development of the Hong Kong SAR and Mainland economies; and the role of the link as an anchor of expectations, economic policy decisions, and confidence in Hong Kong SAR as a regional financial center. The authorities considered that, based on fundamental economic linkages, a wider renminbi trading band should not have adverse effects on the Hong Kong dollar, given the negligible amount of trade competition with the Mainland and the limited impact of exchange rate differentials on Hong Kong SAR's major export to the Mainland—financial services. They noted that while a wider trading band for the renminbi might attract more speculative proxy trading of the Hong Kong dollar, the correlation between the Hong Kong dollar forward rates and the renminbi non-deliverable futures rates had become substantially decoupled in recent years.

C. Structural Policies

14. **How best to enhance Hong Kong SAR's long-term growth potential and meet the challenges arising from growing integration with the Mainland was the overarching theme of the structural policy discussions (see Box 4).** Economic activity in Hong Kong SAR will have to shift increasingly to higher-value added sectors, as low-value added services will migrate to the Mainland. This transformation, and the trade creation from further liberalization in the Mainland, offer major opportunities for the Hong Kong economy, but also challenges that will continually test the flexibility of the economy and policies.

15. **FINANCIAL SECTOR.** **The financial condition of the banking sector remains strong, despite the Asian crisis and the recent slowdown.** The authorities explained that prudent lending practices, effective supervision, and strong legal institutions remained the systemic pillars of sound banking.⁷ In addition, lower

interest rates had contributed to containing nonperforming loans (NPLs) in the recent downturn. Nonetheless, they noted that classified loans might increase somewhat in the coming months if economic conditions—especially unemployment—deteriorated, although they were confident that no bank was at risk of breaching minimum capital adequacy standards. The staff observed that an increasingly competitive banking environment was spurring a search for new products, increased efficiencies, and consolidation. While this was helpful and necessary to sustain industry profitability, the authorities agreed with the staff that increased vigilance was warranted to ensure that the new activities and products offered by banks did not overtax their risk management capabilities. The planned establishment of full-fledged credit reference agencies for consumer and small and medium-sized enterprises should improve banks' capacity for risk-based lending. The staff also welcomed the authorities' plans to introduce a deposit insurance scheme, with features designed to minimize moral hazard (such as a differential premium system). On the experience with fully liberalized interest rates (the last ceiling, on savings deposit rates, was lifted in July 2001), the authorities explained that because of the ample liquidity conditions (with interest rates below the previous ceilings) the move did not have an immediate impact, although over time greater competition for deposits would likely erode interest margins somewhat.

	Bank Indicators (For all authorized institutions, in percent)					
	Hong Kong SAR				U.S.	EU-11
	1997	1999	2000	2001	2001	2001
Return on assets 1/	1.6	1.2	1.4	1.1	1.1	3.0
Capital adequacy ratio 2/	17.5	18.7	17.8	16.6	12.1	11.4
Non-performing loans (domestic) 1/	2.1	9.8	7.2	6.4	2.6	6.5
Property loans (percent of domestic) 1/	44.3	49.4	49.2	50.7	...	...
Loan/value ratio (new mortgage)	...	57.6	59.6	66.4	...	...
Equity financing loans (percent of loans)	3.0	0.9	0.9	0.8	...	...
Claims on the Mainland (percent of assets)	4.9	3.6	3.3	3.2	...	...

Sources: HKMA, U.S. Federal Reserve.

1/ For 2001, figures refer to a new banking measure instead of all locally incorporated banks.

2/ For all locally incorporated authorized institutions.

⁷ For analysis of how the Hong Kong banks weathered the Asian crisis, see SM/01/23 (1/26/01), Chapter II.

16. **Continued efforts are being made to improve Hong Kong SAR's financial regulations and market oversight.** The recently enacted Securities and Futures Ordinance (SFO) consolidates and modernizes existing legislation, with a view to enhancing competition, transparency, investor protection, and regulatory oversight. Newly established cross-market supervisory arrangements⁸ have improved coordination of monitoring efforts, including of cross-market risks that often escape the reach of individual agencies. Increasing attention globally to corporate governance standards has also prompted the Hong Kong authorities to review company practices, with input from a wide process of consultation including market participants. The staff welcomed these efforts, noting that the effectiveness of market oversight depended both on a strong framework of laws and regulations and active enforcement of those rules (for example, in the area of de-listing from the stock market). The staff welcomed the authorities' agreement for Hong Kong SAR to participate in the Financial Sector Assessment Program (FSAP), which will provide a useful peer review and in depth assessment of codes and standards, regulatory practices, and financial sector vulnerabilities.⁹

17. **Hong Kong SAR is also upgrading further its financial infrastructure, and has strengthened its anti-money laundering capacity.** In addition to the interbank U.S. dollar clearing system, the authorities are now exploring the possibility to implement euro and yen clearing systems, which will also be integrated with the debt securities clearing system. The authorities explained that these improvements would provide investors with state-of-the-art risk management, clearing, and settlement systems, as part of their efforts to enhance Hong Kong SAR's attraction as a regional financial center. Hong Kong SAR is also taking a leading role in coordinating the global effort against money laundering and terrorist financing. Basic anti-drug trafficking and anti-money laundering (AML) legislation, in place since the early 1990s, has been supplemented by regulations and guidelines for their application to financial institutions, and AML rules were extended to money changers and remittance agents in June 2000. Hong Kong SAR is in the course of introducing legislation to implement the relevant requirements under the UNSCR 1373 relating to countering terrorist financing. These issues also will be examined in more detail in the upcoming FSAP.

18. **LABOR MARKET AND INCOME DISTRIBUTION. Structural change, accelerated by integration with the Mainland, has contributed to labor market pressures and rising income disparities.** While a large part of the recent increase in unemployment is cyclical, a growing mismatch of skills in the labor force has raised structural unemployment (Chart 12) and income disparities (Box 2). The premium for high-skilled labor has risen as the economy has been drawn to higher-value added activities, while unemployment among low-skilled workers has increased, exacerbated by the economic slowdown.

⁸ The high-level Financial Stability Committee meets monthly to monitor developments and potential risks in the banking, securities, and insurance markets. In addition, a Risk Management Committee monitors cross-market risks at the operational level.

⁹ The results of the FSAP will be incorporated into the next Article IV consultation.

19. **The authorities' approach to dealing with these issues focuses on upgrading workforce skills and providing well-targeted social support.** The staff observed that considerable scope existed to improve educational services (as indicated, for example, by low post-secondary enrollment compared with most OECD countries). The authorities agreed that improving the quality of education as well as promoting lifelong learning were priorities, while also noting that greater cost sharing by the private sector—with safeguards for the needy—was appropriate. In addition, they are reviewing immigration policy, partly with a view to attracting more high-skilled talent to Hong Kong SAR than under current policies. On social support, the authorities explained that the most vulnerable were eligible for social assistance, on which outlays had been rising significantly in recent years; they also pointed to the substantial assistance in the form of public housing¹⁰ and heavily subsidized health care and education.

20. **HOUSING. The authorities have initiated a comprehensive review of housing policies, with a view to moving toward better targeted and more efficient subsidy schemes.** A growing overlap between Home Ownership Scheme (HOS) flats (government-constructed flats sold to qualified buyers at a large discount from market prices) and private (unsubsidized) flats had exacerbated the distortions in the housing market. In September 2001, the government announced a ten-month moratorium on the sale of HOS flats and initiated a broad review of the entire HOS program. The intention was to gradually reduce the scale of the government's intervention in the housing area, with greater emphasis on targeted loan subsidies for buyers of privately constructed flats. The authorities are also piloting a program of rental subsidies in lieu of low-cost government-provided rental flats.

21. **While the authorities remain committed to their sector-specific approach to competition policy, they have stepped up efforts to combat anti-competitive behavior.** A number of measures have been taken to strengthen competition in key regulated sectors such as telecommunications, broadcasting, and transport. The authorities are also keeping a close watch on possible anti-competitive behaviors, with a view particularly to ensuring fair competition in the non-regulated sectors and introducing sector-specific measures to promote competition if necessary. The staff recommended continued close attention to competition issues in unregulated sectors, especially in the absence of a general competition law.

D. Statistical Issues

22. **Hong Kong SAR provides statistics to the Fund on a timely basis for surveillance and publication in IFS, and has subscribed to the SDDS.** The authorities noted their plan to start publishing data on external debt and the international investment position in mid-2002, and production-based quarterly real GDP estimates in the second half of 2002. They also intend to report *Government Finance Statistics (GFS)* data from 2003, following adoption of accrual accounting standards. The staff welcomed these developments, and suggested that efforts be made to report bank assets and liabilities by residency (Annex II).

¹⁰ About half of the population lives in government-provided or subsidized accommodation.

III. STAFF APPRAISAL

23. **After a difficult period of adjustment, the economy is set to recover moderately this year.** Successive downturns from the Asian crisis and the recent global slowdown have hit hard the highly-open economy, and came on top of the structural adjustment needs from growing integration with the Mainland. Even so, confidence in the economy has remained strong, the financial system sound, and the external position robust. Led by exports, economic activity is projected to pick up from the second half of 2002. Although there are risks to this outlook, these have become more evenly balanced in recent months as prospects for global recovery have improved.

24. **The authorities' approach to dealing with the twin challenges of a sharp cyclical downturn and Mainland integration is appropriate.** It centers on maintaining the rules-based and transparent economic policy framework that has served the economy well over the past two decades; focusing near-term policies on facilitating the adjustment process and helping those most affected; and continuing reforms to bolster competitiveness. The record of prudent economic management, with the institutional disposition to fiscal discipline and market-orientation embodied in the Basic Law, gives comfort that these challenges will, once again, be met.

25. **While this year's widening of the fiscal deficit was mainly cyclical, recent years have seen a structural deterioration in the budget that needs remedy.** While the staff sees no case for a sharp fiscal correction in the midst of the cyclical downturn, the recent drift into a sizable structural deficit needs to be reversed to ensure healthy public finances in the longer run (when additional pressures from structural change and demographic trends will come to bear). The staff commends the authorities' proactive and transparent approach to these issues, and supports the conclusions of the two government commissions set up to review them. The FY2002 budget outlines commendable goals for restoring budget balance over the medium term; it will now be important to support these goals with measures to reverse the rising trend of expenditure as a share of GDP and to strengthen the revenue base. The staff supports the initiative to review all public expenditures, including to contain the cost of education and health services—with safeguards for the needy—and the civil service. Strengthening the revenue base should include introduction of a low-rated, broad-based consumption tax. Since implementation will take time, preparations for these measures should start without delay.

26. **As in the past, the staff supports Hong Kong SAR's commitment to the linked exchange rate system.** The economy has adjusted well to shocks under the link, which has been a centerpiece of the rules-based policy framework. Its stability has also played a critical role in boosting confidence in Hong Kong SAR as a financial center. Underpinning the smooth functioning of the link have been prudent fiscal policy, flexible goods and factor markets, a robust financial system, and large foreign reserves, factors that will continue to play a key role in supporting the link in the future.

27. **The banking sector remains well capitalized, notwithstanding the Asian crisis and the recent downturn.** An increasingly competitive banking environment is spurring a

search for new products, efficiencies and consolidation. While this is desirable, vigilance is needed to ensure that the new activities and products offered by banks do not overtax their risk management capabilities. The staff supports the plan to introduce a deposit insurance scheme, with appropriate features to minimize moral hazard, and recommends establishment of full-fledged credit reference agencies covering both commercial and individual borrowers.

28. Continued progress in upgrading financial infrastructure and regulation will enhance Hong Kong SAR's role as a financial center. The staff welcomes the enactment of the Securities and Futures Ordinance, which will consolidate and modernize existing legislation, increase transparency, and improve investor protection. Looking ahead, growing competition from global financial markets as well as those emerging on the Mainland will require continuous upgrading of the regulatory framework and its enforcement. The staff also commends the authorities' efforts to strengthen the financial infrastructure to provide investors with the most secure and efficient operating environment. The staff welcomes Hong Kong SAR's agreement to participate in the Financial Sector Assessment Program.

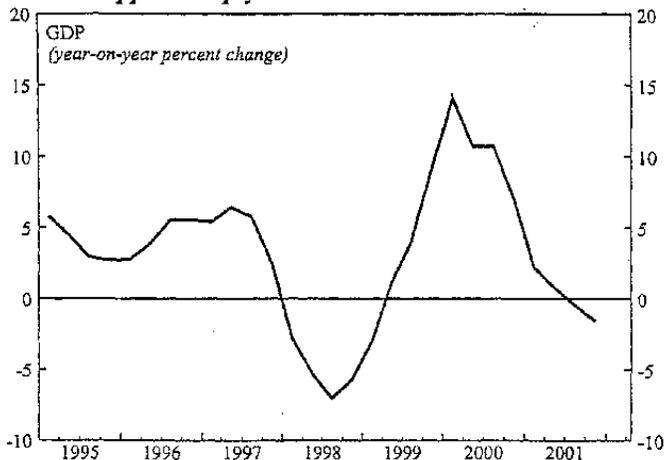
29. Economic integration with the Mainland offers many benefits for Hong Kong SAR, but also implies significant restructuring. To remain a center of trade-related and financial services, Hong Kong SAR will need to continue upgrading its infrastructure, human capital, and business environment. Structural change has also contributed to pressures in the labor market and rising income disparities. The staff supports the government's approach to addressing these issues by improving the skills of the workforce through better education and training, and by providing well-targeted social support to the needy. The staff commends the authorities' efforts to promote competition and lower costs in regulated sectors, and urges continued close attention to domestic competition issues especially in unregulated sectors, given the absence of a comprehensive competition law. The staff also welcomes the ongoing review of housing policies and encourages a move toward better targeted and more efficient subsidy schemes.

30. Hong Kong SAR disseminates a comprehensive set of reliable economic statistics. The staff welcomes its full compliance with the Special Data Dissemination Standard, as well as the plan to publish data on external debt and the international investment position from mid-2002. The staff also looks forward to the presentation of Hong Kong fiscal data in the standardized GFS format. One area where statistics can be improved further is the reporting of assets and liabilities by residency in the banking survey.

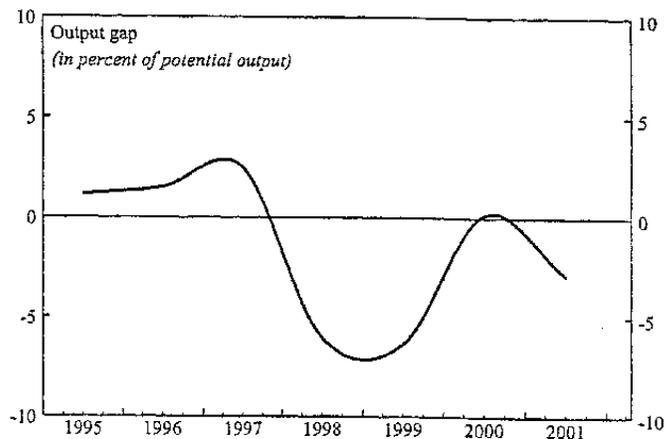
31. It is recommended that the next Article IV consultation with the People's Republic of China in respect of Hong Kong SAR take place on a 12-month cycle.

Chart 1: Hong Kong SAR
OUTPUT AND DEMAND, 1995-2002

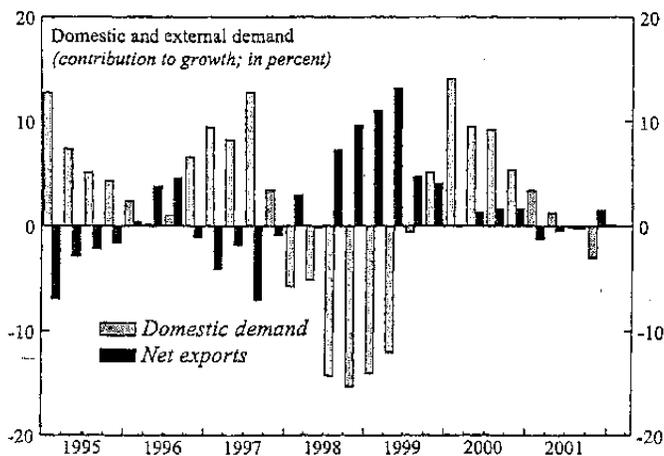
After a strong recovery in 2000, real GDP growth has dropped sharply...



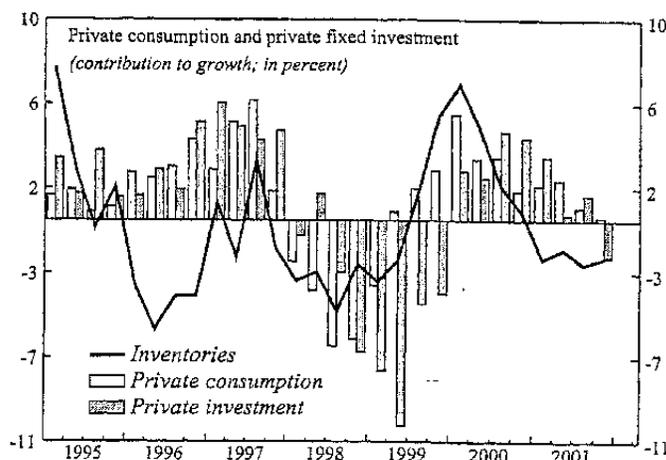
...and the output gap has widened again.



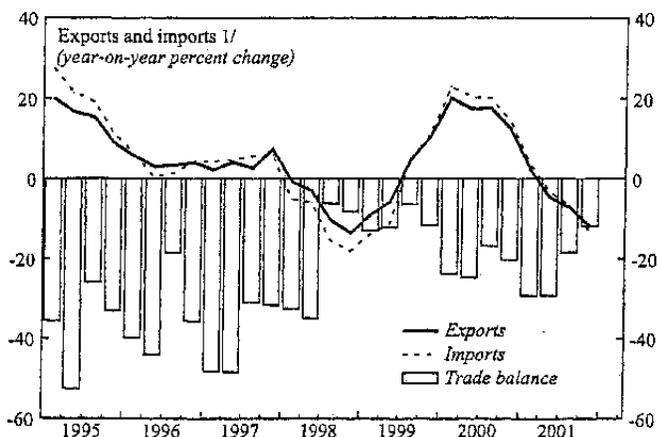
Both external and domestic demand have weakened...



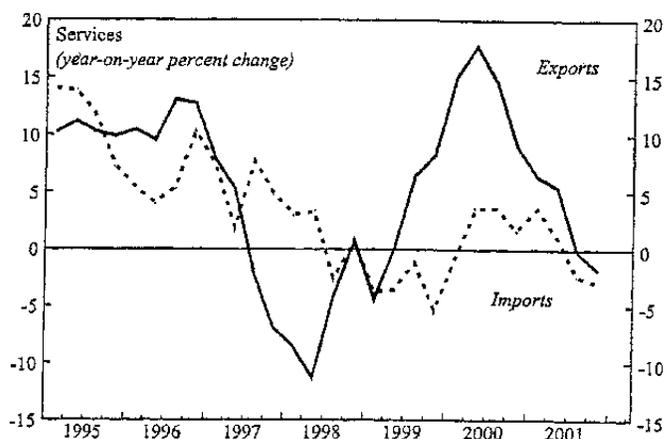
...with inventories and investment falling most sharply.



Exports and imports of goods have fallen sharply...



...and services trade growth has also slowed.

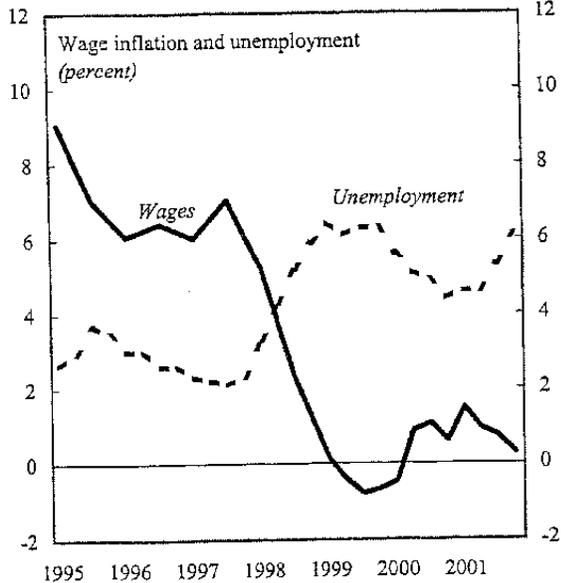


Sources: Data provided by the Hong Kong authorities; and Fund staff estimates.

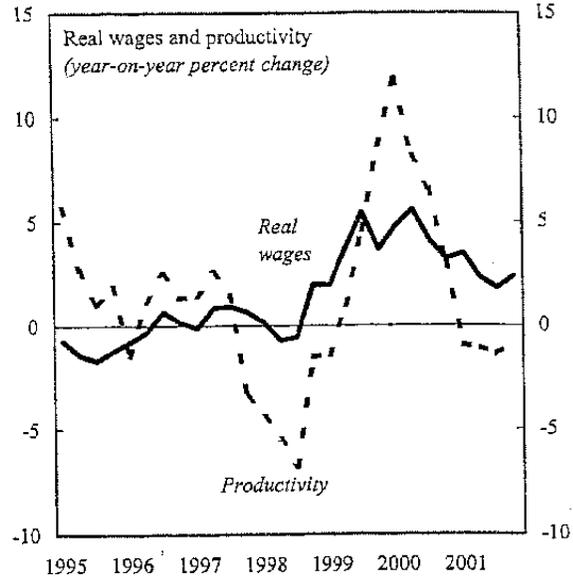
1/ Trade balance in billions of Hong Kong dollars.

Chart 2: Hong Kong SAR
LABOR MARKETS, 1995-2001

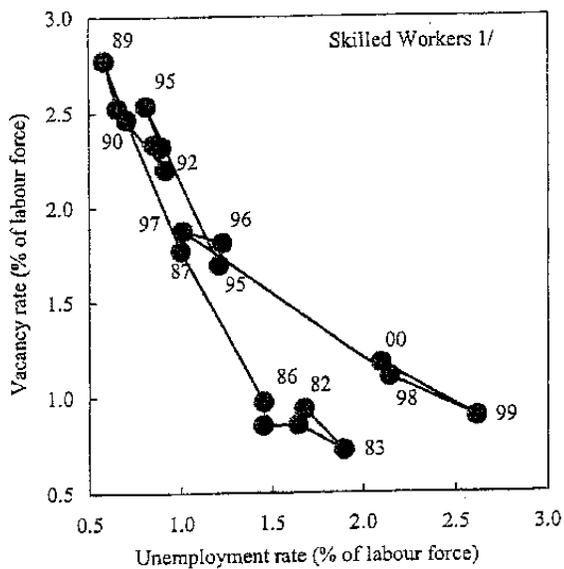
Unemployment has picked up again, and nominal wages seem to have stabilized at a lower level.



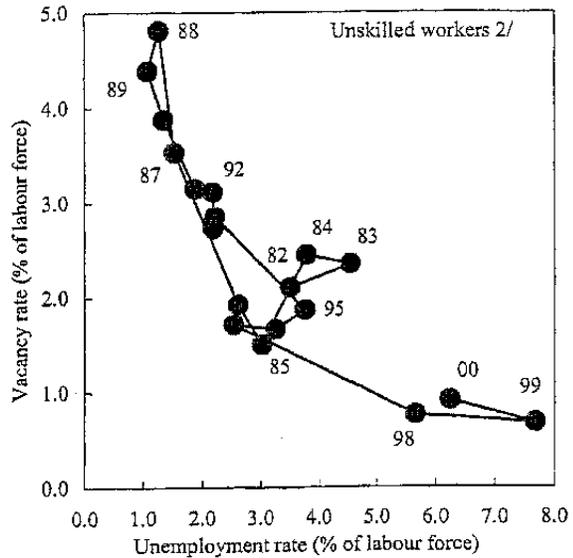
Real wages have continued to rise despite drops in productivity and rising unemployment.



The increase in unemployment at a given vacancy rate signal increasing skill mismatches for both skilled...



...and unskilled workers. Unemployment rates increased much faster among the low-skilled.



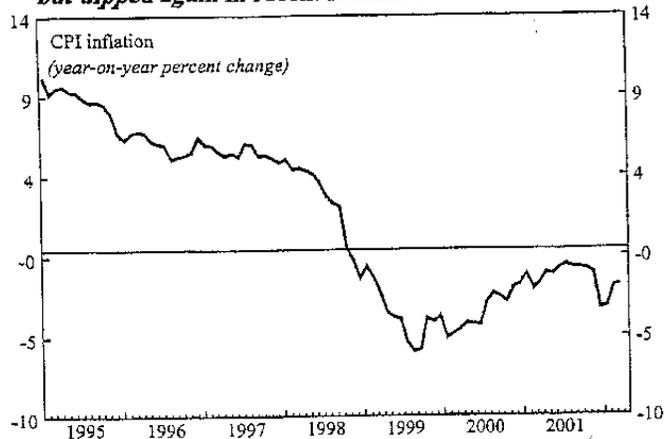
Source: Data provided by the HKMA and IMF staff estimates.

1/ Workers in financing and personal services sectors

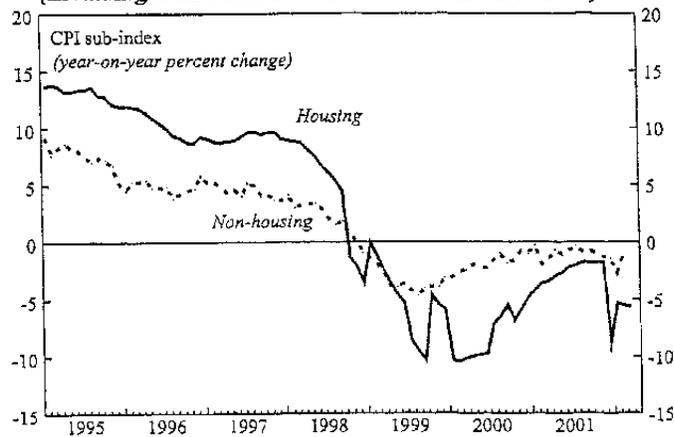
2/ Workers in manufacturing, distributive trade, and construction sectors.

Chart 3: Hong Kong SAR
PRICES AND EXCHANGE RATE, 1995-2002

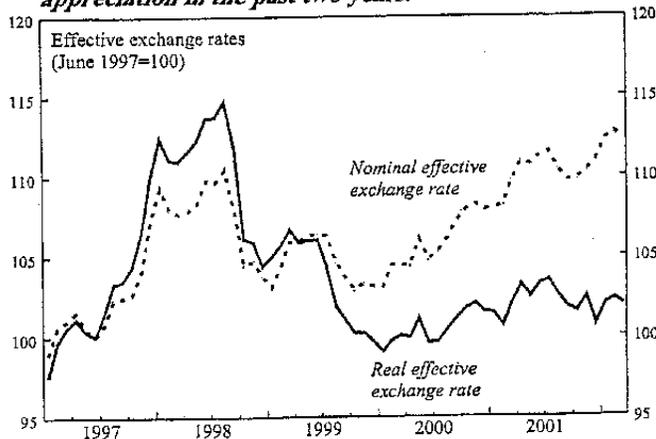
Deflation slowed through late 2001, but dipped again in recent months...



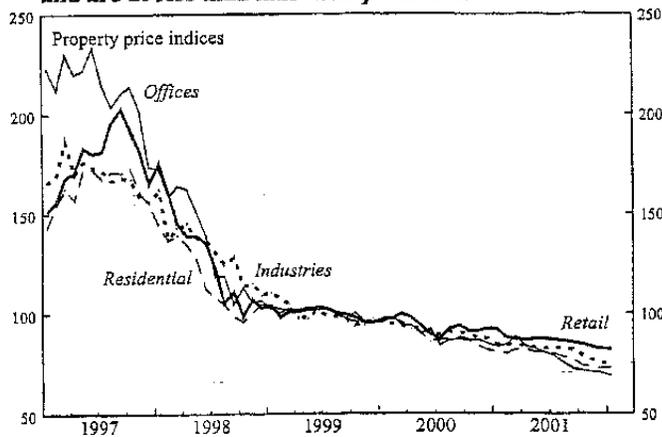
...driven mainly by falling housing costs (including a one-off reduction in the tax on rentals).



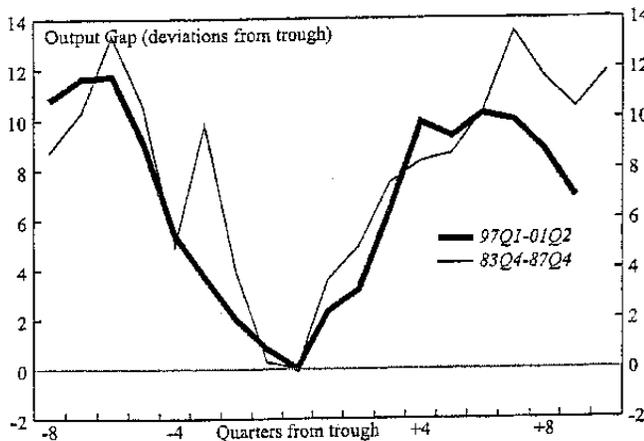
The real effective exchange rate is around its pre-Asian crisis level, despite nominal appreciation in the past two years.



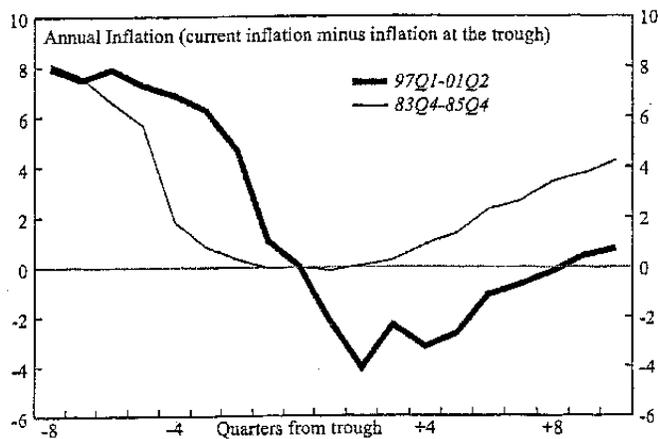
Property prices continue on a declining path, and are at less than half their peak levels.



Compared to past cycles, the recovery was shortlived...



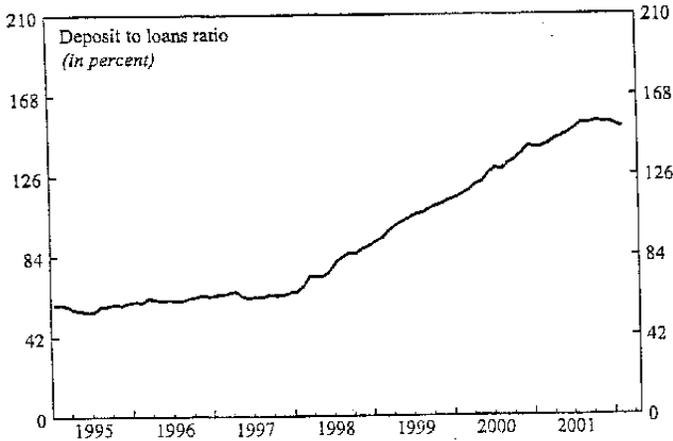
...and prices have dropped more steeply over the cycle.



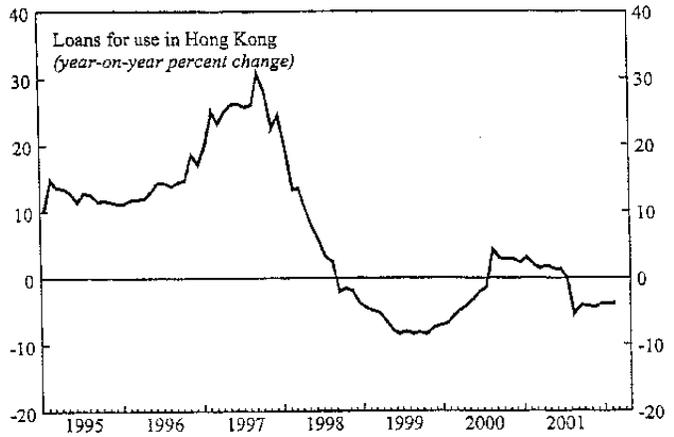
Sources: Data provided by the Hong Kong authorities; and Fund staff estimates.

Chart 4: Hong Kong SAR
ASSETS, MONEY, AND INTEREST RATES, 1995-2002

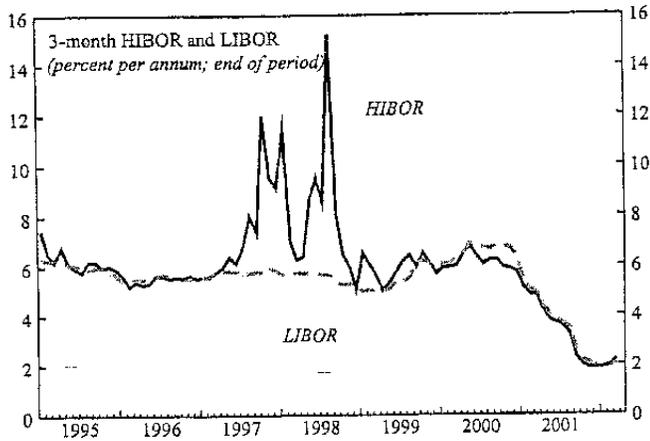
Liquidity in the financial system has increased...



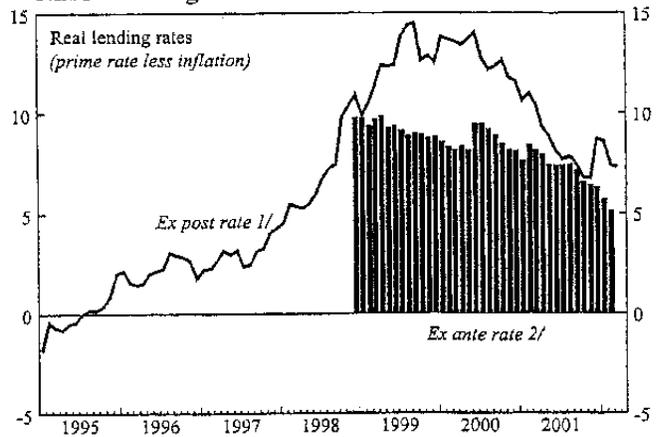
...with loan demand falling again in recent months.



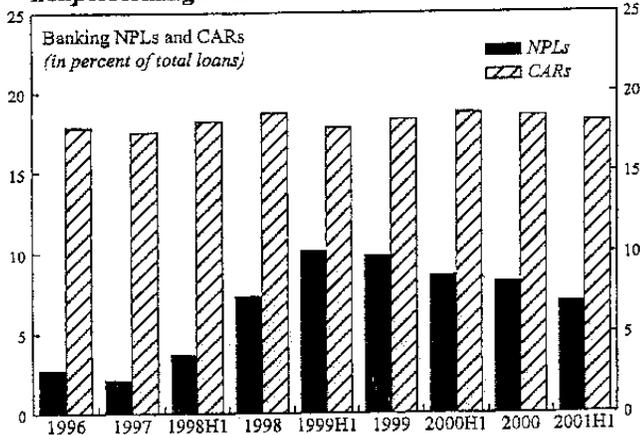
Nominal interest rates have fallen...



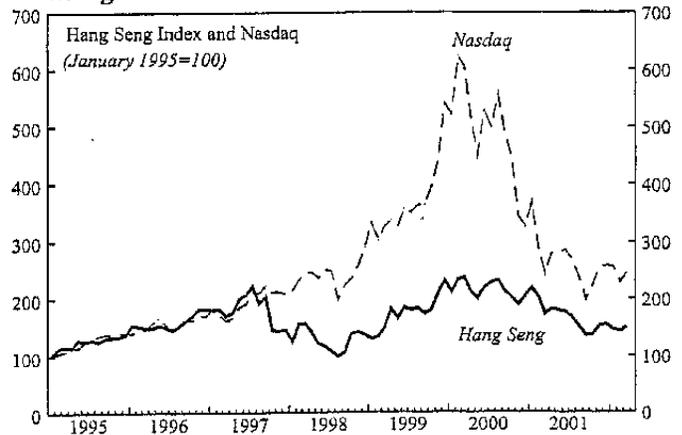
...but real lending rates, although also falling, still remain high due to deflation.



Bank capitalization has remained high, and nonperforming loans have declined since 1999.



The stock market has dropped in line with global markets.

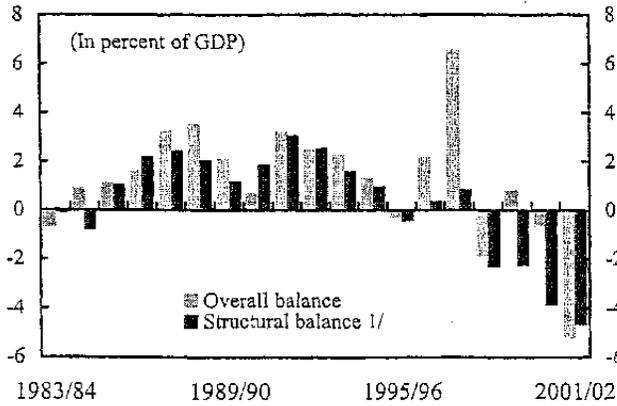


Source: Data provided by the Hong Kong authorities; and Fund staff estimates.

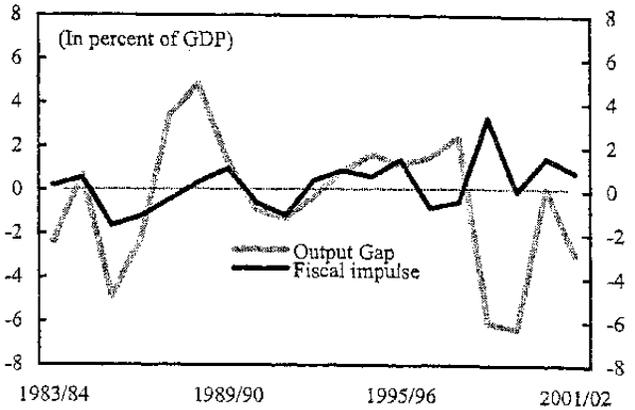
1/ Using 12-month CPI inflation.
2/ Using consensus forecast of inflation.

Chart 5: Hong Kong SAR FISCAL DEVELOPMENTS, FY1983-FY2001

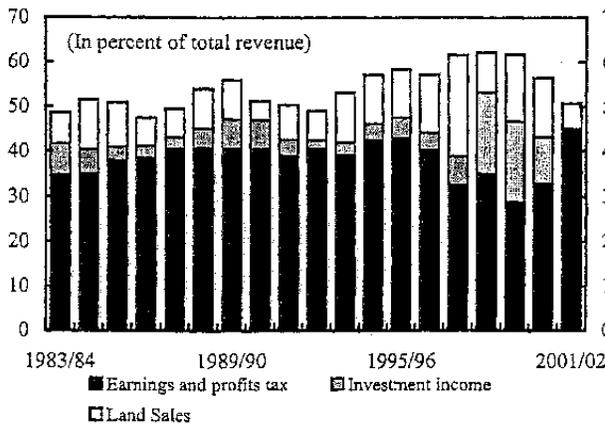
The fiscal balance, traditionally in surplus, has now turned into deficit.



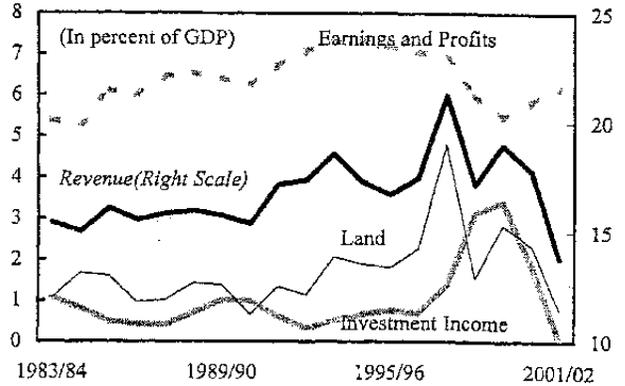
Fiscal policy has not been countercyclical until recently.



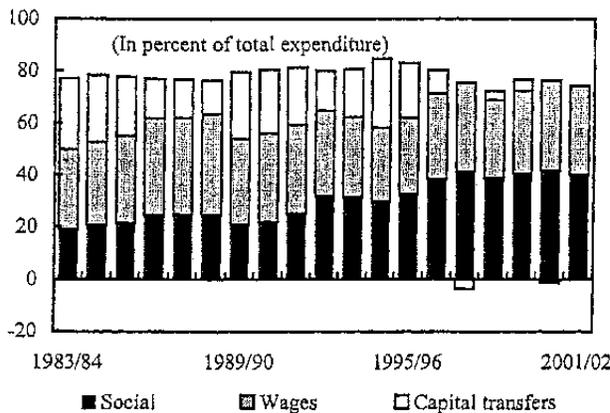
The revenue base is narrow...



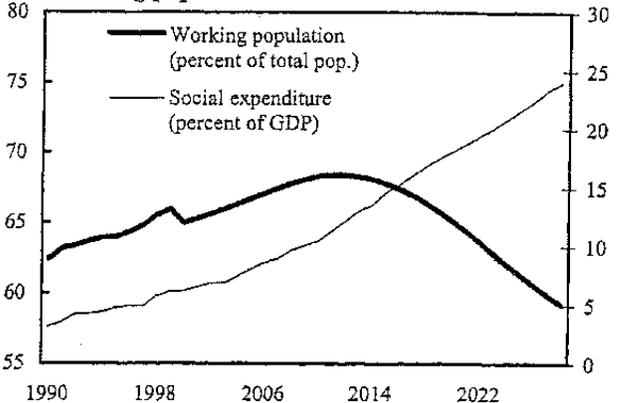
... and revenue has become more volatile...



... while social expenditure is rising...



... and is projected to rise further as the working population declines.



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

1/ Excludes land premium, investment income, privatization receipts, equity injections, and the effect of cyclical fluctuations.

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 1997-2003

Nominal GDP (2001): US\$ 161.9 billion
 Population (mid-2001): 7.2 million
 GDP per capita (2001): US\$ 23,879

	1997	1998	1999	2000	2001	Staff Proj. 2002
Real GDP (percent change)	5.0	-5.3	3.0	10.5	0.1	1.5
Contribution						
Domestic demand	8.4	-10.3	-5.1	9.3	0.2	1.4
Private consumption	3.7	-4.5	0.4	3.1	1.1	0.7
Government consumption	0.2	0.1	0.3	0.2	0.4	0.1
Gross fixed capital formation	4.4	-2.8	-6.3	2.8	0.6	0.6
Inventories	0.2	-3.1	0.5	3.2	-1.9	0.0
Net exports	-3.4	5.0	8.1	1.2	-0.1	0.1
Industrial production	-0.8	-8.7	-6.4	-0.5	-4.4	...
Retail sales	1.1	-16.7	-1.5	8.2	1.2	...
Saving and investment (percent of GDP)						
Gross national saving	30.9	31.4	32.2	33.0	32.9	33.2
Gross domestic investment	34.5	29.0	25.0	27.6	25.8	25.8
Saving-investment balance	-3.6	2.4	7.3	5.5	7.1	7.4
Inflation (percent change)						
Consumer prices	5.8	2.9	-4.0	-3.7	-1.6	-2.5
GDP deflator	5.8	0.4	-5.4	-6.5	-0.5	-2.1
Employment (percent change)	2.9	-1.3	-0.3	3.1	1.3	0.6
Unemployment rate (percent)	2.2	4.7	6.2	4.9	5.1	5.6
Real wages	0.9	0.2	3.7	3.6	3.4	...
Government budget (percent of GDP)						
Revenue	21.2	17.2	19.0	17.8	13.8	17.1
Expenditure	14.7	19.0	18.2	18.4	19.0	20.7
Consolidated budget balance	6.6	-1.8	0.8	-0.6	-5.2	-3.6
Reserves at March 31	34.6	34.5	36.2	34.0	29.4	25.9
Money and credit (percent change, end-period)						
Narrow money (M1)	-4.3	-5.0	13.9	8.3	5.9	...
Broad money (M3)	8.2	10.5	7.7	8.5	-2.8	...
Loans for use in Hong Kong 1/	24.4	-3.8	-7.2	2.3	-3.7	...
Interest rates (percent, end-period)						
Best lending rate	9.5	9.0	8.5	9.5	5.1	...
Three-month HIBOR	9.1	5.1	5.7	5.8	1.9	...
Asset prices						
Hang Seng stock index (July 31, 1964=100)	10723	10049	16962	15096	11397	...
Hang Seng stock index (in percent)	-20.3	-6.3	68.8	-11.0	-24.5	...
Residential property prices (percent change)	39.5	-28.2	-14.6	-10.4	-12.3	...
Merchandise trade (percent change)						
Export volume	6.1	-4.3	3.7	17.1	-3.0	3.1
Domestic exports	2.1	-7.9	-7.2	7.5	-11.0	1.0
Reexports	6.8	-3.7	5.4	18.5	-2.0	3.3
Import volume	7.2	-7.2	0.1	18.1	-2.4	3.6
Export value	4.2	-7.4	0.1	16.6	-5.8	1.9
Import value	5.2	-11.5	-2.6	19.1	-5.5	2.4
Terms of trade	0.7	1.3	-0.8	-0.9	0.8	0.1
External balances (in billions of US\$)						
Merchandise trade balance	-17.3	-7.8	-3.2	-8.2	-8.3	-9.3
In percent of GDP	-10.1	-4.8	-2.0	-5.0	-5.1	-5.8
Service Balance	11.4	9.6	11.7	16.1	17.3	18.8
Income Balance	1.4	3.7	4.5	2.8	4.6	4.7
Current account	-6.2	3.9	11.5	8.9	12.0	12.4
In percent of GDP	-3.6	2.4	7.3	5.5	7.4	7.7
Foreign exchange reserves 2/						
In billions of U.S. dollars, end of period	92.8	89.6	96.3	107.6	111.2	...
In months of retained imports	14.6	17.1	19.8	18.3	20.0	...
Exchange rate						
Linked rate (fixed)		HK\$7.80/US\$1				
Market rate (HK\$/US\$, period average)	7.742	7.745	7.758	7.791	7.799	...
Real effective rate (period average, 1990=100)	149.4	161.6	151.1	146.6	149.0	...

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

1/ Excludes loans to finance external trade.

2/ Includes Land Fund assets from 1997 (US\$17.5 billion at end-1997).

Table 2. Hong Kong SAR: Consolidated Government Account, FY1997-FY2006 1/
(In percent of GDP)

	FY1997	FY1998	FY1999	FY2000	FY2001		Projections (Authorities) 2/				
					Budget	Actual	FY2002	FY2003	FY2004	FY2005	FY2006
					Revenue	21.2	17.2	19.0	17.8	19.9	13.8	17.1	17.0	17.9	18.1	17.4
Tax	11.8	9.1	9.0	9.8	10.4	9.7	9.8	...	...	...	...
Earnings and profits tax	6.9	6.0	5.5	5.8	6.2	6.2	6.0	...	...	...	...
Stamp duties	2.2	0.8	1.0	0.9	0.9	0.7	0.7	...	...	...	...
Nontax	9.4	8.1	10.0	7.9	9.5	4.1	7.2	...	...	...	...
Land sales and Land Fund Revenue	5.3	2.3	4.6	3.3	3.8	0.8	2.8	...	...	...	...
Investment income 3/	1.3	2.5	1.9	1.3	1.7	0.8	2.3	...	...	...	...
MTRC Privatization	...	...	...	0.8	1.2	0.0	1.3	0.0	0.7	0.7	0.0
Expenditure	14.7	19.0	18.2	18.4	20.2	19.0	20.7	20.0	19.1	18.1	17.4
Current	11.3	13.0	14.2	14.6	16.1	15.7	16.6	16.2	15.5	14.9	14.4
Capital	3.4	6.0	4.0	3.8	4.1	3.3	4.1	3.8	3.5	3.2	3.0
Equity injections	0.2	2.3	1.2	1.1	0.9	0.5	0.7	1.0	0.6	0.4	0.3
Other capital	3.2	3.7	2.8	2.8	3.2	2.8	3.4	2.8	2.9	2.8	2.7
Overall Balance	6.6	-1.8	0.8	-0.6	-0.2	-5.2	-3.6	-3.0	-1.2	0.0	0.0
Operating balance 4/	3.3	-0.1	-0.1	-1.2	...	-4.0	-3.9	-2.1	-1.3	-0.4	-0.2
Structural balance 5/	0.3	-2.9	-2.9	-4.4	...	-5.3	-6.3	-4.5	-3.6	-2.5	-2.1
Fiscal impulse 6/	-0.5	3.3	0.0	1.5	...	0.8	1.0	-1.8	-1.0	-1.0	-0.4
Fiscal reserves	34.6	34.5	36.2	34.0	...	29.4	25.9	22.1	19.8	18.8	17.8
(in percent of annual expenditure)	235	181	199	187	...	155	125	110	104	103	102

Source: Data provided by the Authorities; and staff estimates.

1/ Fiscal year begins April 1.

2/ As presented in the FY2002/03 budget proposed in March 2002.

3/ Includes cash payments made by the Exchange Fund for earnings on the government's equity holdings and capital gains from Tracker Fund issues.

4/ The "operating balance" is used by the authorities as a measure of the underlying fiscal position. It is defined to exclude land premium and capital revenue and expenditure, and include recurrent revenue and investment income.

5/ Staff estimates. The "structural balance" is used by staff to measure the impact of fiscal policy on domestic demand.

Table 3. Hong Kong SAR: Standard Vulnerability Indicators

	1997	1998	1999	2000	2001
Public Sector					
Fiscal deficit (in percent of GDP)	6.6	-1.8	0.8	-0.6	-5.2
Accumulated fiscal surplus (in percent of GDP)	34.6	34.5	36.2	34.0	29.4
External Sector					
Export volume (percent change)	6.1	-4.3	3.7	17.1	-3.0
Domestic exports	2.1	-7.9	-7.2	7.5	-11.0
Reexports	6.8	-3.7	5.4	18.5	-2.0
Import volume (percent change)	7.2	-7.2	0.1	18.1	-2.4
Current account (in billions US\$)	-6.2	3.9	11.5	8.9	12.0
Net equity inflow (in billions of US\$)	...	6.4	30.0	29.3	-22.1
Gross official reserves (in billions of US\$)	92.8	89.6	96.3	107.6	111.2
In months of retained imports	14.6	17.1	19.8	18.3	20.0
In percent of monetary base	355.1	360.7	318.6	389.1	377.0
In percent of broad money 1/	43.5	38.3	39.1	42.2	43.5
Short-term debt (in billions of US\$) 2/	174.3	101.4	83.1	79.8	77.8
In percent of gross reserves	187.8	113.2	86.3	74.2	70.0
1-yr forward exchange rate premium (in pips, annual average)	1153	3264	1035	-38	50
Real exchange rate (percent change)	9.7	8.2	-6.5	-3.0	1.6
Financial Sector					
HIBOR(3M)-LIBOR (3M) (In basis points)	146.5	255.6	47.5	-37.3	-15.1
Hang Seng Index (percent change, end-year)	-20.3	-6.3	68.8	-11.0	-24.5
Property prices (percent change, end-year)	39.5	-28.2	-14.6	-10.4	-12.3
Banking Sector 3/					
Deposit-loans ratio	64.6	89.4	113.0	141.5	153.6
Domestic credit growth 4/	24.4	-3.8	-7.2	2.3	-3.7
Real credit growth	17.6	-6.4	-3.3	6.3	-2.2
Capital adequacy ratio 4/	17.5	18.5	18.7	17.8	16.6
Nonperforming loans (in percent of total loans) 5, 6/	2.1	7.3	9.8	7.2	6.4
Net interest margin (in percent of interest-bearing assets) 6/	2.4	2.3	2.3	2.3	2.0
Return on assets (post-tax) 6/	1.6	1.0	1.2	1.4	1.1
Net open spot position (in billions of US\$)	-11.4	6.2	12.4	25.7	24.7
Net open forward position (in billions of US\$)	12.0	-3.6	-5.2	-18.7	-14.6
Exposure to the Mainland (in percent of total assets)	4.9	4.5	3.6	3.3	3.2
Exposure to property sector (in percent of domestic credit)	44.3	46.5	49.4	49.2	50.7
Contagion Indicator					
HK\$-Renminbi forward exchange rate correlation (daily)	0.57	0.73	0.57	-0.06	0.91
Hang Seng-NASDAQ correlation (daily)	0.05	0.22	0.84	0.75	0.85

Sources: Hong Kong SAR authorities, BIS, and staff estimates.

1/ Broad Money refers to M2.

2/ Short-term debt from joint BIS-World Bank statistics on External Debt, Feb. 2002, BIS website.

3/ For all authorized institutions, unless otherwise specified.

4/ For all locally incorporated institutions.

5/ Refers to total gross classified: "substandard", "doubtful" and "loss".

6/ For 2001 refers to a new retail banking measure instead of all locally incorporated banks.

Table 4. Hong Kong SAR: Medium-term Macroeconomic Framework

	Average	Average	Staff Projections								
	1988-97	1998-07	1999	2000	2001	2002	2003	2004	2005	2006	2007
Real GDP (percent change)	5.0	3.1	3.0	10.5	0.1	1.5	3.6	4.5	4.5	4.3	4.0
Contribution											
Real domestic demand	6.5	1.6	-5.1	9.3	0.2	1.4	3.6	4.5	4.4	4.3	4.2
Private consumption	3.5	1.3	0.4	3.1	1.1	0.7	1.7	2.7	2.7	2.5	2.4
Government consumption	0.4	0.1	0.3	0.2	0.4	0.1	0.1	0.1	0.1	0.1	0.1
Gross fixed capital formation	2.6	0.2	-6.3	2.8	0.6	0.6	1.1	1.6	1.6	1.6	1.6
Inventories	0.0	0.0	0.5	3.2	-1.9	0.0	0.8	0.1	0.1	0.1	0.1
Net Exports	-1.5	1.4	8.1	1.2	-0.1	0.1	0.0	0.0	0.0	0.0	-0.1
Output gap (in percent of potential)	1.1	-2.9	-6.3	0.2	-2.8	-4.4	-4.1	-2.9	-1.8	-0.8	0.0
Growth rates											
Real GDP	5.0	3.1	3.0	10.5	0.1	1.5	3.6	4.5	4.5	4.3	4.0
Real domestic demand	6.8	1.9	-5.1	10.0	0.2	1.5	3.9	4.8	4.8	4.6	4.4
Private consumption	6.0	2.3	0.6	5.4	2.0	1.3	3.0	4.9	4.8	4.5	4.3
Government consumption	5.1	1.7	3.3	2.1	5.1	1.3	0.7	1.0	1.0	1.0	1.0
Gross fixed capital formation	9.0	1.4	-17.5	9.8	2.1	1.9	3.6	5.3	5.5	5.4	5.3
Saving and investment (percent of GDP)											
Gross national saving	34.5	33.4	32.2	33.0	32.9	33.2	33.8	33.9	34.1	34.5	34.9
Gross investment	29.9	26.8	25.0	27.6	25.8	25.8	26.4	26.6	27.0	27.3	27.6
Saving-investment balance	4.6	6.6	7.3	5.5	7.1	7.4	7.4	7.3	7.2	7.2	7.2
Inflation (percent change)											
Consumer prices	8.9	-0.3	-4.0	-3.7	-1.6	-2.5	0.0	1.0	1.5	1.5	1.5
GDP deflator	7.8	-1.0	-5.4	-6.5	-0.5	-2.1	-0.1	0.7	1.2	1.3	1.4
Employment (percent change)	1.7	1.1	-0.3	3.1	1.3	0.6	1.5	1.7	1.7	1.6	1.5
Unemployment rate (percent)	2.0	5.0	6.2	4.9	5.1	5.6	5.4	5.0	4.6	4.2	3.9
Government budget (percent of GDP) 1/											
Revenue	17.3	17.2	19.0	17.8	13.8	17.1	17.0	17.9	18.1	17.4	16.8
Expenditure	14.9	18.7	18.2	18.4	19.0	20.7	20.0	19.1	18.1	17.4	16.8
Consolidated budget balance	2.4	-1.5	0.8	-0.6	-5.2	-3.6	-3.0	-1.2	0.0	0.0	0.0
Accumulated fiscal reserves (end-year)	34.6	25.5	36.2	34.0	29.4	25.9	22.1	19.8	18.8	17.8	16.8
Merchandise trade (percent change)											
Export volume	13.0	5.0	3.7	17.1	-3.0	3.1	7.4	7.1	6.6	6.3	6.2
Domestic exports	-0.3	-0.9	-7.2	7.5	-11.0	1.0	1.7	1.7	1.8	1.7	1.7
Reexports	19.3	5.8	5.4	18.5	-2.0	3.3	8.0	7.7	7.1	6.8	6.7
Import volume	13.9	4.7	0.1	18.1	-2.4	3.6	7.6	7.4	6.9	6.6	6.6
Retained import volume	8.1	1.9	-11.7	17.0	-3.2	4.3	6.5	5.7	5.3	4.9	4.9
Export value	14.7	4.3	0.1	16.6	-5.8	1.9	8.0	7.8	7.5	7.2	7.1
Import value	15.9	4.1	-2.6	19.1	-5.5	2.4	8.3	8.2	8.0	7.6	7.6
Terms of trade	0.1	0.0	-0.8	-0.9	0.8	0.1	-0.1	0.0	0.0	-0.1	0.0
External balances (in billions of US\$)											
Trade balance	-7.7	-10.9	-3.2	-8.2	-8.3	-9.3	-10.5	-12.3	-14.3	-16.3	-18.7
In percent of GDP	-5.6	-6.1	-2.0	-5.0	-5.1	-5.8	-6.3	-7.0	-7.7	-8.3	-9.0
Exports of goods			175	202	191	195	210	227	244	261	280
Imports of goods			178	211	199	204	221	239	258	278	299
Current account	2.9	12.0	11.5	8.9	12.0	12.4	12.9	13.4	14.0	14.9	15.8
In percent of GDP	4.3	6.8	7.3	5.5	7.4	7.7	7.7	7.6	7.5	7.6	7.6
Foreign exchange reserves (end-year)	42.9	108.7	96.3	107.6	111.2	112.3	113.3	113.7	114.3	114.4	114.4

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

1/ The budget numbers refer to the fiscal year (April through March)

Table 5. Hong Kong SAR: Medium-term Balance of Payments

	1999	2000	Projections						
			2001	2002	2003	2004	2005	2006	2007
<i>(In billions of US dollars)</i>									
Current account	11.5	8.9	12.0	12.4	12.9	13.4	14.0	14.9	15.8
<i>Goods Balance</i>	-3.2	-8.2	-8.3	-9.3	-10.5	-12.3	-14.3	-16.3	-18.7
<i>Services balance</i>	11.7	16.0	17.3	18.8	20.3	21.9	23.8	25.8	28.1
<i>Income Balance</i>	4.5	2.8	4.6	4.7	4.9	5.5	6.3	7.2	8.2
<i>Transfer balance</i>	-1.5	-1.7	-1.7	-1.7	-1.7	-1.8	-1.8	-1.9	-1.9
Capital and Financial Account	-10.8	-7.4	-11.0	-12.3	-12.8	-13.3	-13.9	-14.8	-15.7
Capital Account	-1.8	-1.5	-1.2	-1.3	-1.4	-1.5	-1.7	-1.9	-2.1
Financial Account	-9.0	-5.9	-9.8	-11.1	-11.4	-11.7	-12.2	-12.9	-13.6
<i>Net Direct investment</i>	5.2	2.5	13.9	-10.5	-11.2	-11.1	-11.1	-11.3	-10.1
<i>Portfolio investment</i>	33.1	24.5	-39.7	5.4	5.3	5.3	4.1	2.8	1.4
<i>Financial derivatives</i>	10.2	0.2	5.0	4.3	3.8	2.9	2.7	2.5	2.3
<i>Net bank loans and other investment</i>	-47.5	-23.1	15.6	-9.2	-8.3	-8.4	-7.3	-6.7	-7.3
<i>Reserve assets (net change)</i>	-10.0	-10.0	-4.7	-1.2	-1.0	-0.4	-0.6	-0.2	0.0
Net errors and omissions	-0.7	-1.5	-1.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
<i>(In percent of GDP)</i>									
Current account	7.3	5.5	7.4	7.7	7.7	7.6	7.5	7.6	7.6
<i>Goods Balance</i>	-2.0	-5.0	-5.1	-5.8	-6.3	-7.0	-7.7	-8.3	-9.0
<i>Services balance</i>	7.4	9.8	10.7	11.7	12.2	12.5	12.8	13.2	13.6
<i>Income Balance</i>	2.8	1.7	2.9	2.9	2.9	3.1	3.4	3.7	4.0
<i>Transfer balance</i>	-1.0	-1.0	-1.0	-1.1	-1.0	-1.0	-1.0	-0.9	-0.9
Capital and Financial Account	-6.8	-4.6	-6.8	-7.7	-7.7	-7.6	-7.5	-7.5	-7.6
Capital Account	-1.1	-1.0	-0.7	-0.8	-0.8	-0.9	-0.9	-1.0	-1.0
Financial Account	-5.7	-3.6	-6.1	-6.9	-6.8	-6.7	-6.6	-6.6	-6.6
<i>Net Direct investment</i>	3.3	1.6	8.6	-6.5	-6.7	-6.4	-6.0	-5.7	-4.9
<i>Portfolio investment</i>	20.9	15.1	-24.5	3.4	3.2	3.0	2.2	1.4	0.7
<i>Financial derivatives</i>	6.4	0.1	3.1	2.7	2.3	1.7	1.5	1.3	1.1
<i>Net bank loans and other investment</i>	-30.0	-14.2	9.7	-5.7	-5.0	-4.8	-3.9	-3.4	-3.5
<i>Reserve assets (net change)</i>	-6.3	-6.2	-2.9	-0.7	-0.6	-0.2	-0.3	-0.1	0.0
Net errors and omissions	-0.4	-0.9	-0.6	0.0	0.0	0.0	0.0	-0.1	-0.1

Source: Hong Kong SAR authorities and staff estimates.

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 staff's International Capital Markets 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 INS courses on balance of payments and monetary statistics, and financial programming.

II. Exchange Rate Arrangement

Hong Kong SAR has its own currency, the Hong Kong dollar, which has been linked to the U.S. dollar under a currency board arrangement since October 1983 at a rate of HK\$7.8/US\$1. The market rate fluctuates around the linked rate, usually within a margin of less than 1 percent. There are no restrictions on current or capital transactions in Hong Kong SAR, and the Hong Kong dollar is freely convertible. The People's Republic of China has accepted the obligations under Article VIII, Sections 2,3 and 4 of the Articles of Agreement on December 1, 1996.

III. Resident Representative

The Hong Kong SAR sub-office of the Beijing resident representative's office was opened on September 23, 2000. Mr. William Lee, who since July 2000 has been informally functioning as the Resident Representative, formally assumed the position on that date.

Hong Kong SAR—Statistical Issues

Hong Kong SAR provides statistics to the Fund on a timely basis for surveillance and publication in *International Financial Statistics*. Hong Kong SAR subscribes to the SDDS and is fully compliant with its requirements.

The Hong Kong SAR authorities plan to disseminate statistics on its international investment position starting June 2002 for the reference year 2001. They have also brought forward the time table for publishing external debt data from September 2003 to June 2002. The authorities plan to begin publishing estimates of GDP by type of economic activity at constant prices starting in the second half of 2002.

However, there are areas where data deficiencies remain, including:

- Hong Kong SAR does not report GFS for publication in the GFS Yearbook or in IFS. The authorities have initiated work on introduction of accrual accounting and aim to start reporting fiscal data in a GFS format in 2003, following the new recommended methodology (*Government Finance Statistics Manual 2001*).
- Foreign assets and foreign liabilities of the banking system are derived from data collected through a separate survey and are not based on banking institutions' balance sheet information, the primary source data for banking sector's analytical accounts.

Hong Kong SAR

Survey of Reporting of Main Statistical Indicators

As of March 6, 2002

	Exchange rates	Inter-national reserves	Reserve/ base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index	Exports/ Imports	Current account balance	Overall government balance 1/	GDP/GNP
Date of latest observation	Mar. 6, 2002	Jan. 2002	Jan. 2002	Jan. 2002	Jan. 2002	Mar. 6, 2002	Jan. 2002	Jan. 2002	Q3 2001	FY 2000/01	Q4 2001
Date received	Mar. 6, 2002	Mar. 1, 2002	Mar. 1, 2002	Mar. 2002	Mar. 1, 2002	Mar. 6, 2002	Feb. 22, 2002	Feb. 26, 2002	Dec. 27, 2001	March 2001	Mar. 6, 2002
Frequency of data	D	M	M	M	M	D	M	M	Q	A, Q	Q
Frequency of reporting	D	M	M	M	M	D	M	M	Q	A, Q	Q
Frequency of publication	D	M	M	M	M	D	M	M	Q	A, Q	Q
Source of data	C, N	N	N	N	N	C, N	N	N	N	N	N
Mode of reporting	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M	E, M
Confidentiality	C	C	C	C	C	C	C	C	C	C	C

1/ Fiscal year beginning April 1.



INTERNATIONAL MONETARY FUND

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IMF Concludes 2002 Article IV Consultation with People's Republic of China — Hong Kong Special Administrative Region

On May 1, 2002, 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

Over the last five years, the Hong Kong SAR economy has suffered two rounds of external shocks, while also adjusting to growing integration with the Mainland of China. Aided by favorable external conditions, a recovery from the Asian crisis started in 1999, and GDP growth surged to 10½ percent in 2000. However, before sustained growth could take hold, the global slowdown in 2001 dealt another blow to the economy, and real GDP growth dropped to almost zero. While the renewed downturn was led by falling exports, domestic demand also slowed. The unemployment rate reached 6.8 percent in early 2002, and deflation has continued for over three years, reflecting adjustment to the successive external shocks under the linked exchange rate system. The outlook for 2002 is for a moderate recovery, spurred by the expected rebound in global activity.

Despite the economic slowdown, market confidence has remained strong and contagion from the crisis in Argentina has been minimal. Interest rates have declined significantly following the successive cuts in the US rates; nevertheless, domestic credit growth has remained weak reflecting the uncertain business outlook and weak asset prices. The banking sector remains

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. This PIN summarizes the views of the Executive Board as expressed during the May 1, 2002 Executive Board discussion based on the staff report.

robust, thanks to the traditionally prudent banking practice and strong supervision. Bank capitalization remains well above Basle standards, and the ratio of non-performing loans to total loans has declined to below 7 percent, from a peak of 10½ percent in the aftermath of the Asian crisis.

The overall fiscal deficit widened to over 5 percent of GDP in FY2001 (from near balance in FY2000), mainly due to a cyclical decline in revenues. In late 2001, the government also introduced a set of measures (totaling about 1 percent of GDP over two years) to cushion the impact of the economic slowdown. However, the structural budget position has deteriorated significantly over the last four years. The FY2002 budget, while maintaining a mildly expansionary fiscal stance for this year, outlines a framework of medium-term fiscal targets toward eliminating both the overall and the structural deficits by FY2006. This is to be achieved largely by containing the growth of government expenditures, with revenue measures to be considered if necessary.

Growing economic integration with the Mainland is challenging Hong Kong SAR to continue its transformation to a high-value added, service-based economy. This process, while offering many new opportunities, has also raised income disparities and structural unemployment. To meet these challenges, the government has made strengthening the skills of the workforce through better education and training a policy priority, in addition to the continuing efforts to upgrade infrastructure and the regulatory environment (such as by the recently enacted new Securities and Futures Ordinance).

Executive Board Assessment

Executive Directors observed that the highly-open economy of Hong Kong SAR has been hit hard by successive cyclical shocks, while also facing structural changes from growing integration with the Mainland of China. Directors commended the authorities' skillful and proactive economic management in dealing with those challenges, which centers on maintaining the rules-based policy framework that has served the economy well over the past two decades, while limiting the impact of the downturn; and continuing reforms to bolster competitiveness. Looking ahead, they expected the economy to recover as the global environment improves, and were confident that Hong Kong SAR would, as in the past, adapt successfully to the structural changes underway.

Directors noted that, while the widening of the fiscal deficit last year was mainly cyclical, recent years have seen a significant structural deterioration in the budget. While a sharp fiscal correction during the cyclical downturn may not be warranted, the recent drift into a sizable structural deficit will need to be reversed in order to ensure healthy public finances in the longer run. Directors therefore welcomed the authorities' commitment to restore budget balance over the next four years, as outlined in the fiscal-year 2002 budget. They emphasized the importance of supporting this goal with concrete measures to reverse the rising trend of expenditure as a share of GDP and to strengthen the revenue base, and urged the authorities to start preparing these measures as soon as possible. Directors supported the initiative to review all public expenditures for possible cost savings while protecting priority social spending and public expenditure programs contributing to long-term competitiveness. Many Directors considered that efforts to strengthen the revenue base would likely have to include the introduction of a low-

rated, broad-based consumption tax, but the authorities were encouraged to carefully consider other revenue enhancing options as well, including in the income tax area.

Directors expressed their continued support for the linked exchange rate system and unanimously viewed the link as the best option for Hong Kong SAR. They noted that the economy has adjusted well to shocks under the link, which has also contributed to boosting confidence in Hong Kong SAR as a financial center. Directors emphasized that the smooth functioning of the link will continue to depend critically on prudent fiscal policies, flexible goods and factor markets, a robust financial system, and large foreign reserves. They also noted that the exchange rate regime and supporting conditions should be, as they have always been, subject to continuous review.

Directors noted that the banking sector remains well capitalized, notwithstanding the recent economic slowdown. While the search for new products and consolidation in an increasingly competitive banking environment is desirable, Directors cautioned that vigilance will be needed to ensure that the new activities and products offered by banks do not overtax their risk management capabilities. They supported the plan to introduce a deposit insurance scheme, with appropriate safeguards to minimize moral hazard, as well as the establishment of credit reference agencies covering commercial and individual borrowers.

Directors noted that growing competition from global financial markets as well as those emerging in the Mainland will require continuous upgrading of financial infrastructure and regulations. In this regard, they welcomed the recent enactment of the Securities and Futures Ordinance and the steps taken to provide investors with a highly secure and efficient operating environment. Directors commended the leadership role which Hong Kong SAR is playing in the international effort to combat money laundering and the financing of terrorism. They welcomed the authorities' agreement to participate in the Financial Sector Assessment Program.

Directors observed that economic integration with the Mainland offers many benefits for Hong Kong SAR, but also implies significant restructuring to direct economic activity to higher-value added sectors. To remain a center of trade-related and financial services, Hong Kong SAR will need to continue upgrading its infrastructure, human capital, and business environment. Directors supported the authorities' efforts to address pressures in the labor market and rising income disparities by improving the skills of the workforce through better education and training, and providing well-targeted social support to the needy. Directors commended the authorities' efforts to promote competition and lower costs in regulated sectors, and urged continued close attention to domestic competition issues especially in unregulated sectors, given the absence of a comprehensive competition law. They welcomed the ongoing review of housing policies and the envisaged move toward better targeted and more efficient subsidy schemes.

Directors commended Hong Kong SAR's compliance with the Fund's Special Data Dissemination Standard. They welcomed the authorities' intention to soon start publishing data on external debt and the international investment position, and encouraged them to make continued progress toward the presentation of fiscal accounts in the standard *Government Finance Statistics* format.

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 2002 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**

	1997	1998	1999	2000	2001	2002 (proj.)
Real GDP (percent change)	5.0	-5.3	3.0	10.5	0.1	1.5
Real domestic demand (contribution)	8.4	-10.3	-5.1	9.3	0.2	1.4
Foreign balance (contribution)	-3.4	5.0	8.1	1.2	-0.1	0.1
Saving and investment (percent of GDP)						
Gross national saving	30.9	31.4	32.2	33.0	32.9	33.2
Gross domestic investment	34.5	29.0	25.0	27.6	25.8	25.8
Inflation (percent change)						
Consumer prices	5.8	2.9	-4.0	-3.7	-1.6	-2.5
GDP deflator	5.8	0.4	-5.4	-6.5	-0.5	-2.1
Employment (percent change)	2.9	-1.3	-0.3	3.1	1.3	0.6
Unemployment rate (percent)	2.2	4.7	6.2	4.9	5.1	5.6
Real wages	0.9	0.2	3.7	3.6	3.4	...
Government budget (percent of GDP) 1/						
Revenue	21.2	17.2	19.0	17.8	13.8	17.1
Expenditure	14.7	19.0	18.2	18.4	19.0	20.7
Consolidated budget balance	6.6	-1.8	0.8	-0.6	-5.2	-3.6
Reserves at March 31	34.6	34.5	36.2	34.0	29.4	25.9
Money and credit (percent change, end-period)						
Narrow money (M1)	-4.3	-5.0	13.9	8.3	5.9	...
Broad money (M3)	8.2	10.5	7.7	8.5	-2.8	...
Loans for use in Hong Kong SAR 2/	24.4	-3.8	-7.2	2.3	-3.7	...
Interest rates (percent, end-period)						
Best lending rate	9.5	9.0	8.5	9.5	5.1	...
Three-month HIBOR	9.1	5.1	5.7	5.8	1.9	...
Merchandise trade (percent change)						
Export volume	6.1	-4.3	3.7	17.1	-3.0	3.1
Domestic exports	2.1	-7.9	-7.2	7.5	-11.0	1.0
Reexports	6.8	-3.7	5.4	18.5	-2.0	3.3
Import volume	7.2	-7.2	0.1	18.1	-2.4	3.6
Export value	4.2	-7.4	0.1	16.6	-5.8	1.9
Import value	5.2	-11.5	-2.6	19.1	-5.5	2.4
External balances (in billions of US\$)						
Merchandise trade balance	-17.3	-7.8	-3.2	-8.2	-8.3	-9.3
In percent of GDP	-10.1	-4.8	-2.0	-5.0	-5.1	-5.8
Current account balance	-6.2	3.9	11.5	8.9	12.0	12.4
In percent of GDP	-3.6	2.4	7.3	5.5	7.4	7.7
Foreign exchange reserves						
Foreign exchange reserves (in billions of U.S. dollars, end of period)	92.8	89.6	96.3	107.6	111.2	...
(In months of retained imports)	14.6	17.1	19.8	18.3	20.0	...

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

1/ Fiscal year.

2/ Figures exclude trade financing.