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IMF Concludes 2004 Article IV Consultation with the People's Republic of China—Hong Kong Special Administrative Region

On February 2, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the People's Republic of China—Hong Kong Special Administrative Region.[1]

Background

After a period of prolonged weakness in economic activity, persistent deflation and rising fiscal deficits, the macroeconomic outlook has improved significantly since mid-2003. The recovery has gained significant momentum and become broad-based in 2004. The recovery was spurred by continued strong growth in the Mainland—complemented by the package of policy measures approved by the Mainland authorities for Hong Kong SAR—and the global recovery. The strong growth in the Mainland has provided a boost to growth in regional economies and the associated improvement in intra-regional trade has contributed to Hong Kong SAR's higher export growth. The easing of restrictions on individual travel from the Mainland to Hong Kong SAR helped to bolster tourism and private consumption. Investment spending also rose significantly as business sentiment improved. The unemployment rate has fallen by almost 2 percentage points from its peak last year, to 6.7 percent at end-November 2004.
Strong domestic demand has contributed to the rebound of the property sector and the end of consumer price deflation. After five years of persistent price declines, the CPI index rose slightly

[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.

during July-November 2004. Residential property prices bottomed out in July 2003, and have soared by about 40 percent since then, but remain below their peak in October 1997. The Hang Seng index has increased by about 70 percent since its trough in June 2003. The external current account surplus increased in 2003, in part due to the decline in domestic investment, however, it has narrowed in 2004, reflecting the increase in private consumption and the rise in domestic investment following the economic recovery.

The consolidated fiscal deficit for FY2004/05 (before bond issuance) is now projected at about 1¾ percent of GDP, compared with the budget target of about 5 percent of GDP. The improvement relative to the budget is on account of buoyant revenue performance (reflecting stronger growth and large proceeds from land sales) and continued expenditure restraint. Fiscal reserves are projected at about 13 months of expenditures at the end of this fiscal year, well above the budget target of 10 months.

The staff projects that real GDP growth will decline from 8¼ percent in 2004 to 4 percent in 2005, reflecting a slowing in global growth and some easing of activity on the Mainland. CPI inflation is expected to remain subdued in 2005. The unemployment rate should fall below 6 percent in 2005, with employment growth in the range of 2 to 2½ percent. The risks to this outlook are largely external. The downside risks are related to the durability of the global expansion, including the possible negative effects of persistently high oil prices. On the upside, there is some potential for stronger inbound tourism and more robust intra-regional trade.

Executive Board Assessment

Executive Directors commended the authorities for their skillful macroeconomic management, including their efforts to rein in the fiscal deficit. Directors noted that the economic recovery has become more broad-based in 2004, driven by the authorities' package of policy measures as well as the global recovery. Consumer price deflation appears to have ended, mainly reflecting robust domestic demand. Directors considered these achievements to be a testament to the resilience and flexibility of the Hong Kong SAR economy, especially given the significant external shocks of recent years.

Against the background of a promising near-term macroeconomic outlook, Directors noted that sustaining strong growth over the medium term will depend crucially on effectively managing the challenges of ongoing integration with the Mainland. In particular, Directors noted that Hong Kong SAR will need to continue to bolster its competitiveness by complementing its traditional strengths—flexible product and factor markets, and strong institutions—with sound macroeconomic policies and productivity-enhancing reforms.

Directors commended the authorities for continued expenditure restraint which, together with revenue buoyancy, has led to a significant decline in the fiscal deficit over the past two years. They welcomed the likelihood that budget balance on a consolidated basis will be achieved earlier than expected. Nevertheless, Directors encouraged the authorities to take advantage of the current favorable macroeconomic environment to forcefully address the long-standing structural deficit problem. They stressed that eliminating the structural deficit as soon as possible would help bolster fiscal reserves and facilitate adjustment to shocks that the economy might face. Directors welcomed the authorities' continued commitment to expenditure restraint, which will require careful monitoring of the civil service wage bill and adequate control of social expenditures.

Directors stressed that broadening the tax base and stabilizing revenues remains a key policy priority. They considered a goods and services tax (GST) as an appropriate instrument for improving the efficiency of the tax regime and reducing the reliance on volatile revenue sources. Directors welcomed the authorities' plans to engage in extensive public consultations in order to build consensus on the introduction of a GST. Given the long lead time required, Directors emphasized that technical preparations for the implementation of a GST will need to get under way without delay.

In addition, Directors encouraged the authorities to develop a longer-term focus for fiscal policy that takes into account potential fiscal pressures that are likely to arise from Hong Kong SAR's aging population. Such a focus could include targeting a higher level of fiscal reserves or net government assets.

Directors noted that the Hong Kong Monetary Authority has effectively managed pressures on the Hong Kong dollar over the past year and that the linked exchange rate system (LERS) remains robust. They reiterated their support for the authorities' commitment to the LERS.

Directors commended the Hong Kong SAR authorities for implementing the recommendations of the 2003 Financial Sector Assessment Program report, including the enhancement of regulatory and supervisory arrangements. They noted that the passage of legislation to introduce a deposit insurance scheme is a positive development—its launch in 2006 will further strengthen the banking system. Directors stressed that it was important for Hong Kong SAR to continue strengthening its financial infrastructure as well as its supervisory and regulatory systems in order to maintain its position as a leading international financial center. Directors welcomed the significant progress that has been made in strengthening the Anti-Money Laundering framework, including the issuance of relevant guidelines for its implementation.

Directors welcomed the progress made by the authorities in improving cooperation with their Mainland supervisory counterparts in the banking, securities, and insurance industries. They noted that coordination of supervisory activities between the two economies will become increasingly important as their integration intensifies.

Directors noted the progress made by the government in reducing its direct involvement in the property market and encouraged the authorities to take further steps in this direction. In this respect, they emphasized that continued provision of timely information about the government's plans concerning the supply of land will help reduce uncertainty and mitigate any associated instability in property prices.

Directors emphasized that tackling structural unemployment is a key policy priority. They noted that outsourcing of manufacturing and low-end service sector jobs to the Mainland has reduced the demand for low-skilled workers in Hong Kong SAR. Directors expressed their support for the government's proposed education reforms and its ongoing retraining and skills-upgrading programs. They encouraged the authorities to maintain Hong Kong SAR's labor market flexibility, which has traditionally delivered good outcomes and will help facilitate adjustment to further shifts in the structure of the economy.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with the People's Republic of China—Hong Kong Special Administration Region is also available.

People's Republic of China, Hong Kong Special Administrative Region:

Selected Economic and Financial Indicators

	2000	2001	2002	2003	2004	2005
					Proj.	
Real GDP (percent change)	10.2	0.5	1.9	3.2	8.2	4.0
Real domestic demand (contribution)	9.8	0.9	-0.8	0.0	6.2	3.6
Foreign balance (contribution)	0.4	-0.5	2.7	3.2	2.1	0.4
Inflation (percent change)						
Consumer prices	-3.7	-1.6	-3.0	-2.6	-0.3	1.0
GDP deflator	-6.2	-1.9	-3.6	-5.2	-2.7	1.2
Government budget (percent of GDP) 1/						
Revenue	17.5	13.8	14.2	17.0	18.0	18.5
Expenditure	18.1	18.8	19.2	20.2	19.7	18.7
Consolidated budget balance	-0.6	-5.0	-4.9	-3.2	-1.7	-0.2
External balances (in billions of US$)						
Merchandise trade balance	-8.2	-8.3	-5.1	-5.8	-9.1	-13.0
In percent of GDP	-5.0	-5.1	-3.2	-3.7	-5.5	-7.5
Current account balance	7.1	9.9	12.6	17.0	16.2	16.5
In percent of GDP	4.3	6.1	7.9	10.7	9.8	9.5
Foreign exchange reserves						
Foreign exchange reserves						
(in billions of U.S. dollars, end of period)	107.6	111.2	111.9	118.4	123.5	...
(In months of retained imports)	18.0	20.4	22.6	23.3	25.3	...

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

1/ Fiscal year begins April 1.