

People's Republic of China—Hong Kong Special Administrative Region: 2003 Article IV Consultation—Staff Report; Staff Supplement; 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 2003 Article IV consultation 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 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **February 14, 2003**, 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 23, 2003.** 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.
- a staff supplement of **May 15, 2003** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 16, 2003 discussion** of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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

Staff Report for the 2003 Article IV Consultation Discussions

Prepared by the Staff Representatives for the Consultation Discussions Held in 2003
In Respect of the Hong Kong Special Administrative Region

Approved by Wanda Tseng and Shigeo Kashiwagi

April 23, 2003

- The consultation discussions were held in the Hong Kong Special Administrative Region of the People's Republic of China during February 4–14, 2003. The staff team comprised Mr. Prasad (Head), Ms. Iakova, Ms. Liang, and Mr. N'Diaye (all APD), and Mr. Chan-Lau (ICM). Ms. Tseng (APD) joined the mission during February 11–14. Ms. Brenner (MAE) joined the mission during February 6–14 for FSAP-related discussions. The team was assisted by Mr. Lee (Resident Representative). Messrs. Wei, Wang, and Wong (OED) attended key meetings.
- The mission met with Financial Secretary Mr. Antony Leung, Chief Executive of the Hong Kong Monetary Authority Mr. Joseph Yam, Secretary for Financial Services and Treasury Mr. Frederick Ma, Chairman of the Securities and Futures Commission Mr. Andrew Sheng, and a wide range of other senior government officials, labor unions, and private sector representatives.
- In concluding the last Article IV consultation, the Executive Directors welcomed the authorities' commitment to restore budget balance in the medium term. They emphasized the importance of implementing concrete measures to reverse the rising trend of expenditure as a share of GDP and to strengthen the revenue base. Directors reiterated their support for the authorities' commitment to the linked exchange rate system, noting that its smooth functioning would continue to depend crucially on strong supporting conditions. To take full advantage of opportunities created by the Mainland of China's WTO accession and maintain its status as a leading financial center, Directors observed that Hong Kong SAR would need to strengthen efforts to upgrade the economy's infrastructure and human capital.
- The authorities have indicated their intention, as in the past, to publish the staff report.
- The principal authors of this report are Hong Liang and Eswar Prasad.

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EXECUTIVE SUMMARY

Economic Setting:

Hong Kong SAR faces a challenging macroeconomic environment. While output growth recovered somewhat in 2002 (to 2.3 percent), the unemployment rate remains above 7 percent and deflation has now entered into its fifth successive year. The outbreak of Severe Acute Respiratory Syndrome (SARS) is expected to adversely affect activity in 2003. Assuming that disruptions from SARS are limited to the first half of 2003, and that exports and domestic demand recover in the second half, growth in 2003 could be maintained at 2.2 percent. However, even this outlook is subject to substantial downside risks related to the possible persistence of the adverse effects of SARS and uncertain prospects for recovery in advanced countries. The medium-term outlook depends on how Hong Kong SAR meets the challenges of integration with the Mainland and rising regional competition.

The consolidated fiscal deficit widened to 5.5 percent of GDP in FY2002, a significant slippage relative to the budget target for a second consecutive year, mainly on account of deferred asset sales. The structural fiscal deficit has also widened in recent years due to rising expenditures and a narrowing revenue base. In the FY2003 budget, the authorities reaffirmed their objective of restoring budget balance by FY2006 through a three-pronged approach based on cutting expenditures, increasing tax revenues, and boosting economic growth. Only a small reduction in the deficit, amounting to about 0.2 percent of GDP, is envisaged for 2003, owing to the gradual phasing in of the proposed expenditure and revenue measures.

Key Policy Issues:

Fiscal Policy. The continued deterioration of the fiscal position has made it the main source of potential macroeconomic vulnerabilities. The staff supports the authorities' objective of achieving a balanced budget by FY2006. Forceful implementation of the proposed measures will ensure progress towards this objective and help build market confidence. Additional concrete measures to reduce expenditures will be necessary to achieve successful fiscal consolidation that is consistent with the objective of maintaining a small government. The staff views the introduction of a goods and services tax as the best option to broaden the tax base and stabilize revenues in the medium term.

Exchange Rate Regime. The staff supports the authorities' commitment to the linked exchange rate system, which remains robust. The challenge will be to strengthen the supporting conditions, including sound fiscal and structural policy frameworks, that have underpinned the smooth functioning of the linked exchange rate system.

Medium-Term Structural Issues. The Financial Sector Assessment Program (FSAP) has concluded that the Hong Kong SAR financial system is fundamentally sound and resilient to adverse shocks. To enhance its competitiveness as an international financial center, continued efforts are needed to improve Hong Kong SAR's financial sector infrastructure and legal environment. In addition, for a successful move towards a high-value added services economy, efficient investment in education and expansion of labor retraining programs are required to upgrade the skill level of the labor force.

I. BACKGROUND

A. Recent Developments

1. **The Hong Kong SAR economy has begun to show some signs of recovery from a prolonged cyclical downturn.** The highly open economy experienced a sharp output decline during the Asian crisis. Before sustained growth could take hold, the global slowdown in 2001 brought on another recession. After four quarters of negative or near zero growth, the economy posted average growth of 4 percent (y/y) in the second half of 2002. The recovery has, however, been driven entirely by robust reexports growth on the back of strengthening exports of the Mainland of China. Domestic demand has remained weak: private consumption and investment spending contracted significantly in 2002, reflecting the uncertain economic outlook, high unemployment, and wealth effects associated with the collapse of property prices. Overall, real GDP grew by 2.3 percent in 2002 (Figure 1 and Table 1).

2. **Continuing integration with the Mainland has precipitated major structural changes in the Hong Kong SAR economy.** A shift towards higher value-added services, driven by increased outsourcing of manufacturing and low-end services to the Mainland of China, has contributed to rising structural unemployment. The traditional trade intermediary role of Hong Kong SAR is likely to diminish further as the Mainland of China's trade restrictions are lifted; direct trade relations between Taiwan Province of China and the Mainland of China strengthen; and more foreign businesses set up directly in the Mainland. The proportion of exports from the Mainland of China shipped through Hong Kong SAR has fallen steadily from 67 percent to 34 percent over the period 1993–2002. In addition, exports of trade-related services (comprising mainly offshore trade) have grown much faster than reexports in recent years.

3. **Domestic goods, factor, and asset prices have been undergoing significant downward adjustment.** Consumer price deflation has now entered into a fifth consecutive year, reflecting weak domestic demand, asset price deflation, weak import prices, and other structural factors (Box 1).¹ The consumer price index (CPI) declined by 3 percent in 2002, and by 2 percent in the first quarter of 2003. Property prices have continued to drift downwards since the collapse of the property price bubble, and are now about 60 percent below their peak attained in 1997 (Figure 2). Nominal wage growth has turned negative and real wage growth has moderated (Figure 3). The adjustment in the labor market has partially

¹ The determinants and dynamics of property prices and the overall price level, including the roles of various structural factors in these developments, are examined in the Selected Issues paper.

Box 1. Deflation in Hong Kong SAR

Hong Kong SAR has experienced continued deflation since the last quarter of 1998.

The composite CPI fell by almost 13 percent from the third quarter of 1998 to the last quarter of 2002. About half of this decline is accounted for by the fall in housing costs, following the bursting of the property price bubble in the mid 1990s. Other items that have also contributed significantly to the decline in prices include food, clothing and footwear, and durable goods. Figures for March 2003 indicate that deflation is still continuing as prices fell by 2.1 percent year on year.

Previous research suggests that, although structural factors have played a role, deflation was mainly attributable to cyclical factors. Staff analysis carried out during the 2002 Article IV Consultation suggested that fluctuations in unemployment, nominal credit and the nominal effective exchange rate, which were considered as cyclical variables, may have been the main determinants of the decline in prices (IMF Country Report, No 02/99, Chapter III). This result implies that, as these cyclical factors turn around, deflation would end. Research by the Hong Kong Monetary Authority (HKMA) arrived at similar conclusions (HKMA Research Memoranda, November 2001).

However, the persistence of deflation into a fifth successive year suggests that structural factors are playing an increasingly important role. A more comprehensive analysis carried out by staff has identified changes in the relative importance of different factors underlying the origins and the persistence of deflation.¹ The study concludes that temporary shifts in aggregate demand, i.e., cyclical factors, may indeed have triggered the process of deflation. However, the effects of these factors on deflation have been perpetuated by the negative wealth and balance sheet effects in the corporate and household sectors arising from asset price declines over the past five years. In addition, price convergence with the Mainland of China has become more important over time in explaining the deflationary process.² These results illustrate that, in Hong Kong SAR, “temporary” shocks could have prolonged effects on deflation because of the important effects of asset prices on consumption and investment. Moreover, additional negative shocks could magnify the risks of continued deflation over the medium term.

¹ This analysis is described in detail in the Selected Issues paper.

² Recent research by the HKMA indicates that price convergence with the Mainland has indeed contributed to the deflationary process in Hong Kong SAR (HKMA Research Memoranda, June 2002).

taken place through a reduction in employment in certain sectors; and the unemployment rate, although declining from its record high level in mid-2002, has remained above 7 percent (Box 2). The CPI-based real effective exchange rate has depreciated by around 19 percent since June 1998.²

4. **The structural weakening of the fiscal position has been exacerbated by cyclical factors, including declining asset-related revenues.** Hong Kong SAR had traditionally conducted a conservative fiscal policy, resulting in the accumulation of sizable fiscal reserves. However, the fiscal position has deteriorated gradually since 1998, and substantial structural deficits have emerged (Table 2). In last year's budget, the government announced the goal of eliminating the fiscal deficit by FY2006, but few specific measures were outlined. The consolidated fiscal deficit reached 5½ percent of GDP in FY2002 (April–March), relative to a budget target of 3½ percent of GDP. Although this slippage was largely due to deferred asset sales, it resulted in a higher than budgeted headline deficit for a second consecutive year. Market reaction to these developments has been negative. In October 2002, the S&P rating agency changed Hong Kong SAR's long-term currency outlook from "stable" to "negative," citing the large budget deficits as the main concern. Hong Kong dollar forward rates rose slightly in September 2002, but have since declined (Figure 4).

5. **Financial market activity weakened in 2002, reflecting the slowdown of the economy.** Bank credit declined further in 2002 despite lower interest rates and ample liquidity (Figure 4). Both demand and supply conditions played a role as firms have delayed investment, and banks have adopted a more cautious approach to corporate lending. The best lending rate is now at 5 percent, and deposit rates are close to zero. As of end-March 2003, the Hang Seng Index has declined by 24 percent since end-2001.

B. Outlook and Risks

6. **Real GDP is expected to grow by 2.2 percent in 2003, but the near-term outlook is subject to significant uncertainties and downside risks.** The economy has been hard hit by SARS in the second quarter of 2003, with indications that tourism has collapsed and retail sales have declined sharply. The baseline projection assumes that the outbreak of SARS will be brought under control relatively quickly and result in only a temporary decline in activity in the first half of the year. Renewed strength in external demand, supported by robust growth in the Mainland, should enable a gradual recovery of domestic demand in the second half of the year. CPI deflation is projected to ease to 2 percent in 2003 as the one-off effects of administrative factors dissipate, but weak property prices, high unemployment, and other structural factors are likely to continue to dampen both domestic demand and the overall level of prices. The external current account is expected to record further sizable surpluses

² Alternative measures of real effective exchange rates also suggest significant improvements in competitiveness over this period (see HKMA *Quarterly Bulletin*, 3/2003).

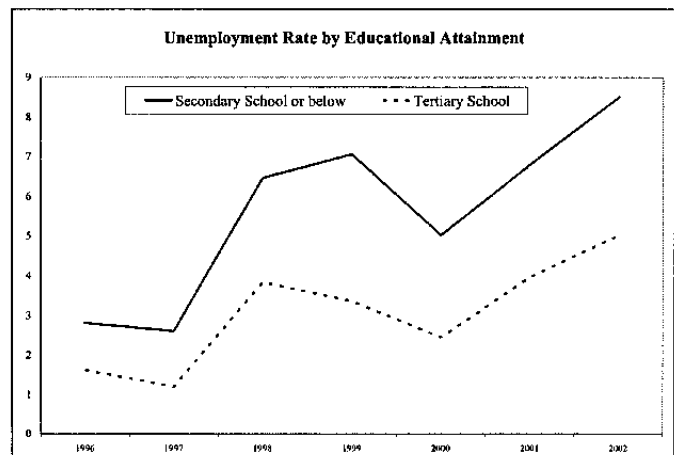
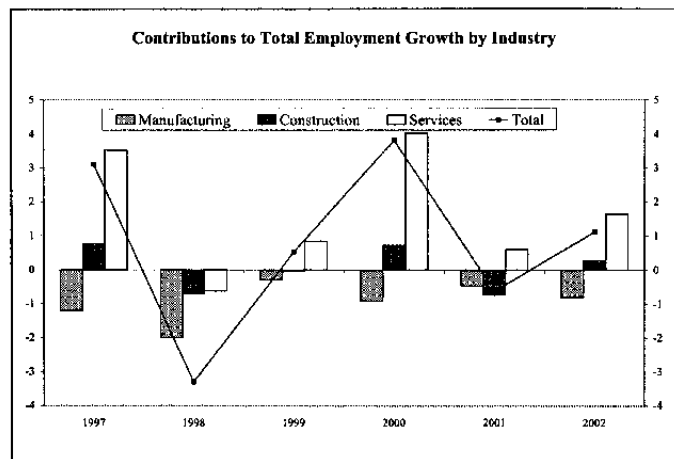
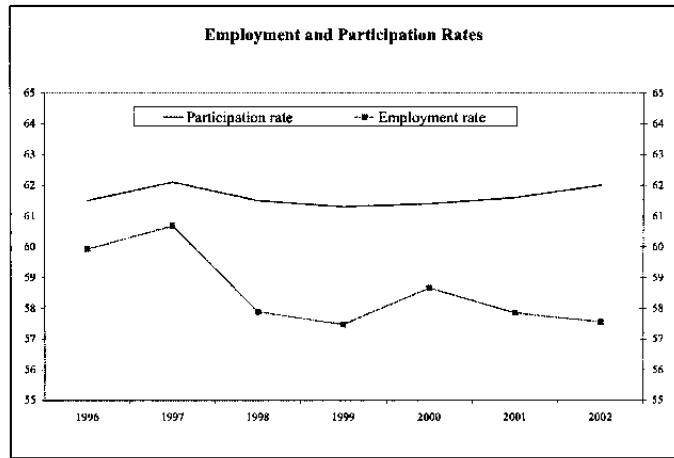
Box 2. Labor Market Developments

Hong Kong SAR's unemployment rate has increased markedly in recent years. From less than 3 percent in 1996, the seasonally adjusted unemployment rate reached 7.5 percent in March 2003 (Figure 3). With a relatively stable participation rate, the decline in the employment-population ratio reflects primarily the deterioration in labor market conditions in the manufacturing and construction sectors.

The increase in unemployment is partly related to the ongoing labor reallocation from the manufacturing to the services sector. Of the 0.5 percent average growth in total employment over the period 1997Q2–2002Q4, the manufacturing sector accounted for -1.1 percent while services contributed 1.6 percent. Over the last two years, most of the deterioration in total employment is the result of declining manufacturing sector employment.

The burden of labor market adjustment has fallen mainly on low-skill workers. The unemployment rate for workers with low levels of education reached 8.5 percent in the third quarter of 2002, an increase of 5.7 percentage points since 1996. The gap between the unemployment rates of skilled and unskilled workers has widened since 2000.

The structural unemployment rate has also increased. Staff estimates suggest that the structural unemployment rate increased from 3 percent at the end of 1996 to about 4.5 percent in the last quarter of 2002 (Figure 3). This rise in structural unemployment reflects changes in the structure of employment and production, labor reallocation, and the increase in the relative demand for skilled labor. There are signs of increases in the share of long-term unemployment. The median duration of unemployment increased from 72 days in 1996 to 87 days in 2002.



in 2003.³ This outlook is subject to considerable downside risks. Prospects for the rapid containment of SARS remain uncertain; persistence of the adverse effects of SARS could seriously weaken the economy. In addition, further weakening of growth prospects for advanced economies could affect Hong Kong SAR's export performance.

7. **The medium-term outlook depends on how Hong Kong SAR meets the challenges of integration with the Mainland and rising regional competition.** In the near term, increased trade and investment between the Mainland of China and the rest of the world should benefit Hong Kong SAR and support the vibrancy of its financial and professional services, logistics, and tourism sectors. However, increasing competition from other regional financial centers and rising direct trade linkages between the Mainland and other economies could reduce the need for Hong Kong SAR-based intermediation services. To meet these challenges, Hong Kong SAR's traditional strengths—flexible markets and strong legal and institutional frameworks—will need to be complemented by sound macroeconomic and structural policies.

II. REPORT ON THE DISCUSSIONS

8. **There was broad agreement on the assessment of the economic situation, the associated risks, and policy requirements.** The authorities and the staff concurred that the top policy priority was to address the continued deterioration of the fiscal position. The authorities also agreed with the staff that appropriate structural policies were needed to meet the medium-term challenges, including those arising from rising integration with the Mainland, and to enhance Hong Kong SAR's long-term growth potential. The main challenge lies in the implementation of the necessary policies in a weak macroeconomic environment, coupled with difficulties in reaching political consensus on deficit reduction measures. On the structural policy front, the authorities have already taken a number of steps to strengthen Hong Kong SAR's financial sector infrastructure and upgrade the skill level of the labor force.

A. Fiscal Policy and the Linked Exchange Rate System

9. **The continued deterioration of the fiscal position has made it the main source of potential macroeconomic vulnerabilities.** The structural budget balance (excluding land premium, asset-related receipts, equity injections, and cyclical effects) has deteriorated significantly over the last four years (Figure 5). Government expenditure has grown rapidly in real terms, in part because major spending components such as civil service salaries and welfare benefits have not been adjusted for recent deflation. Revenues have been dampened by a set of reductions in various fees and charges intended to cushion the impact of the economic slowdown. Direct tax revenues have been weakened as businesses increasingly invest abroad, since only Hong Kong SAR-based profits are subject to tax. The consolidated

³ Standard vulnerability indicators (Table 3) suggest that the near-term risks of an external financial crisis in Hong Kong SAR are quite limited.

budget deficit has also widened sharply since 2001, as revenues from land leases and investment income have fallen markedly. Staff analysis shows that, in the absence of corrective measures, fiscal deficits in the range of 6–7 percent of GDP per annum could lead to a depletion of fiscal reserves by FY2006 (Annex I).⁴

10. The authorities recognized the urgent need to tackle the fiscal deficit and, in the FY2003 budget proposed in early March, reiterated their commitment to achieving budget balance by FY2006 (Box 3). The targeted consolidation amounts to HK\$70 billion (5½ percent of GDP).

- Expenditure cuts are to contribute HK\$20 billion (1½ percent of GDP) toward fiscal consolidation. Identified measures, mainly downsizing and wage reductions in the civil service, are expected to yield a cost savings of HK\$13.6 billion.
- Revenue measures are projected to yield HK\$20 billion (1½ percent of GDP) over the medium term, the bulk of which (HK\$14 billion) has been identified through specific measures such as increases in tax rates on profits and salaries.
- A recovery in growth is expected to generate the additional revenue needed to close the budget gap (HK\$30 billion or 2½ percent of GDP).
- The government has ruled out issuing debt as a financing option. Consequently, fiscal reserves will be drawn down to finance the deficits in the next few years.

11. The staff supported the government’s objective of balancing the budget by FY2006, but emphasized that it needed to be underpinned by a well-specified and credible deficit reduction plan. In light of the substantial deviations from budget targets in the past two years, the staff argued during the mission (prior to the outbreak of SARS) that significant steps toward fiscal consolidation had to begin in FY2003 to rebuild market confidence. Although domestic demand remains weak, the effectiveness of fiscal policy in supporting economic activity is in any case limited by the openness of the economy.⁵ The authorities agreed with the staff that front-loading, in the sense of putting in place necessary revenue and expenditure measures, would be important for achieving the medium-term

⁴ A government task force on the Review of Public Finances reported in February 2002 that, with unchanged policies, fiscal reserves would be exhausted by FY2008. The staff’s estimation uses similar revenue and expenditure assumptions, but takes into account more recent data on fiscal developments and GDP growth. The fiscal outlook and policy options are examined in more detail in the Selected Issues paper.

⁵ According to the authorities’ calculations, the tax multiplier is only 0.4 and the expenditure multiplier is 0.6 (HKMA, *Quarterly Bulletin*, 2/2000).

Box 3. Fiscal Policy and Medium-Term Outlook

Institutional Background

The Basic Law, Hong Kong SAR's de facto constitution, in principle limits the scope for discretionary fiscal policy. It requires that the Government strive to avoid deficits; keep expenditure growth commensurate with the growth rate of nominal GDP; keep taxes low, benchmarked to the rates prevailing in 1997; and maintain the status of Hong Kong SAR as a free port (i.e., no import tariffs).

Fiscal Structure

Hong Kong SAR's public finances have the following features: (1) the tax burden is low (9 percent of GDP) and the tax system is simple; (2) the tax base is narrow, with no general consumption taxes or any duty on imports, and a majority of the working population is outside the tax net; (3) nontax revenues, mainly from proceeds of land sales and investment income, account for half of total revenue; (4) education (24 percent of total government expenditure in FY2001) and health (14 percent) are the two major areas of public spending, while the corresponding fees and charges are low; and (5) welfare spending (13 percent) has more than doubled over the past decade, reflecting expanding assistance to the elderly, immigrants from the Mainland of China, and the unemployed. In addition, the public sector wage bill accounts for about one-third of total government expenditure.

Policy Response

The government recognizes that structural pressures could threaten the long-term health of the public finances. In February 2002, a government Task Force on Public Finances found rising structural deficits in recent years primarily owing to (1) lower revenues from land sales and taxes, (2) falling investment income, and (3) the government expenditure deflator rising faster than the general price level. It concluded that, in the absence of corrective measures, continued sizable deficits would lead to a depletion of fiscal reserves and eventually move the government into a net debtor position. To ensure medium-term sustainability, the Task Force advised that priority 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 that a low-rate goods and services tax (GST) would be the best choice for broadening the tax base.

In the FY2003 budget, the government reiterated its commitment to return to a balanced budget by FY2006. The government proposed to achieve the targeted fiscal consolidation of HK\$70 billion (5.5 percent of GDP) through a three-pronged approach based on cutting expenditures, increasing tax rates, and boosting economic growth.

Expenditures: The target for expenditure reductions by FY2006 is set at HK\$20 billion (which would amount to a 10 percent reduction in total expenditures). The specific measures that have been proposed so far amount to about HK\$13.6 billion, including a 6 percent cut in the public sector wage bill, a reduction of 11.1 percent in welfare benefits, and a 10 percent cut in the size of the civil service workforce.

Revenue: The revenue target is also set at HK\$20 billion to be achieved by FY2006. Measures for raising HK\$14 billion in additional revenues, mainly through increases in rates of profits and salaries taxes, have been proposed in the FY2003 budget. The government indicated that additional revenue measures of HK\$6 billion would be proposed in the medium term to achieve the revenue target. It has also declared that a GST is essential for broadening the tax base and stabilizing public revenues in the long term, but has noted that the current weak macroeconomic environment precludes its introduction in the short term.

Economic Growth: Nominal GDP growth averaging 3 percent annually over the next four years is projected to yield HK\$30 billion in additional revenue.

The government has ruled out issuing debt as a financing option. Consequently, fiscal reserves will have to be drawn down to finance the deficits in the next few years. The Budget indicates that last year's objective of holding reserves equal to 12 months of expenditures will no longer be pursued (instead, reserves will be maintained at a level of nine to ten months of expenditures).

target. However, they noted that measures such as reductions in public sector wage rates and downsizing of the civil service establishment could only be phased in gradually. As a result, the planned deficit reduction in FY2003 would be limited to 0.2 percent of GDP.⁶ In the event, higher expenditures on health services and temporary fiscal measures being considered by the authorities in response to the recent outbreak of SARS are likely to render it infeasible to achieve even this modest deficit reduction target.

12. **Successful fiscal consolidation that is consistent with the objective of maintaining a small size of government will require significant cuts in expenditures.** The target of reducing expenditures by HK\$20 billion by FY2006 poses difficult political challenges.⁷ The proposed expenditure measures in the FY2003 budget need to be fully implemented, and additional measures may be needed to achieve this target.

- **The authorities recognize that reducing the public sector wage bill, which accounts for a substantial share of current expenditures, will have to constitute a key component of deficit reduction.** The staff recommended that civil servants' compensation be rationalized, and that the Pay Level Review be completed expeditiously to facilitate this process. In addition, de-linking the pay scales for employees in government-funded organizations from those of the civil service would help reduce wage rigidities in the public sector. In the 2003 Policy Address, the authorities announced that the civil service establishment would be reduced by 10 percent by FY2006 through normal attrition and voluntary early retirement. In addition, the authorities have recently reached an agreement with civil service unions to reduce salaries by 6 percent over the next two years, and have announced that the Pay Level Review will be completed by 2004.⁸
- **The staff noted that major changes are needed in the financing of health and education services,** particularly since expenditures on these services will come under increasing pressures from demographic trends and the need to upgrade the education system to remain competitive. The authorities have started to increase user fees, and have taken initiatives to promote greater private sector participation in the provision and financing of these services. The staff suggested that these measures could be

⁶ However, the budget implies that the structural deficit would increase by 1 percent of GDP in FY2003. The IMF's definition of the structural deficit excludes asset-related revenues (land sales, privatization revenues, investment income), which have traditionally constituted an important component of total revenues in Hong Kong SAR. The FY2003 budget envisages an increase of 1.4 percent of GDP in total expenditures but an increase of only 0.4 percent of GDP in non-asset-related revenues.

⁷ For instance, the 4.75 percent average civil service pay cut assumed in the FY2002 budget speech met with strong opposition and was implemented only half-way.

⁸ The pay reduction, which will restore civil service pay to the levels as of June 1997, applies to civil servants as well as public officers whose pay is related to civil service pay scales.

strengthened further and, in particular, noted the need for better distribution of spending among different levels of education with more resources allocated towards basic education.

- **The authorities have begun restructuring the Comprehensive Social Security Assistance (CSSA) program to enhance the affordability and effectiveness of the safety net.** The staff supported the proposed welfare reform measures, including adjustments of welfare benefit levels to account for recent deflation, programs to facilitate reemployment of able-bodied individuals, and outsourcing of direct services to the private sector.

13. **Substantive measures will be required to broaden the tax base and stabilize revenues in the medium term.** While a pickup in economic activity may generate some recovery in revenues, the effects are likely to be modest since traditional revenue sources are coming under increasing pressure—in particular, revenues from land leases are likely to remain low due to weaknesses in the property market.

- In the FY2003 budget, the authorities proposed several measures to increase revenue by HK\$14 billion over the medium term and indicated that other measures would soon be introduced to meet the target of increasing revenue by HK\$20 billion by FY2006.
- The staff suggested that a low rate goods and services tax (GST) would be the best option to broaden the tax base and to generate the additional revenues needed to achieve the medium-term fiscal objective. Given the long lead time required for its implementation, preparation for its introduction would need to start soon.⁹ The authorities broadly agreed with the staff's analysis, and signaled a shift in attitude towards the GST by declaring it a measure essential for broadening the tax base and stabilizing public revenues in the long term. However, they noted that the current circumstances of weak growth, persistent deflation, and a worsening income distribution were not propitious for the introduction of a GST.

14. **The authorities are firmly committed to the linked exchange rate system, which remains robust.** However, the recent weak growth performance, as well as continued downward adjustment in property prices and the CPI, have prompted some public discussion about the appropriateness of the linked exchange rate system. The authorities have reiterated their commitment to the link, noting that it has been the centerpiece of the “one country, two

⁹ The staff presented two alternative fiscal consolidation paths to illustrate the implications of not having a GST in the medium term (Annex I). In the absence of a GST and revenue measures other than those identified in the FY2003 budget, the expenditure to GDP ratio would have to be cut from its current level of 20 percent to 15 percent by FY2006 in order to reach a balanced budget. On the other hand, if a GST of 3 percent was implemented in FY2005, expenditure cuts could be less severe.

systems” rules-based governance model, and has underpinned confidence in Hong Kong SAR as a stable financial center. Staff emphasized their support for the authorities’ commitment to the linked exchange rate system and noted that Hong Kong SAR’s external position remains very strong. Staff also observed that further adjustments in goods and factor prices may be needed as integration with the Mainland deepens and regional competitive pressures continue to intensify.¹⁰ The authorities and staff concurred that prudent fiscal policies, a sound financial system, and improved flexibility of goods and factor markets were crucial to ensure the long-term sustainability of the linked exchange rate system and to enhance its contributions to economic growth.

B. Structural Policies

Financial Sector

15. **As discussed in the accompanying Financial System Stability Assessment (FSSA), the FSAP analysis confirms that the Hong Kong SAR financial system is resilient and fundamentally sound (Box 4).** The banking system is well capitalized and profitable; stress tests indicate that banks are well positioned to absorb the effects of a range of macroeconomic shocks without systemic consequences. The staff noted that an increasingly competitive banking environment and ample liquidity could spur a search for new activities and products that may overstretch the risk management capabilities of small banks. The authorities agreed with the staff that increased supervisory vigilance was warranted to ensure that higher risk taking would not reduce the resilience of the banking system. They also concurred with the staff that, as banks and other financial institutions expanded the scope of their businesses both domestically and overseas, there was a need for enhanced supervisory coordination among regulators of the banking, insurance, and securities industries, and cross-border supervisory coordination.

16. **The regulatory and supervisory systems are well developed but could be further strengthened to deal with systemic and financial stability issues.** The authorities are cognizant that Hong Kong SAR needs to upgrade continuously its financial sector infrastructure and legal environment to maintain its competitiveness as an international financial center. The new Securities and Futures Ordinance is a major achievement in modernizing the securities legislation and enhancing investor protection, transparency, and regulatory oversight. The staff endorsed the government’s plan to introduce legislation to provide statutory powers for the oversight of important payment systems in line with the

¹⁰ It is difficult to construct comprehensive measures of external competitiveness for Hong Kong SAR due to lack of adequate data for some of its major trading partners (e.g., the Mainland of China). Rough indicators such as the CPI-based real effective exchange rate suggest that competitiveness has improved since 1998 but remains below the levels of the early 1990s.

Box 4. Findings of the Financial Sector Assessment Program

Overall, the assessment confirms that the Hong Kong SAR financial system is robust and fundamentally sound.

Hong Kong SAR's financial system has shown resilience in the midst of recent international financial crises and during the domestic cyclical downturn. While some improvements in financial sector supervision and regulatory governance arrangements are recommended, no immediate issues of systemic instability are apparent.

Financial markets are well-developed, liquid, and efficient. The banking system, in particular, is well capitalized and profitable. However, weak demand for corporate loans and declining interest rate margins on mortgage loans are driving banks, even smaller ones, to expand into investment banking, securities brokerage, insurance brokerage, and asset management services. Linkages of the banking sector with the capital markets and insurance sectors are growing, motivating enhanced supervisory coordination among regulators of the banking, insurance and securities industries. This also highlights the need to strengthen legislation related to regulatory and insolvency procedures for financial conglomerates. The recently established Mandatory Provident Fund will help to develop the local capital market, but faces structural challenges stemming from its low current returns and a projected income replacement rate that is within international norms, but that depends on maintaining the present contribution rates, long service in the system, and nonwithdrawal of funds upon separation.

The assessment finds that the necessary regulatory infrastructure is in place to support the efficient functioning of financial markets. Nevertheless, governance of the securities settlement system (SSS) would benefit from greater stakeholder participation. As with the SSS for securities transfer, the payments system would also benefit from approval of pending legislation to ensure finality of settlements in funds transfer. In the area of corporate governance, fostering wider shareholder participation would help ensure equitable treatment of minority shareholders, especially in view of the concentrated ownership structures. The Report by the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure, released in March 2003, has made a number of recommendations to strengthen the regulatory structure. The government broadly considers the recommendations to be appropriate and is currently reviewing them. It is also reviewing the feasibility of transferring the listing function from Hong Kong Exchanges and Clearing to the Securities and Futures Commission (SFC). Prompt approval of these proposed changes would clarify regulatory roles and strengthen enforcement in oversight of the equities market. The accounting and auditing professions and practices are adequate to support a market-based financial system; emphasis should be placed on improved corporate disclosure requirements and enhanced disciplinary procedures in cases of professional misconduct.

The supervisory framework in Hong Kong SAR, which is well developed by international standards, is evolving rapidly from a regulatory compliance focus toward addressing prudential and market conduct issues, and comprehensively assessing financial intermediaries' risk management capabilities and contingency plans. Coordinated supervisory contingency planning, stress testing, and the use of early-warning indicators are welcomed recent developments. The SFC and the HKMA have developed effective information-sharing arrangements, including with foreign regulators and offshore centers. Oversight and regulation of the life insurance sector has been strengthened but may still pose some risks related to excessive supervisory reliance on actuaries and self-regulatory organizations. Data collection could be further improved to enable better assessment of market risk and profitability of the life insurance sector.

The assessment recommends further strengthening of regulatory governance arrangements dealing with systemic and financial stability issues. Cross-sector and system-wide regulatory responsibilities can be better clarified and made public, the monitoring of factors affecting financial stability can be strengthened, and the collection of data on a system-wide basis can be improved. The transparency of institutional and policy frameworks for financial and systemic stability could be further enhanced by publishing the Terms of Reference of the high-level Council of Financial Regulators, and by formalizing accountability and disclosure procedures in dealings between the Chief Executive of Hong Kong SAR and the Financial Secretary.

Hong Kong SAR has largely put in place a framework for Anti-Money Laundering and Combating the Financing of Terrorism that is in accordance with the Financial Action Task Force (FATF) recommendations. The banking, securities, and insurance authorities have issued guidelines on the prevention of money laundering since enactment of the anti-money laundering legislation in 1989, with a number of subsequent revisions. Recently, the authorities have issued for industry consultation proposed supplements, primarily aimed at updating existing guidelines to reflect legislative changes and/or to conform with international standards set out by the Basel Committee and with certain recommendations currently under review by the FATF.

FSAP recommendations. The authorities have also taken steps to upgrade the regulatory framework in the area of corporate governance, as well as to enhance accounting and auditing standards. The staff welcomed these efforts, and recommended that priority be given to reform of the equity market regulatory system in order to clarify regulatory roles and strengthen enforcement (notably in the area of delisting).¹¹ The staff also welcomed the authorities' plan to introduce a deposit protection scheme, which should help enhance the stability of the banking system. In addition, the establishment of a consumer credit reference agency should improve banks' capacity for risk-based lending.

Labor Market

17. **The labor market is generally flexible but structural shifts have imposed significant adjustment costs and resulted in rising income disparities.** Employment opportunities for low-skilled workers have diminished as manufacturing and some service sector jobs have been outsourced to the Mainland. Changes in the structure of production and the resulting inter-sectoral reallocation of labor have increased structural unemployment. The staff suggested that, while social assistance programs serve a useful purpose in aiding unemployed workers and facilitating labor reallocation, some restructuring of these programs may be required to mitigate potential disincentive effects. In particular, the high replacement ratio and indefinite length of benefits could dissuade able-bodied individuals from actively seeking reemployment, and may have contributed to rising long-term unemployment. The authorities agreed that, to remain competitive and move successfully to a high-value added services economy, Hong Kong SAR will need to increase the supply of skilled labor. They noted that a number of steps have already been taken to foster more efficient investment in education (including support for private provision of education) and expand labor retraining programs. They have also proposed to ease restrictions on the entry of professionals from the Mainland of China.

Land and Housing Policy

18. **The authorities launched a package of measures in November 2002 with a view to stabilizing the property market.** These include the move towards a more transparent and market-oriented auction mechanism for land sales and the cessation of the supply of residential units through the Home Ownership Scheme (Box 5).¹² The staff welcomed these

¹¹ The government has indicated that it would continue to review the relationship between Hong Kong Exchanges and Clearing (HKEx) and the Securities and Futures Commission (SFC), including possible transfer of the listing function from HKEx to the SFC. The Report by the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure, released in March 2003, has also urged the government to reduce its involvement in HKEx.

¹² The government owns all the land in Hong Kong SAR, and sells long-term leases. About half of the population lives in government-provided or subsidized housing.

Box 5. Property Market Developments

Prices in the property market have been declining steadily since 1997 (which marked the peak of the property price bubble), owing to the weak performance of Hong Kong SAR's economy, overbuilding, and, possibly, increased integration with the Mainland of China. This box describes recent developments in the property market and reviews policy measures taken in 2002.

During 2002, the low interest rate environment prompted a significant pickup in primary market transactions in the **residential sector**. However, aggressive sales tactics including price cuts, cash rebates, and developer-provided subsidies have kept downward pressure on prices. Econometric analysis by the staff suggests that current housing prices are approximately consistent with fundamental factors, including real disposable income growth as well as rental and mortgage rates.¹ However, future prospects remain uncertain unless the economic recovery strengthens significantly.

In the **office market**, excess vacant office space and weak business demand contributed to a pronounced decline in rental rates for office space. Vacancy rates currently stand at 10 percent, well above the 4 percent average vacancy rate in the pre-Asian crisis period. In the **retail sector**, increased tourism spending, especially by tourists from the Mainland of China, has helped to offset faltering domestic consumption and kept rental rates for retail space from falling as fast as those in the office sector. Short-term prospects for both of these sectors are likely to be adversely affected by the outbreak of SARS.

The government has been actively involved in reducing the **supply of subsidized housing** and encouraging private ownership since 1998. Two important measures supporting these objectives were implemented recently. In November 2002, the Hong Kong Housing Authority announced that it would end the construction and sale of flats under the Home Ownership Scheme (HOS) from 2003 onwards. In January 2003, the government implemented the new Home Assistance Loan Scheme (HALS). The scheme provides no-interest loans to low income families for purchasing private residential units. The scheme replaces both the Home Purchase Loan Scheme (HPLS) and the Home Starter Loan Scheme (HSLs); the main differences are the lowering of the maximum household income ceiling to be eligible, and the reduction of the maximum loan amount, the latter reflecting the decline in residential prices.

Two other important measures were also announced in November 2002. The first measure affects the **land allocation process**. Starting in 2004, land leases will be auctioned only through the Application List system, thereby enhancing transparency in the allocation mechanism. This and the two measures discussed above will reduce direct government intervention in the land and property markets.

The second measure suspends **land sales** temporarily until end-2003, and affects both land sales by the government through the Application List, and land tenders from the two railway operators, Mass Transit Railway Corporation (MTRC) and the Kowloon-Canton Railway Corporation (KCRC). While it may contribute to stabilizing the property market in the near term, this measure could also increase uncertainty about the nature of the government's future role in the property market.

¹ See the Selected Issues paper for further details.

reforms that would reduce direct government intervention in the land market and put in place better targeted and more efficient housing subsidy schemes. However, the staff cautioned that steps such as the suspension of land sales until end-2003 could generate some uncertainty about the nature of the government's future role in the property market. The authorities acknowledged this risk but noted that this suspension was a one-off temporary measure that could be justified by extraordinary circumstances.

Competition Policy

19. **The authorities have maintained that a sector-specific approach is effective in fostering a competitive environment.** In its recent Trade Policy Review, the World Trade Organization (WTO) expressed concern that high firm concentration in certain sectors, and the absence of a comprehensive competition law, may hinder business investment by local and foreign firms. The staff recommended continued close attention to competition issues in unregulated sectors, especially in the absence of a general competition law. The authorities noted that, while remaining committed to the sector-specific approach to competition policy, they were also keeping a close watch on possible anti-competitive behaviors, with a view to ensuring fair competition in the nonregulated sectors and introducing additional sector-specific measures to promote competition if necessary.

C. Other Issues

20. **Hong Kong SAR continues to maintain one of the most liberal trade regimes in the world.** It is intensifying discussion with the Mainland on the Closer Economic Partnership Arrangement (CEPA), with a view to reaching agreement on some key issues by June 2003. The authorities noted that, as the Mainland of China opens up to meet WTO accession commitments, CEPA would give Hong Kong SAR's services sectors and other businesses a head start in their expansion into the Mainland market.

21. **The authorities produce and disseminate a comprehensive set of economic statistics.** Hong Kong SAR provides data to the IMF on a timely basis for surveillance and publication, and is fully compliant with the IMF's Special Data Dissemination Standards (SDDS). Starting in June 2002, the authorities have published data on the international investment position and gross external debt. In August 2002, the authorities started publishing production-based quarterly real GDP estimates to supplement the existing expenditure-based GDP estimates. The authorities indicated that they were on track to provide the IMF with accrual-based fiscal data in accordance with the new Government Finance Statistics (GFS) manual in November 2003.

III. STAFF APPRAISAL

22. **Hong Kong SAR faces a challenging macroeconomic and external environment.** The outbreak of SARS could undermine the fragile recovery, although real GDP growth could be maintained at just over 2 percent in 2003, assuming a revival in exports and domestic demand in the second half of the year. There are significant downside risks related to uncertain prospects for the global economic recovery and the containment of SARS. In the medium term, Hong Kong SAR's prospects will depend on how best it meets the challenges of growing integration with the Mainland and rising regional competition. Prudent

macroeconomic management and sound structural policies are needed to buttress Hong Kong SAR's traditional strengths that include flexible product and labor markets as well as strong legal and institutional frameworks.

23. The main policy priority is to address the continued deterioration of the fiscal position. Such large and persistent fiscal deficits could undermine the long-term sustainability of the public finances and the stability of the linked exchange rate system. The staff supports the authorities' objective of achieving a balanced budget by FY2006. In view of weaknesses in the macroeconomic environment that have been exacerbated by SARS, significant retrenchment of the consolidated fiscal deficit would not be feasible or appropriate in FY2003. However, in order to build market confidence and to enable progress toward medium-term fiscal consolidation, it will be essential to put in place the proposed revenue and expenditure measures in an expeditious manner. These measures, which are to be phased in gradually, would lead to significant reductions in the deficit beginning in FY2004. Additional measures may be needed to achieve the medium-term objective, especially if growth turns out to be weaker than assumed in the budget projections.

24. Significant cuts in expenditures will be required for successful fiscal consolidation that is consistent with the objective of maintaining a small size of government. The authorities' proposals to reduce the public sector wage bill will, if fully implemented, result in substantial progress in this direction. Completing the Pay Level Review expeditiously and de-linking the pay scales for employees in government-funded organizations from those of the civil service would help reduce wage rigidities in the public sector. The initiatives to increase private sector participation in the financing and provision of health and education services are to be commended, and could be strengthened further. The staff also supports the proposed welfare reforms that would enhance the affordability and effectiveness of the social safety net.

25. Broad-based and stable revenue sources need to be developed to achieve the medium-term fiscal objective. The revenue measures proposed in the FY2003 budget will be essential to complement expenditure measures in making progress toward fiscal consolidation. However, traditional revenue sources, including revenues from land sales, are likely to remain volatile and come under increasing pressure. The best option for strengthening the revenue base and reducing its volatility in the medium term would be the introduction of a GST. Since Hong Kong SAR has very low effective tax rates, a low rate GST is unlikely to affect its status as a low-tax jurisdiction that has enhanced its attractiveness as an international financial center. Given the long lead time required, technical preparations for the implementation of a GST will need to get underway soon.

26. The staff supports the authorities' commitment to the linked exchange rate system, which remains robust. Hong Kong SAR's external position continues to be strong—the current account is in sizable surplus, there is no net external debt, and foreign

exchange reserves are at high levels. Successful implementation of fiscal consolidation and other structural measures would strengthen the supporting conditions that enable the economy to fully derive the benefits of a stable exchange rate.

27. **The financial system remains resilient and fundamentally sound, and is supported by a strong financial stability framework.** The banking system remains well capitalized and profitable, notwithstanding the recent economic downturn. However, the profitability of banks, especially the smaller ones, could be eroded if weaknesses persist in overall economic activity and the property market. With shrinking profit opportunities in traditional lending, vigilance is needed to ensure that higher risk taking does not undermine the banks' resilience to shocks. Enhanced supervisory coordination among regulators of the banking, insurance, and securities industries is also called for as banks and other financial institutions expand the scope of their businesses.

28. **Continued efforts to upgrade Hong Kong SAR's financial sector infrastructure and legal environment will enhance its competitiveness as an international financial center.** The staff commends the enactment of the Securities and Futures Ordinance, and endorses the government's plan to introduce legislation to provide statutory powers for the oversight of important payment and settlement systems. Also welcome are recent initiatives to upgrade the regulatory framework in the area of corporate governance, as well as to enhance accounting and auditing standards. Prompt approval of the proposed reforms to the equity market regulatory system would help clarify regulatory roles and strengthen enforcement. The staff also commends the authorities for having put in place a framework for Anti-Money Laundering and Combating Financing of Terrorism that is largely in accordance with the FATF recommendations.

29. **Structural changes have contributed to pressures in the labor market and rising income disparities.** The staff supports the government's efforts to address these issues by improving the skills of the labor force through better education (including support for private provision of education) and expansion of labor retraining programs, and by providing well-targeted social support to the needy. However, some restructuring of the CSSA program is needed to mitigate disincentive effects to work that may have contributed to rising long-term unemployment. The staff welcomes the proposed changes in immigration policy that will ease restrictions on the entry of professionals from the Mainland.

30. **Recent reforms to land and housing policies are welcome steps towards reducing direct government intervention in the housing and land markets.** However, frequent changes in policy, such as the temporary suspension of land sales, could create uncertainty about the nature of the government's future role in the property market and hinder the effective stabilization of property prices in the short run.

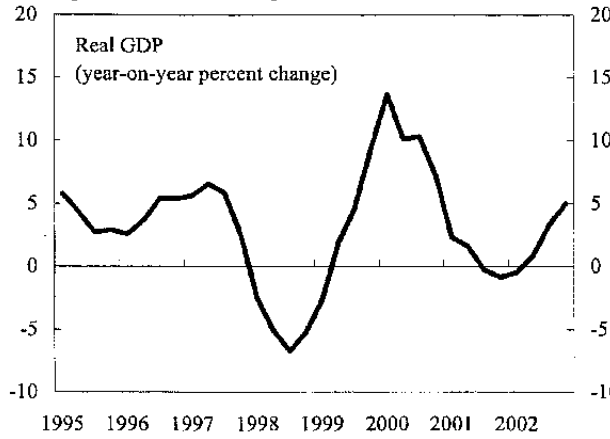
31. **Hong Kong SAR produces and disseminates a comprehensive set of economic statistics.** The staff commends its full compliance with the IMF's Special Data Dissemination Standards, as well as the publication, since June 2002, of data on the

international investment position, gross external debt, and production-based quarterly real GDP estimates. The staff also looks forward to the presentation of accrual-based fiscal data for Hong Kong SAR in accordance with the GFS manual in November 2003.

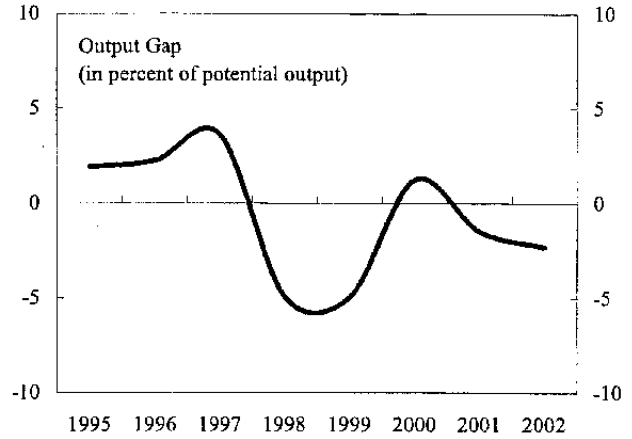
32. It is recommended that the next Article IV consultation with the People's Republic of China in respect of Hong Kong SAR take place on a 12-month cycle.

Figure 1. Output and Demand, 1995-2002

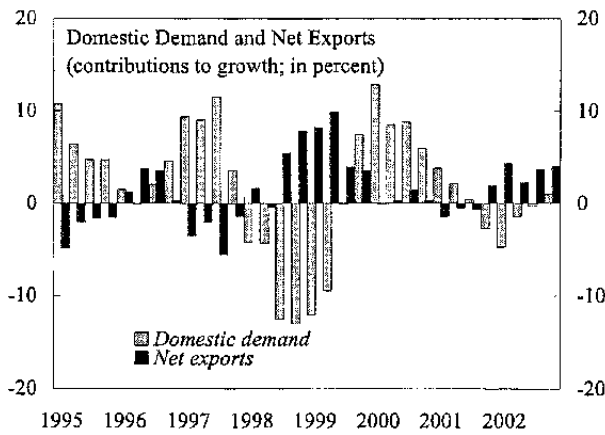
After three quarters of negative growth, GDP growth has turned up...



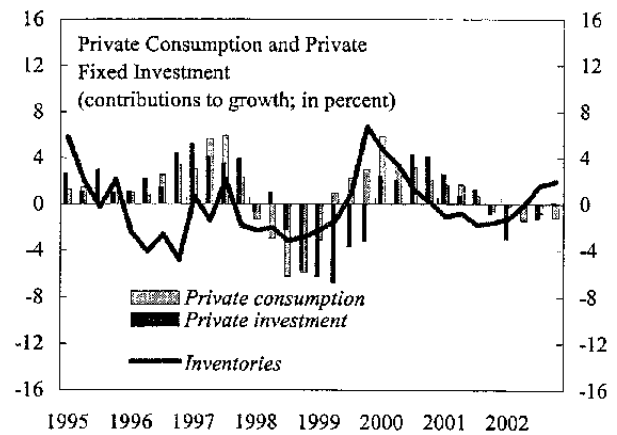
...however, a large output gap remains.



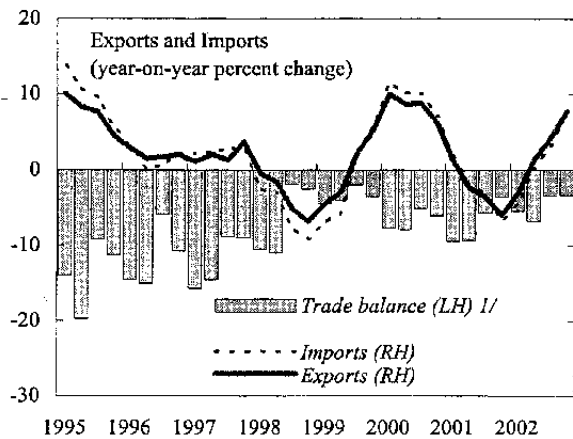
Net exports have strengthened, while domestic demand remains weak...



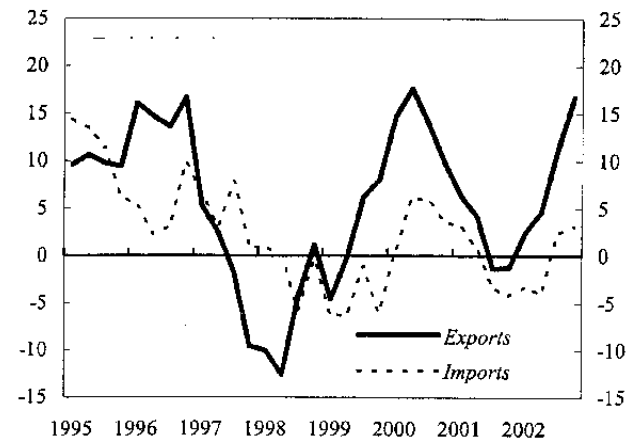
...with both consumption and investment still falling.



Exports and imports of goods have recovered markedly...



...and services trade has picked up as well.



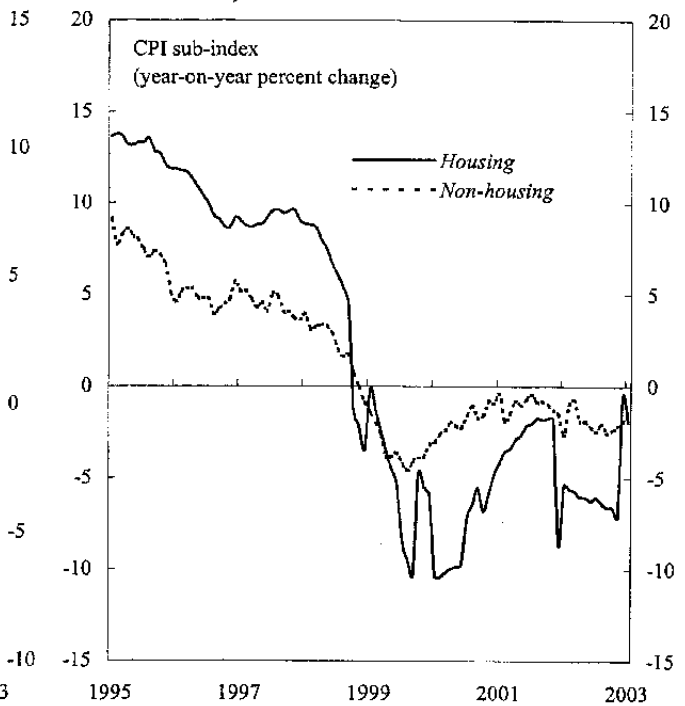
Sources: Data provided by the Hong Kong SAR authorities; and staff estimates.
1/ Trade balance in percent of GDP.

Figure 2. Prices and Exchange Rate, 1995-2003

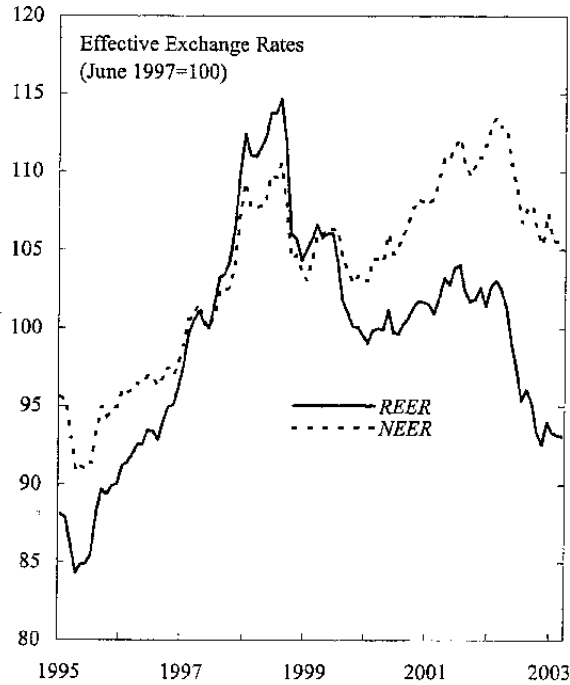
Deflation has entered its fifth year...



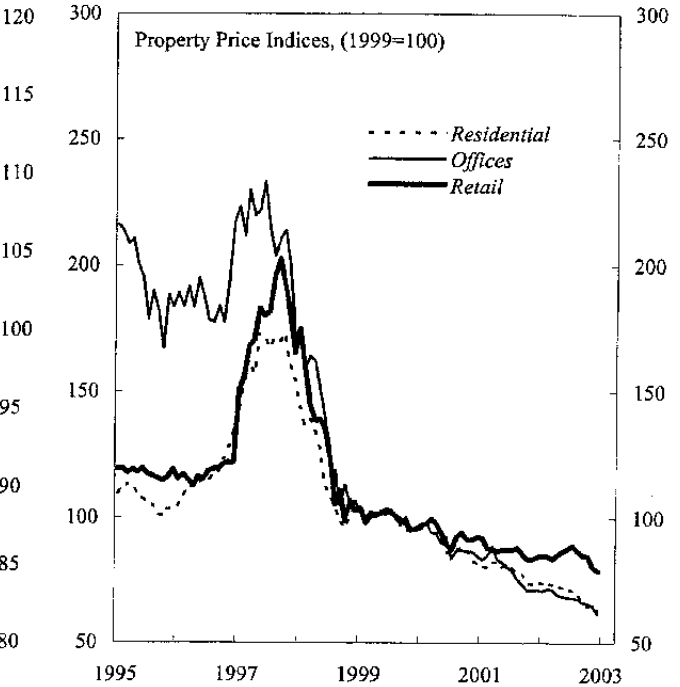
...driven in part by falling housing costs (including a one-off reduction in the tax on rentals).



The real effective exchange rate has depreciated since the Asian crisis.



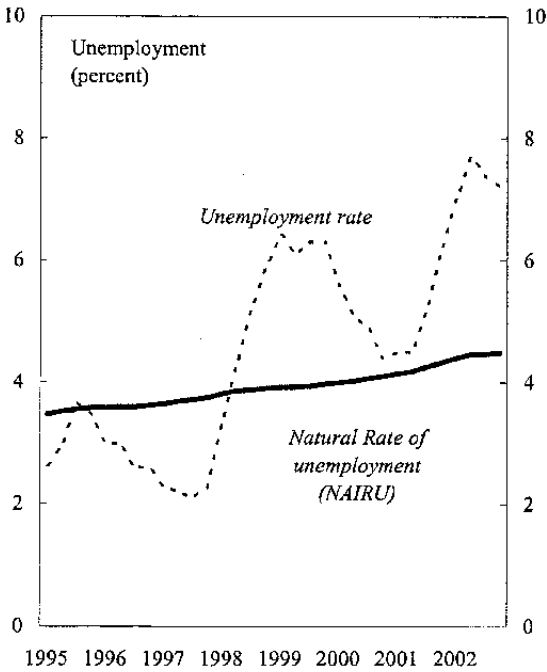
Property prices continue on a declining path and are at less than half their peak levels.



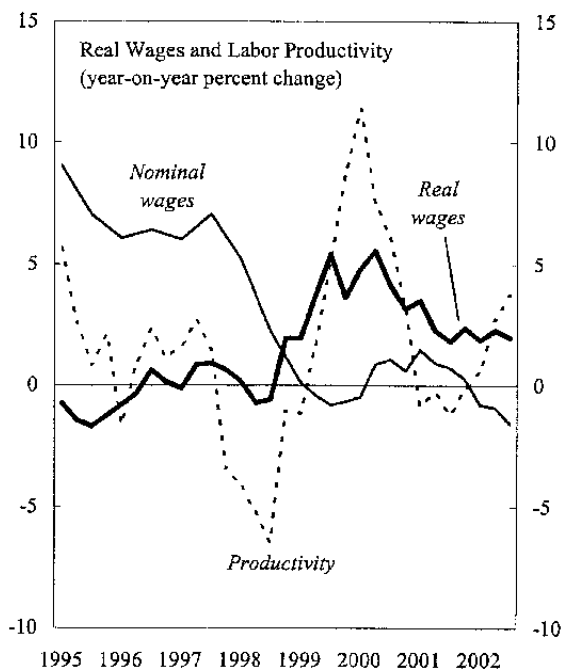
Sources: Data provided by the Hong Kong SAR authorities; and staff estimates.

Figure 3. Labor Markets, 1995-2002

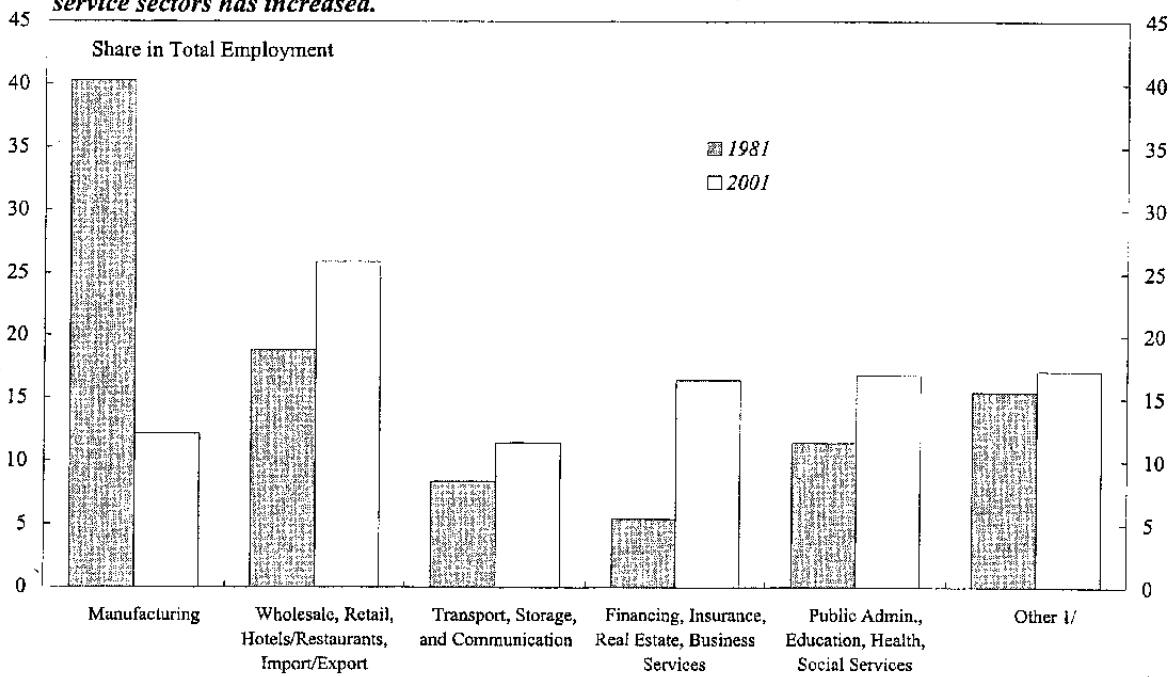
The unemployment reached historically high levels in 2002, and the NAIRU increased as well.



Nominal wages started to decline, but real wage growth remained high.



The share of employment in manufacturing has declined sharply, while the share of employment in service sectors has increased.

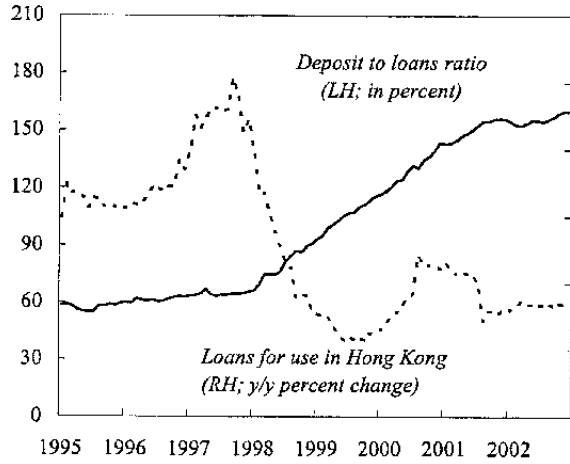


Sources: Data provided by the Hong Kong SAR authorities; Hong Kong Population Census; and staff estimates.

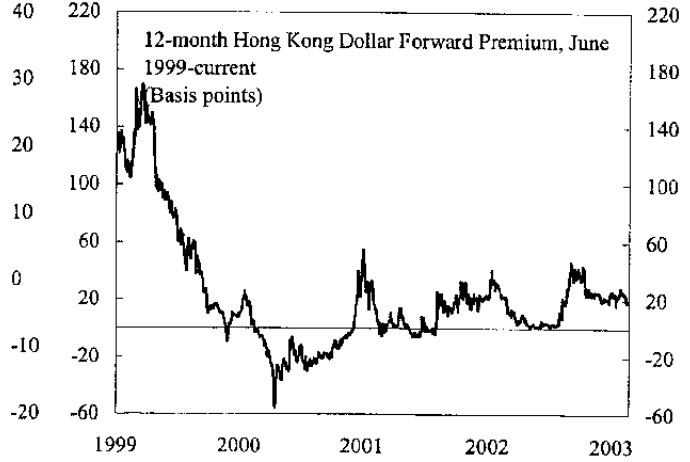
I/ Includes Personal Services, Construction, Utilities, and Agriculture.

Figure 4. Financial Indicators, 1995-2003

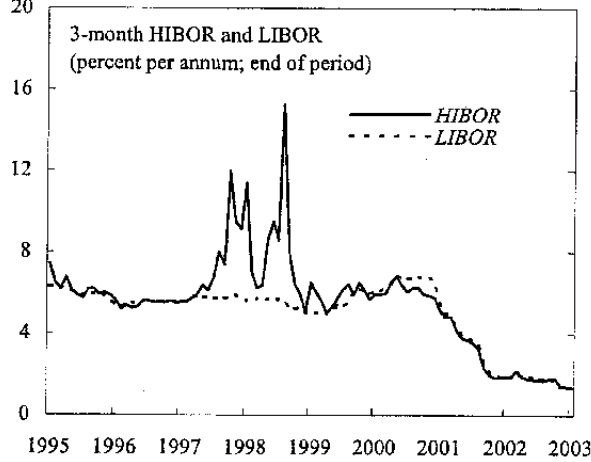
Liquidity in the financial system has increased but credit growth remains weak.



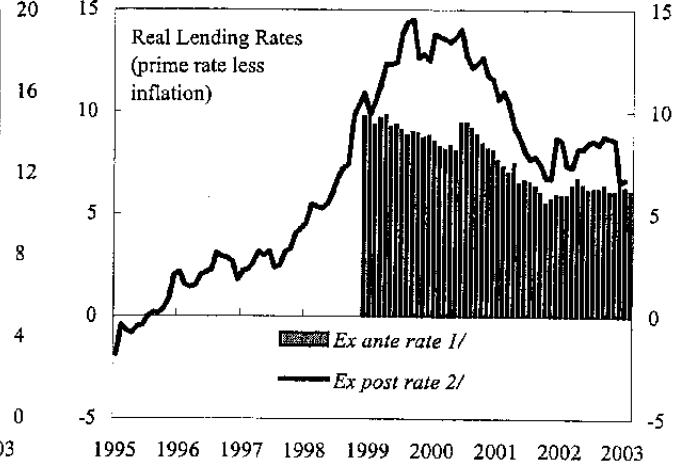
The forward premium has declined after a slight increase in Sept.-Oct. 2002.



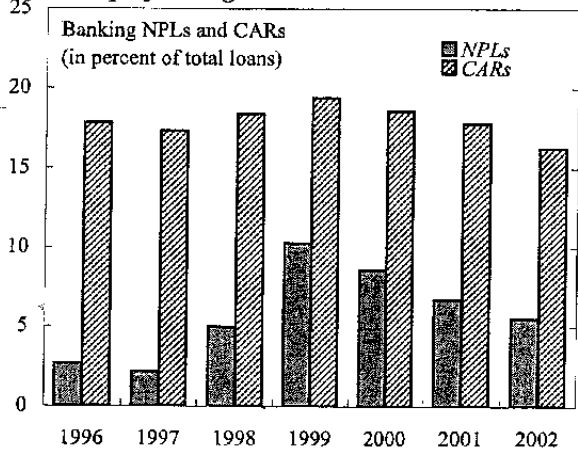
Nominal interest rates have fallen...



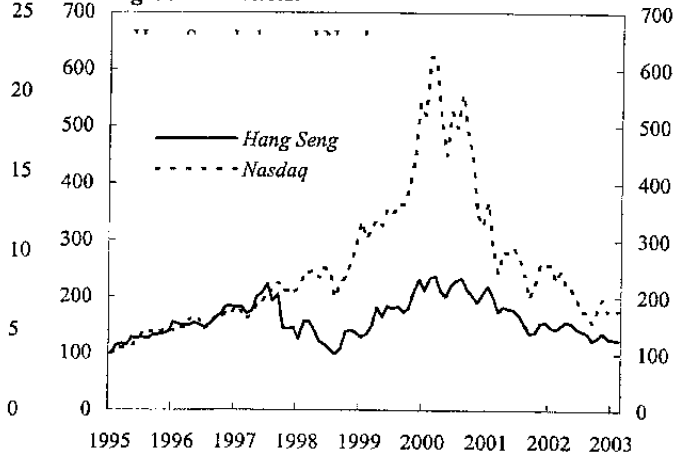
...but real lending rates still remain high.



Bank capitalization has remained high and nonperforming loans have declined.



The stock market has dropped in line with global markets.



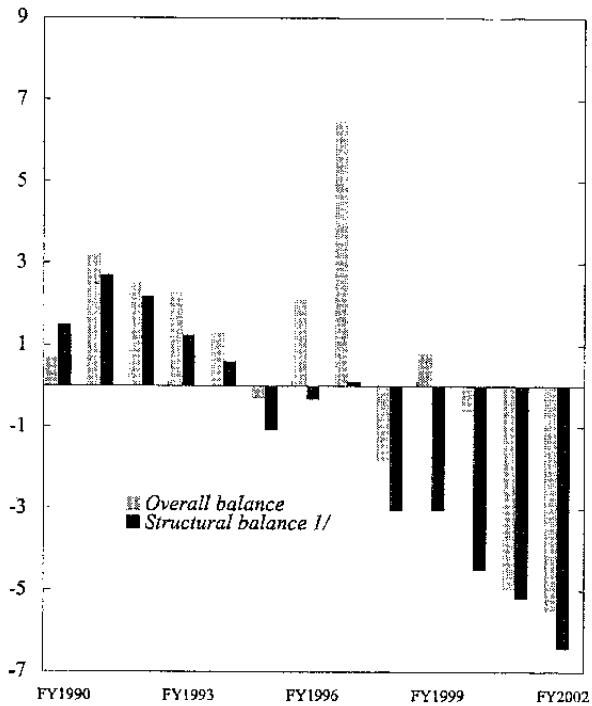
Sources: Data provided by the Hong Kong SAR authorities; and staff estimates.

1/ Using consensus forecast of inflation.

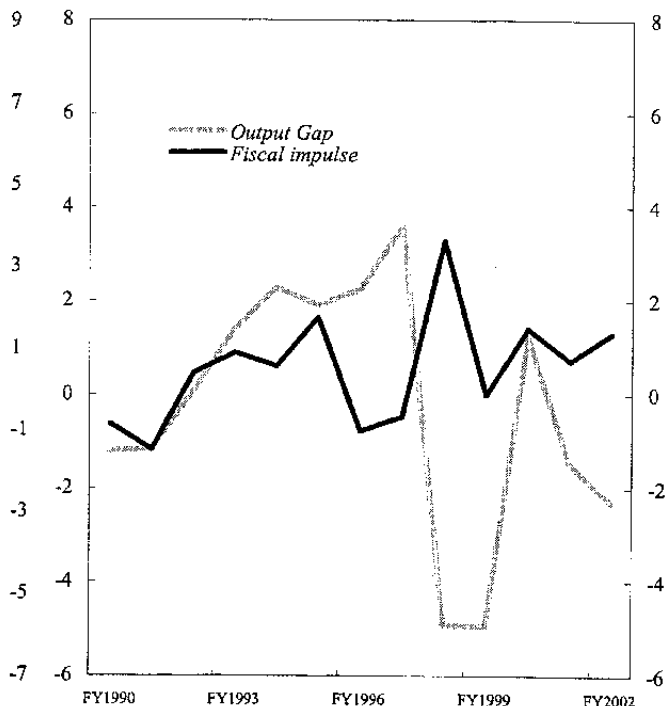
2/ Using 12-month CPI inflation.

Figure 5. Fiscal Developments, FY1990-2002
(In percent of GDP)

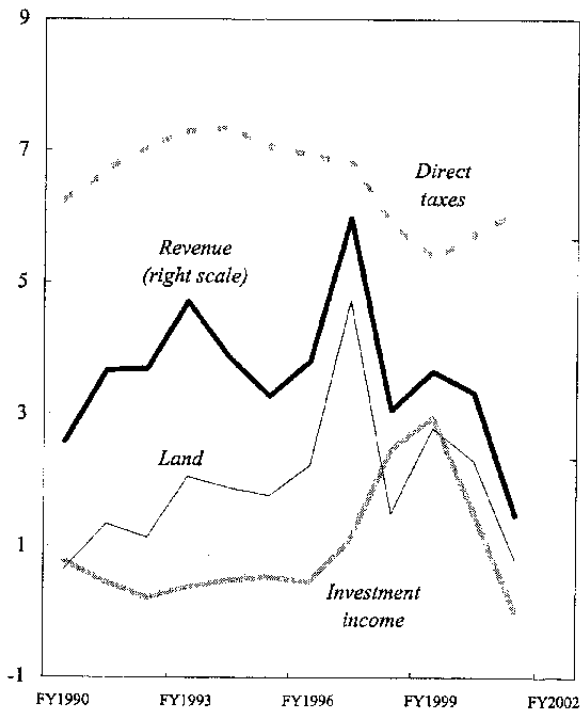
The fiscal balance, traditionally in surplus, has turned into sizable deficits in recent years.



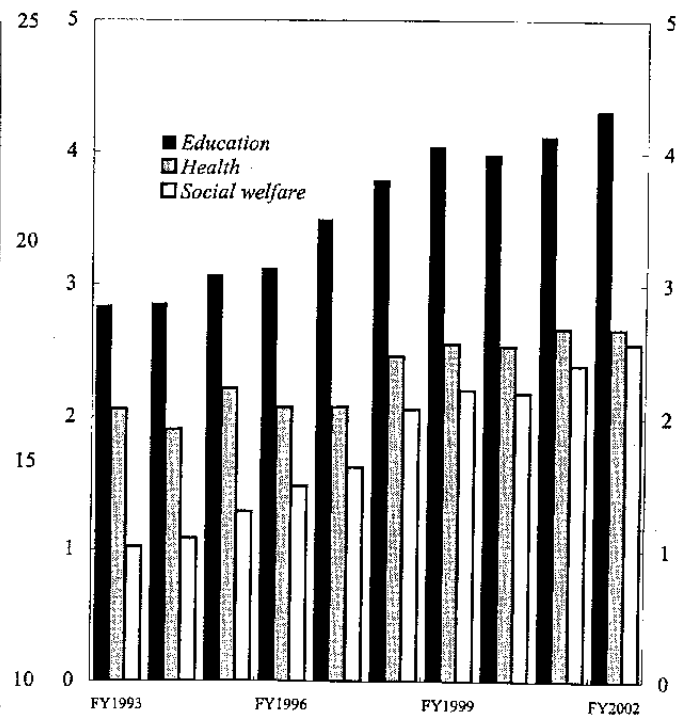
Fiscal policy has not been countercyclical until recently.



Revenue has become more volatile...



...while social expenditures are rising.



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

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

Table 1. Selected Economic and Financial Indicators, 1998–2003

Nominal GDP (2002):	US\$163.0 billion					
Population (mid-2002):	6.8 million					
GDP per capita (2002):	US\$24,014					
	1998	1999	2000	2001	2002	Staff Proj. 2003
Real GDP (percent change)	-5.0	3.4	10.2	0.6	2.3	2.2
Contribution						
Domestic demand	-9.8	-4.7	9.5	0.8	-1.3	1.0
Private consumption	-4.1	0.6	3.4	0.8	-0.9	0.5
Government consumption	0.0	0.2	0.2	0.6	0.2	0.1
Gross fixed capital formation	-2.7	-6.0	3.2	0.8	-1.2	0.3
Inventories	-3.0	0.5	2.8	-1.4	0.6	0.0
Net exports	4.9	8.1	0.6	-0.2	3.6	1.2
Saving and investment (percent of GDP)						
Gross national saving	31.8	32.8	33.6	33.8	34.9	36.0
Gross domestic investment	29.2	25.3	28.1	26.5	24.2	24.3
Saving-investment balance	2.7	7.5	5.5	7.2	10.7	11.6
Inflation (percent change)						
Consumer prices	2.8	-4.0	-3.8	-1.6	-3.0	-2.0
GDP deflator	0.2	-5.9	-6.2	-1.4	-2.8	-0.1
Employment (percent change)						
Unemployment rate (percent, period average)	4.7	6.2	5.0	5.1	7.3	7.4
Real wages	0.1	3.8	3.6	3.4	1.3	...
Government budget (percent of GDP)						
Revenue	16.9	18.7	17.5	13.7	13.6	14.9
Expenditure	18.7	17.9	18.1	18.7	19.1	20.1
Consolidated budget balance	-1.8	0.8	-0.6	-5.0	-5.5	-5.2
Reserves as of March 31	33.9	35.6	33.4	29.2	23.8	18.4
Interest rates (percent, end-period)						
Best lending rate	9.0	8.5	9.5	5.1	5.0	...
Three-month HIBOR	5.1	5.7	5.8	1.9	1.4	...
Asset prices						
Hang Seng stock index (July 31, 1964=100)	10,048.6	16,962.1	15,095.5	11,397.2	9,321.3	...
Hang Seng stock index (in percent)	-6.3	68.8	-11.0	-24.5	-18.2	...
Residential property prices (percent change)	-28.2	-14.6	-10.4	-12.2	-11.1	...
Merchandise trade (percent change)						
Export volume	-4.3	3.7	17.1	-3.3	8.6	6.1
Import volume	-7.1	0.2	18.1	-2.0	7.8	6.0
Terms of trade	1.2	-0.7	-0.9	0.9	1.2	0.1
External balances (in billions of US\$)						
Merchandise trade balance	-7.8	-3.2	-8.2	-8.3	-5.1	-5.1
In percent of GDP	-4.7	-2.0	-5.0	-5.1	-3.1	-3.1
Service Balance	10.1	12.3	16.2	17.1	21.0	24.2
Current account	4.4	12.0	9.1	12.3	17.5	19.3
In percent of GDP	2.7	7.5	5.5	7.5	10.7	11.6
Foreign exchange reserves 1/						
In billions of U.S. dollars, end of period	89.6	96.3	107.6	111.2	111.9	104.0
In months of retained imports	17.1	19.8	18.0	20.4	21.9	20.3
Exchange rate						
Linked rate (fixed)	HK\$7.80/US\$1					
Market rate (HK\$/US\$, period average)	7.745	7.758	7.791	7.799	7.799	...
Real effective rate (period average, 1990=100)	161.6	151.1	146.6	149.4	142.7	...

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

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

Table 2. Consolidated Government Account, FY1998–FY2007 1/
(In percent of GDP)

	FY1998	FY1999	FY2000	FY2001 Actual	FY2002 Budget	FY2002 Actual	FY2003 Budget	FY2004 Budget	FY2005 Budget	FY2006 Budget	FY2007 Budget
Revenue	16.9	18.7	17.5	13.7	16.9	13.6	15.2	17.5	18.1	18.0	16.8
Tax	8.9	8.9	9.7	9.6	9.7	9.6	9.7	...	...	...	...
Earnings and profits tax	5.9	5.4	5.7	6.1	5.8	6.2	...	...	...	...	...
Stamp duties	0.8	1.0	0.8	0.7	0.9	0.9	...	...	...	...	...
Nontax	8.0	9.8	7.8	4.1	7.2	4.1	5.5	...	...	...	...
Land sales and Land Fund Revenue	2.3	4.5	3.3	0.8	2.8	1.5	0.6	...	...	...	...
Investment income 2/	1.7	1.2	1.3	0.9	0.2	0.4	0.5	0.7	0.7	0.7	0.7
Sales of government assets	...	...	0.8	0.0	1.3	0.0	1.6	...	...	...	...
Expenditure	18.7	17.9	18.1	18.7	20.2	19.1	20.5	20.4	19.3	17.4	16.3
Current	12.8	14.0	14.3	15.3	16.1	15.6	...	...	...	...	...
Capital	5.9	3.9	3.8	3.4	4.1	3.5	...	...	...	...	...
Primary balance 3/	-3.5	-0.4	-1.9	-5.8	-3.5	-5.9	-5.8	-3.6	-1.8	-0.1	-0.1
Overall Balance	-1.8	0.8	-0.6	-5.0	-3.3	-5.5	-5.3	-2.9	-1.2	0.6	0.6
Structural balance 4/	-3.0	-3.0	-4.5	-5.2	-6.5	-6.2	-7.4	-6.2	-4.4	-2.8	-2.6
Fiscal impulse 5/	3.3	0.0	1.4	0.7	1.3	0.9	1.3	-1.2	-1.8	-1.6	-0.2
Fiscal reserves	33.9	35.6	33.9	29.2	26.0	23.8	18.7	15.4	13.8	13.9	13.6
(in percent of annual expenditure)	181.4	199.2	187.4	156.2	128.8	124.5	91.5	75.7	71.8	80.3	83.7

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

1/ Fiscal year begins April 1.

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

3/ Balance excluding investment income.

4/ Staff estimates. The "structural balance" is used by staff to measure the impact of fiscal policy on domestic demand. It excludes asset-related transactions, land premium, investment income, privatization receipts, equity injections, and the impact of cyclical fluctuations.

5/ Change in the structural balance from the previous year.

Table 3. Standard Vulnerability Indicators, 1997–2002

	1997	1998	1999	2000	2001	2002
Public Sector						
Fiscal deficit (in percent of GDP)	6.5	-1.8	0.8	-0.6	-5.0	-5.5
Accumulated fiscal surplus (in percent of GDP)	34.0	33.9	35.6	33.4	29.2	23.8
External Sector						
Export volume (percent change)	6.1	-4.3	3.7	17.1	-3.3	8.6
Domestic exports	2.2	-7.9	-7.2	7.6	-10.2	-11.2
Reexports	6.8	-3.7	5.4	18.5	-2.4	11.0
Import volume (percent change)	7.3	-7.1	0.2	18.1	-2.0	7.8
Current account (in billions US\$)	-5.3	4.4	12.0	9.1	12.3	17.5
Net equity inflow (in billions of US\$)	...	6.4	30.0	29.3	-23.5	-13.7
Gross official reserves (in billions of US\$)	92.8	89.6	96.3	107.6	111.2	111.9
In months of retained imports	14.6	17.1	19.8	18.0	20.4	21.9
In percent of monetary base	355.1	360.6	318.3	388.7	377.0	355.2
In percent of broad money 1/	25.8	22.3	22.1	23.0	24.4	24.8
In percent of Hong Kong dollar M3	42.7	37.7	38.6	41.9	43.0	43.5
Short-term debt (in billions of US\$) 2/	n.a.	n.a.	n.a.	n.a.	n.a.	226.4
In percent of gross reserves	n.a.	n.a.	n.a.	n.a.	n.a.	202.3
1-yr forward exchange rate premium (in pips, annual average)	1,170.0	3,284.5	1,042.9	-35.5	52.7	138.8
Real exchange rate (percent change)	9.7	8.2	-6.5	-3.0	1.9	-4.5
Financial Sector						
HIBOR(3M)-LIBOR (3M) (in basis points)	159.3	267.3	45.5	-41.8	-17.5	-0.6
Hang Seng Index (percent change, end-year)	-20.3	-6.3	68.8	-11.0	-24.5	-18.2
Residential property prices (percent change, end-year)	15.2	-32.5	-8.5	-14.5	-9.8	-13.0
Banking Sector 3/						
Deposit-loans ratio 4/	65.8	90.8	115.6	143.3	155.9	159.8
Domestic credit growth 5/	24.4	-3.8	-7.2	2.3	-3.8	-2.6
Real credit growth	17.6	-6.4	-3.3	6.3	-2.3	0.4
Capital adequacy ratio 6/	17.4	18.5	18.7	17.8	16.5	15.8
Nonperforming loans (in percent of total loans) 7/, 8/	2.1	7.7	10.1	7.3	6.5	5.0
Net interest margin (in percent of interest-bearing assets) 8/	2.2	2.0	2.1	2.1	2.0	2.1
Return on assets (post-tax) 8/	1.4	0.9	0.9	1.2	1.0	1.2
Net open spot position (in billions of US\$)	-11.4	6.2	12.4	25.7	24.7	18.2
Net open forward position (in billions of US\$)	12.0	-3.6	-5.2	-18.7	-14.6	-6.7
Contagion Indicator						
HK\$-Renminbi forward exchange rate correlation (daily)	0.6	0.7	0.6	-0.1	0.1	-0.2
Hang Seng-NASDAQ correlation (daily)	0.1	0.2	0.8	0.7	0.9	0.8

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

1/ Broad Money refers to M2.

2/ Official statistics on Hong Kong SAR's external debt are available as from the first quarter of 2002.

3/ For all authorized institutions, unless otherwise specified.

4/ Figures have been revised due to a change in the definition of customer deposits to include short term Exchange Fund placements.

5/ Refers to loans for use in Hong Kong SAR excluding trade finance.

6/ For all locally incorporated authorized institutions.

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

8/ For retail banks, which comprise all the locally incorporated banks plus a number of the larger foreign banks whose operations are similar to those of the locally incorporated banks, in that they operate a branch network and are active in retail banking.

Table 4. Medium-term Macroeconomic Framework, 1988–2008

	Average	1999	2000	2001	2002	Staff Projections					
	1988-97					2003	2004	2005	2006	2007	2008
Real GDP (percent change)	5.2	3.4	10.2	0.6	2.3	2.2	3.1	3.4	3.8	3.5	3.5
Contribution											
Real domestic demand	6.6	-4.7	9.5	0.8	-1.3	1.0	2.9	3.2	3.4	3.2	3.2
Private consumption	3.6	0.6	3.4	0.8	-0.9	0.5	1.6	1.8	2.0	1.9	1.9
Government consumption	0.4	0.2	0.2	0.6	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Gross fixed capital formation	2.6	-6.0	3.2	0.8	-1.2	0.3	1.2	1.2	1.3	1.2	1.2
Inventories	0.0	0.5	2.8	-1.4	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Net Exports	-1.4	8.1	0.6	-0.2	3.6	1.2	0.2	0.3	0.4	0.3	0.3
Output gap (in percent of potential)	1.4	-4.9	1.2	-1.5	-2.3	-2.6	-1.7	-0.8	-0.2	0.0	0.0
Growth rates											
Real GDP	5.2	3.4	10.2	0.6	2.3	2.2	3.1	3.4	3.8	3.5	3.5
Real domestic demand	6.8	-4.6	10.3	0.8	-1.4	1.1	3.18	3.5	3.7	3.5	3.6
Private consumption	6.1	1.3	5.9	1.4	-1.6	1.0	2.9	3.3	3.7	3.5	3.5
Government consumption	5.0	3.1	2.0	6.0	2.4	1.5	1.0	1.0	1.0	1.0	1.0
Gross fixed capital formation	9.0	-16.6	11.0	2.9	-4.4	1.2	4.7	4.8	4.8	4.5	4.5
Saving and investment (percent of GDP)											
Gross national saving	n.a.	32.8	33.6	33.8	34.9	36.0	35.2	35.0	35.0	34.8	34.5
Gross investment	30.0	25.3	28.1	26.5	24.2	24.3	24.5	24.6	24.3	24.2	24.1
Saving-investment balance	n.a.	7.5	5.5	7.2	10.7	11.6	10.7	10.4	10.7	10.6	10.4
Inflation (percent change)											
Consumer prices	8.9	-4.0	-3.8	-1.6	-3.0	-2.0	-1.4	-0.7	-0.1	0.0	0.0 ^v
GDP deflator	7.8	-5.9	-6.2	-1.4	-2.8	-0.1	-1.8	-1.3	-0.1	-0.2	-0.2
Employment (percent change)	1.7	-0.3	3.1	1.3	-0.5	1.2	1.7	1.9	2.1	1.9	1.9
Unemployment rate (percent)	2.0	6.2	5.0	5.1	7.3	7.4	7.0	6.4	5.7	5.1	4.5
Real wages	1.2	3.8	3.6	3.4	1.3	...	...	...	...	...	...
Government budget (percent of GDP) 1/											
Revenue	17.3	18.7	17.5	13.7	13.6	14.9	17.3	18.0	17.9	17.3	17.3
Expenditure	14.9	17.9	18.1	18.7	19.1	20.1	20.2	19.2	17.3	16.7	16.7
Consolidated budget balance	2.4	0.8	-0.6	-5.0	-5.5	-5.2	-2.9	-1.2	0.6	0.6	0.6
Accumulated fiscal reserves (end-year)	34.0	35.6	33.4	29.2	23.8	18.4	15.3	13.8	13.9	14.0	14.1
Merchandise trade (percent change)											
Export volume	13.0	3.7	17.1	-3.3	8.6	6.1	6.4	6.5	6.5	6.6	6.5
Domestic exports	-0.3	-7.2	7.6	-10.2	-11.2	-6.0	-4.0	0.0	0.0	0.0	0.0
Reexports	19.3	5.4	18.5	-2.4	11.0	7.3	7.3	7.0	7.0	7.0	7.0
Import volume	13.9	0.2	18.1	-2.0	7.8	6.0	6.9	6.8	6.8	6.8	6.8
Export value	14.7	0.1	16.6	-5.8	5.4	14.7	7.1	7.2	7.3	7.6	7.6
Import value	16.0	-2.5	19.2	-5.3	3.4	14.4	7.5	7.7	7.2	7.7	7.7
Terms of trade	0.1	-0.7	-0.9	0.9	1.2	0.1	0.0	-0.2	0.4	0.1	0.1
External balances (in billions of US\$)											
Trade balance	n.a.	-3.2	-8.2	-8.3	-5.1	-5.1	-6.6	-8.3	-8.5	-9.4	-10.5
In percent of GDP	n.a.	-2.0	-5.0	-5.1	-3.1	-3.1	-3.9	-4.8	-4.7	-5.1	-5.5
Exports of goods	n.a.	175	202	191	200	230	246	264	283	305	328
Imports of goods	n.a.	178	211	199	205	235	253	272	292	314	338
Current account	n.a.	12.0	9.1	12.3	17.5	19.3	18.0	17.9	19.1	19.5	19.9
In percent of GDP	n.a.	7.5	5.5	7.5	10.7	11.6	10.7	10.4	10.7	10.6	10.4
Foreign exchange reserves (end-year)	42.9	96.3	107.6	111.2	111.9	104.0	99.1	97.2	98.2	99.2	100.4
In percent of GDP		60	65	68	69	62	59	56	55	54	53

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. Medium-term Balance of Payments, 1999–2008

	1999	2000	2001	Projections						
				2002	2003	2004	2005	2006	2007	2008
	<i>(In billions of U.S. dollars)</i>									
Current account	12.0	9.1	12.3	17.5	19.3	18.0	17.9	19.1	19.5	19.9
<i>Goods Balance</i>	-3.2	-8.2	-8.3	-5.1	-5.1	-6.6	-8.3	-8.5	-9.4	-10.5
<i>Services balance</i>	12.3	16.2	17.1	21.0	24.2	25.4	26.8	28.6	30.3	32.1
<i>Income Balance</i>	4.5	2.8	5.3	3.5	2.3	1.4	1.7	1.5	1.3	1.2
<i>Transfer balance</i>	-1.5	-1.7	-1.8	-1.9	-2.0	-2.2	-2.3	-2.5	-2.7	-2.9
Capital and Financial Account	-10.7	-7.4	-12.5	-24.5	-16.5	-16.3	-17.0	-18.2	-18.6	-19.0
Capital Account	-1.8	-1.5	-1.2	-2.0	-1.8	-1.5	-1.3	-1.1	-1.1	-1.0
Financial Account	-9.0	-5.9	-11.3	-22.5	-14.7	-14.7	-15.7	-17.1	-17.5	-17.9
<i>Net Direct investment</i>	5.2	2.6	12.4	-4.0	-4.6	-5.0	-5.6	-5.7	-6.7	-7.6
<i>Portfolio investment</i>	33.1	24.5	-41.3	-37.3	-34.4	-29.1	-25.6	-22.6	-22.6	-22.4
<i>Financial derivatives</i>	10.2	0.2	5.1	1.4	1.3	1.2	1.2	1.1	1.2	1.2
<i>Net bank loans and other investment</i>	-47.5	-23.1	17.2	15.0	15.1	13.4	12.3	11.2	11.6	12.0
<i>Reserve assets (net change)</i>	-10.0	-10.0	-4.7	2.4	7.9	4.8	2.0	-1.0	-1.0	-1.2
Net errors and omissions	-1.3	-1.7	0.2	7.1	-2.9	-1.7	-0.9	-0.9	-0.9	-0.9
	<i>(In percent of GDP)</i>									
Current account	7.5	5.5	7.5	10.7	11.6	10.7	10.4	10.7	10.6	10.4
<i>Goods Balance</i>	-2.0	-5.0	-5.1	-3.1	-3.1	-3.9	-4.8	-4.7	-5.1	-5.5
<i>Services balance</i>	7.6	9.8	10.4	12.9	14.5	15.0	15.6	16.0	16.4	16.8
<i>Income Balance</i>	2.8	1.7	3.2	2.2	1.4	0.8	1.0	0.8	0.7	0.6
<i>Transfer balance</i>	-1.0	-1.0	-1.1	-1.1	-1.2	-1.3	-1.3	-1.4	-1.4	-1.5
Capital and Financial Account	-6.7	-4.5	-7.6	-15.1	-9.9	-9.6	-9.9	-10.2	-10.1	-9.9
Capital Account	-1.1	-0.9	-0.7	-1.2	-1.1	-0.9	-0.8	-0.6	-0.6	-0.5
Financial Account	-5.6	-3.6	-6.9	-13.8	-8.8	-8.7	-9.1	-9.6	-9.5	-9.4
<i>Net Direct investment</i>	3.3	1.6	7.6	-2.4	-2.7	-3.0	-3.2	-3.2	-3.6	-4.0
<i>Portfolio investment</i>	20.6	14.8	-25.2	-22.9	-20.7	-17.3	-14.8	-12.7	-12.2	-11.7
<i>Financial derivatives</i>	6.4	0.1	3.1	0.8	0.8	0.7	0.7	0.6	0.6	0.6
<i>Net bank loans and other investment</i>	-29.6	-14.0	10.5	9.2	9.0	7.9	7.1	6.3	6.3	6.3
<i>Reserve assets (net change)</i>	-6.2	-6.1	-2.9	1.5	4.8	2.9	1.1	-0.6	-0.6	-0.6
Net errors and omissions	-0.8	-1.0	0.1	4.3	-1.7	-1.0	-0.5	-0.5	-0.5	-0.5

Sources: Hong Kong SAR authorities, and staff estimates.

ALTERNATIVE SCENARIOS FOR MEDIUM-TERM FISCAL OUTLOOK

Hong Kong SAR's fiscal position has gradually deteriorated since 1998. The Task Force on Public Finances developed a budget model to examine the long-term sustainability of the fiscal system in Hong Kong SAR up to FY2021. Using similar assumptions, this Annex aims to provide indicative estimates of how revenue and expenditure might evolve in the next five years under a no policy action scenario, and two fiscal consolidation scenarios with different combinations of revenue and expenditure measures that would bring the fiscal position to balance by FY2006.¹

No Policy Action Scenario

This illustrative scenario highlights the pressing need for the fiscal consolidation measures proposed in the FY2003 budget. The scenario assumes that government expenditure is going to continue growing faster than nominal GDP, and also takes into account the likely impact of continued weaknesses in the property market and an ageing population (Table). It shows that, in the absence of corrective measures, continued sizable deficits in the range of 6–7 percent of GDP per annum are likely to continue, leading to a depletion of fiscal reserves by FY2006 (Figure).

Fiscal Consolidation Scenarios

Two scenarios are developed by the staff to illustrate the implications of using different combinations of expenditure and revenue measures to achieve the targeted fiscal consolidation in the medium term.

Basic Assumptions

- In both scenarios, real GDP growth is assumed at 2.2 percent in 2003, gradually returning to the potential growth rate of 3.5 percent in the medium term. Deflation is projected to continue at 2 percent in 2003, and gradually dissipate by FY2006.²
- On the revenue side, all recurrent revenue items (except investment income) are assumed to grow at the same rate as nominal GDP, and annual capital revenues (including land premium) are assumed to be 2.8 percent of nominal GDP, in line with their historical averages before the mid-1990s. A nominal rate of return of 5 percent is assumed for investment income on fiscal reserves.
- On the expenditure side, the government expenditure deflator is assumed to grow in line with nominal GDP after FY2006 when a balance budget is achieved, and social security expenditure is projected to grow in line with the long-term population projections.

¹ The medium-term fiscal outlook is examined in more detail in the Selected Issues paper.

² The FY2003 budget assumes annual real GDP growth of 3 percent over the medium term. The deflation projections are similar to those of the staff.

Table: Assumptions for Medium-Term Projections**Basic Assumptions:**

	<u>FY2003</u>	<u>FY2004</u>	<u>FY2005</u>	<u>FY2006</u>	<u>FY2007</u>
			(in percent)		
Real GDP Growth	2.2	3.1	3.4	3.8	3.5
CPI inflation	-2.0	-1.4	-0.7	-0.1	0.0
GDP deflator	-1.9	-1.0	-0.7	-0.2	-0.2
Demographic Parameters	Based on <i>Hong Kong SAR Population Projections 2000–2029 and the 2001 Population Census</i>				

FY2004–FY2007

Recurrent revenue items	Growth rate= growth rate of nominal GDP
Land premium 1/	2 percent of annual GDP
Investment income	5 percent nominal return on fiscal reserves
Other capital revenue 1/	0.8 percent of annual GDP
Social security expenditure 1/	Growth rate=0.44*CPI*portion of population aged 65+

No Policy Action ScenarioFY2003–FY2007

Revenue	No revenue efforts
Government expenditure excluding social security expenditure 1/	Growth rate=growth rate of nominal GDP+0.8 percent

Scenario 1

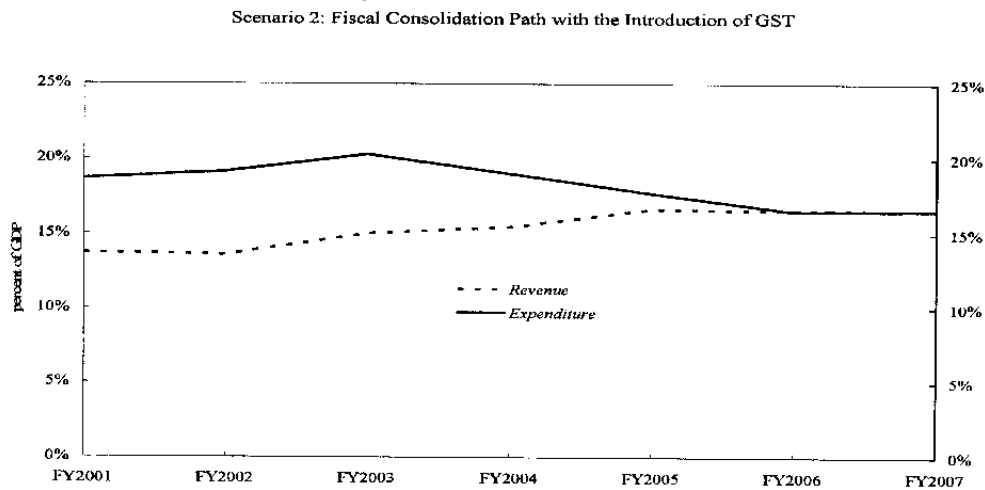
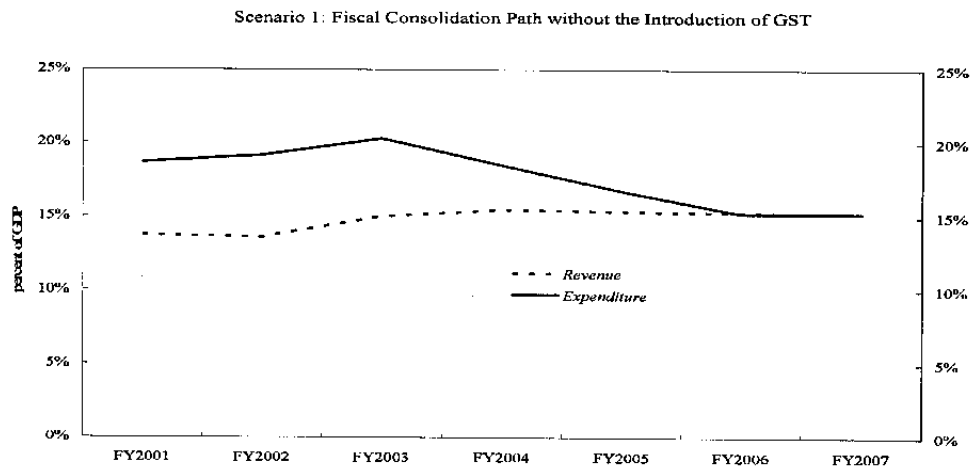
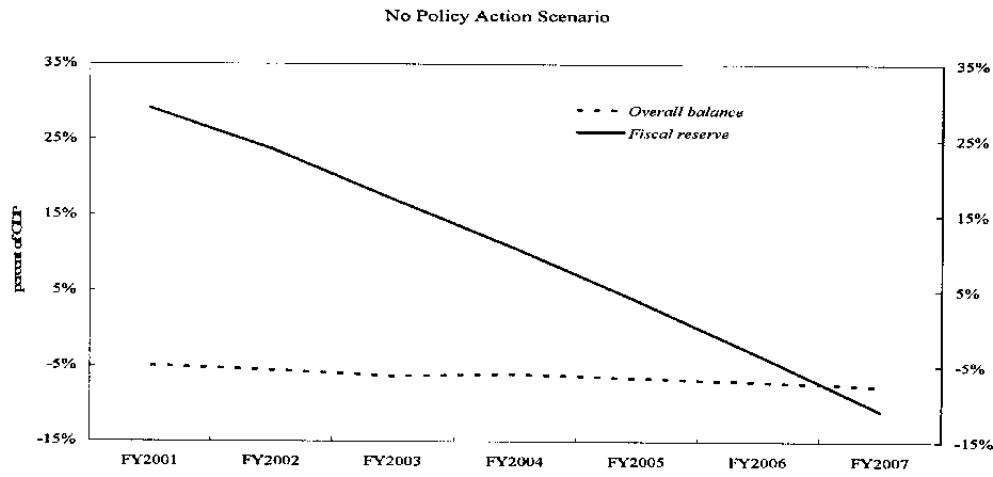
	<u>FY2003</u>	<u>FY2004</u>	<u>FY2005</u>
Additional revenue from proposed measures in FY2003 Budget (HK\$bn)	6	13	14
	<u>FY2004–FY2006</u>		<u>FY2007 onward</u>
Government expenditure excluding social security expenditure (in percent)	-9.0	Growth rate=growth rate of nominal GDP	

Scenario 2

	<u>FY2003</u>	<u>FY2004</u>	<u>FY2005</u>
Additional revenue from proposed measures in FY2003 Budget (HK\$bn)	6	13	14
GST (HK\$bn)			18
	<u>FY2004–FY2006</u>		<u>FY2007 onward</u>
Government expenditure excluding social security expenditure (in percent)	-5.7	Growth rate=growth rate of nominal GDP	

1/ Parameters are drawn from the budget model in the Final Report by the Task Force on Review of Public Finances.

Figure: Medium-Term Fiscal Outlook



Paths of Fiscal Consolidation

- In both scenarios, a modest fiscal consolidation of 0.2 percentage of GDP is projected in FY2003, as envisaged in the FY2003 budget. In addition, the proposed revenue measures, mainly increases in rates of profits and salaries taxes, are expected to yield HK\$14 billion in additional revenues by FY2005.
- In Scenario 1, no further revenue raising measures are introduced after FY2003. As a result, an expenditure cut of 9 percent per annum between FY2004 and FY2006 will be needed to reach the targeted fiscal consolidation. This implies a revenue (and expenditure) to GDP ratio of about 15 percent in the long run. In this scenario, revenue efforts provide about 20 percent of the required fiscal adjustment of 5–6 percent of GDP.
- In Scenario 2, a GST of 3 percent is assumed to be introduced in FY2005, with a projected revenue yield of 1.4 percent of GDP. Consequently, expenditure will only need to be cut by 5.7 percent per annum between FY2004 and FY2006, resulting in an expenditure to GDP ratio of 16½ percent in the long run. In this scenario, revenue efforts contribute about 45 percent of the required fiscal adjustment.

The two fiscal consolidation scenarios highlight the need for significant adjustment in government expenditures if Hong Kong SAR intends to maintain its tradition of having a small size of government. The total government expenditure to GDP ratio would need to be brought down from its current level of near 20 percent to about 16–17 percent over the medium term to reach a balanced budget. Absent the introduction of a GST, the required reduction in expenditure could be even greater.

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 Global Financial Stability reports. STA has provided Hong Kong SAR with technical assistance in the area of balance of payments statistics and Hong Kong SAR officials have attended INS courses on balance of payments and monetary statistics, and financial programming.

II. Exchange Rate Arrangement

The Hong Kong dollar 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 account 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 had been informally functioning as the Resident Representative, formally assumed the position on that date.

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.

In 2002, Hong Kong SAR published comprehensive international investment position statistics for the reference periods 2000 and 2001. It also published quarterly External Debt statistics for the reference period of the third quarter of 2002 according to the recommendations given in the *External Debt Statistics: Guide for Compilers and Users*.

Hong Kong SAR does not yet report GFS for publication in the GFS Yearbook or in IFS. The authorities have made significant progress towards the 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*).

Hong Kong SAR: Survey of Reporting of Main Statistical Indicators

As of March 31, 2003

	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	GDP/GNP
Date of latest observation	3/31/2003	2/2003	2/2003	2/2003	2/2003	3/31/2003	2/2003	2/2003	Q4/2002	3/2003	Q4/ 2002
Date received	3/31/ 2003	3/2003	3/2003	3/2003	3/2003	3/31/ 2003	3/2003	3/2003	4/2003	3/2003	3/2003
Frequency of data	D	M	M	M	M	D	M	M	Q	M	Q
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1/ The codes are explained below.

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Source of data: A – direct reporting by authorities, N – official publications and websites.

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INTERNATIONAL MONETARY FUND

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

**Staff Report for the 2003 Article IV Consultation
Supplementary Information**

Prepared by the Asia and Pacific Department

(In consultation with the Policy Development and Review Department)

Approved by Wanda Tseng and Shigeo Kashiwagi

May 15, 2003

1. This statement provides additional information that has become available since the circulation of the staff report (SM/03/151) and Financial System Stability Assessment (SM/03/139). The projected weakening of the fiscal position in FY2003 reflects an appropriate fiscal response to the outbreak of Severe Acute Respiratory Syndrome (SARS). This accentuates the need for forceful medium-term measures to attain the authorities' objective of balancing the budget by FY2006.
2. **The outbreak of (SARS) hit the economy hard in the second quarter, but recent news suggests that the epidemic may be coming under control.** Since mid-March, economic activity in Hong Kong SAR has been severely disrupted by the outbreak of SARS, with four sectors—tourism, entertainment, retail, and catering—being particularly hard hit. The volume of retail sales fell by 3.7 percent (y/y) in March and tourist arrivals declined by about 33 percent between mid-March and mid-April. The seasonally adjusted unemployment rate rose slightly to 7.5 percent in the first quarter and the composite CPI fell by 2.1 percent (y/y) in March. On the other hand, total exports continued to surge in March (15.4 percent, y/y), mainly owing to the Mainland of China's soaring external trade. There are signs that the SARS epidemic is being successfully contained. Assuming that the effects of SARS will be limited to the first half of the year and that exports and domestic demand will revive in the second half, the growth projection for 2003 can be maintained at 2.2 percent, but with the balance of risks remaining on the downside.
3. **Newly released fiscal data indicate that the consolidated fiscal deficit was HK\$61.7 billion (4.9 percent of GDP) in FY2002,** compared to HK\$70 billion (5.5 percent of GDP) estimated by the authorities in March 2003 (Table 1). Higher revenues and lower expenditures each contributed to about half of the more favorable outturn in the consolidated fiscal position. However, since asset-related revenues were markedly higher than previously estimated, the underlying structural deficit only narrowed to 6.2 percent of GDP in FY2002, compared to staff's previous estimate of 6.4 percent. The Legislature approved the expenditure appropriations for FY2003 in April, and will debate the revenue measures some time before the July recess.

4. **On April 23, the government announced a temporary fiscal relief and support package, totaling HK\$11.9 billion (1 percent of GDP), to mitigate the economic impact of SARS.** These measures include a rebate on the salaries tax and concessions on property taxes and water and sewage charges. Coupled with weaker than expected economic growth, these measures are likely to result in a widening of the consolidated fiscal deficit to 6½–7 percent of GDP in FY2003, compared to the original deficit target of 5.3 percent. Staff's assessment is that these measures constitute a timely and appropriate response to the adverse economic impact of SARS. Despite the setback in FY2003, the authorities remain committed to the objective of attaining budget balance by FY2006. This underscores the point made in the staff appraisal that the proposed medium-term fiscal consolidation measures will need to be implemented fully and expeditiously, and additional measures such as the introduction of a goods and services tax will be required to achieve this objective.

5. **Hong Kong SAR's debt rating outlook was downgraded from stable to negative by Fitch Ratings,** a day after the government announced the fiscal relief package, citing risks to growth and the government's finances.¹ The 12-month forward premium on the Hong Kong dollar rose slightly after Fitch's announcement, but has subsided in recent days. Other rating agencies—Moody's and Standard and Poor's—have so far left their ratings unchanged.

6. **New developments in the financial sector include:**

- The bill on a deposit protection scheme was introduced to the Legislative Council on April 30, 2003.
- Commencing in April 2003, all authorized life insurers, whether incorporated locally or overseas, are required to submit returns (for the financial year ending on or after December 31, 2003) in respect of their Hong Kong SAR business on a prescribed basis. Collection of this information will facilitate the preparation of industry-wide statistics on the life insurance sector, and help strengthen insurance supervision.
- The authorities launched the euro clearing system on April 28, 2003, in an effort to offer more comprehensive foreign exchange and securities settlement services.
- On March 31, 2003, the Hong Kong Monetary Authority (HKMA) issued a Supplement to the Guideline on Prevention of Money Laundering that brings Hong Kong SAR into conformity with the Basel recommendations on bank customer due diligence.
- As of March 6, 2003, the Chairman of the Securities and Futures Commission and the Chief Executive of the HKMA are no longer members of the Risk Management Committee (RMC) of the Hong Kong Exchanges and Clearing Limited. They have been replaced by a senior member of their respective staffs who will sit on the RMC in their personal capacity.

¹ There is no long-term government debt in Hong Kong SAR but these ratings are relevant for borrowing by government-owned companies.

Table 1. Consolidated Government Account, FY1998–FY2007 1/
(In percent of GDP)

	FY1998	FY1999	FY2000	FY2001 Actual	FY2002 Budget	FY2002 Estimate 6/ Revised 7/	FY2003 Budget	FY2004 Budget	FY2005 Budget	FY2006 Budget	FY2007 Budget	
Revenue	16.9	18.7	17.5	13.7	16.9	13.6	14.0	15.2	17.5	18.1	18.0	16.8
Tax	8.9	8.9	9.7	9.6	9.7	9.6	9.7	9.7	...	...	...	...
Earnings and profits tax	5.9	5.4	5.7	6.1	5.8	6.2	5.8	...	...	...	...	...
Stamp duties	0.8	1.0	0.8	0.7	0.9	0.9	0.9	...	...	...	...	...
Nontax	8.0	9.8	7.8	4.1	7.2	4.1	4.2	5.5	...	...	...	...
Land sales and Land Fund Revenue	2.3	4.5	3.3	0.8	2.8	1.5	1.9	0.6	...	...	...	...
Investment income 2/	1.7	1.2	1.3	0.9	0.2	0.4	0.4	0.5	0.7	0.7	0.7	0.7
Sales of government assets	...	...	0.8	0.0	1.3	0.0	0.0	1.6	...	...	...	...
Expenditure	18.7	17.9	18.1	18.7	20.2	19.1	18.8	20.5	20.4	19.3	17.4	16.3
Current	12.8	14.0	14.3	15.3	16.1	15.6	15.3	...	...	...	...	...
Capital	5.9	3.9	3.8	3.4	4.1	3.5	3.5	...	...	...	...	...
Primary balance 3/	-3.5	-0.4	-1.9	-5.8	-3.5	-5.9	-5.2	-5.8	-3.6	-1.8	-0.1	-0.1
Overall Balance	-1.8	0.8	-0.6	-5.0	-3.3	-5.5	-4.9	-5.3	-2.9	-1.2	0.6	0.6
Structural balance 4/	-3.0	-3.0	-4.5	-5.2	-6.5	-6.4	-6.2	-7.4	-6.2	-4.4	-2.8	-2.6
Fiscal impulse 5/	3.3	0.0	1.4	0.7	1.3	1.2	0.9	1.3	-1.2	-1.8	-1.6	-0.2
Fiscal reserves	33.9	35.6	33.9	29.2	26.0	23.8	24.5	18.7	15.4	13.8	13.9	13.6
(in percent of annual expenditure)	181.4	199.2	187.4	156.2	128.8	124.5	126.7	91.5	75.7	71.8	80.3	83.7

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

1/ Fiscal year begins April 1.

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

3/ Balance excluding investment income.

4/ Staff estimates. The "structural balance" is used by staff to measure the impact of fiscal policy on domestic demand. It excludes asset-related transactions, land premium, investment income, privatization receipts, equity injections, and the impact of cyclical fluctuations.

5/ Change in the structural balance from the previous year.

6/ Reported in the staff report (SM/03/151).

7/ The 2002 provisional outturn was revised in April 2003.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 03/65
FOR IMMEDIATE RELEASE
May 30, 2003

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

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

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

Background

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

Domestic goods and factor prices have continued to undergo significant downward adjustment. Deflation in consumer prices has now entered into a fifth consecutive year. Property prices have continued to drift downwards since the collapse of the property price bubble, and are now about 60 percent below their peak attained in 1997. Nominal wage growth has turned negative and real wage growth has moderated. The adjustment in the labor market has partially taken place

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.

through a reduction in employment in certain sectors; and the unemployment rate, although declining from its record high level in mid-2002, has remained above 7 percent.

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

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

Executive Board Assessment

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

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

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

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

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

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

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

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

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

agency will further strengthen the banking system. They encouraged the authorities to enhance coordination among regulators of the banking, insurance, and securities industries.

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

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

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

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

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

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

	1998	1999	2000	2001	2002	2003
Real GDP (percent change)	-5.0	3.4	10.2	0.6	2.3	2.2
Real domestic demand (contribution)	-9.8	-4.7	9.5	0.8	-1.3	1.0
Foreign balance (contribution)	4.9	8.1	0.6	-0.2	3.6	1.2
Saving and investment (percent of GDP)						
Gross national saving	31.8	32.8	33.6	33.8	34.9	36.0
Gross domestic investment	29.2	25.3	28.1	26.5	24.2	24.3
Inflation (percent change)						
Consumer prices	2.8	-4.0	-3.8	-1.6	-3.0	-2.0
GDP deflator	0.2	-5.9	-6.2	-1.4	-2.8	-0.1
Employment (percent change)	-1.3	-0.3	3.1	1.3	-0.5	1.2
Unemployment rate (percent)	4.7	6.2	5.0	5.1	7.3	7.4
Real wages	0.1	3.8	3.6	3.4	1.3	...
Government budget (percent of GDP) 1/						
Revenue	16.9	18.7	17.5	13.7	14.0	14.9
Expenditure	18.7	17.9	18.1	18.7	18.8	20.1
Consolidated budget balance	-1.8	0.8	-0.6	-5.0	-4.9	-5.2
Reserves at March 31	33.9	35.7	32.9	29.1	24.5	18.7
Money and credit (percent change, end-period)						
Narrow money (M1)	-5.0	13.9	8.3	5.8	14.6	...
Broad money (M3)	10.3	8.4	7.5	-2.7	-0.9	...
Loans for use in Hong Kong SAR 2/	-3.8	-7.2	2.3	-3.8	-2.6	...
Interest rates (percent, end-period)						
Best lending rate	9.0	8.5	9.5	5.1	5.0	...
Three-month HIBOR	5.1	5.7	5.8	1.9	1.4	...
Merchandise trade (percent change)						
Export volume	-4.3	3.7	17.1	-3.3	8.6	6.1
Domestic exports	-7.9	-7.2	7.6	-10.2	-11.2	-6.0
Reexports	-3.7	5.4	18.5	-2.4	11.0	7.3
Import volume	-7.1	0.2	18.1	-2.0	7.8	6.0
Export value	-7.4	0.1	16.6	-5.8	5.4	14.7
Import value	-11.4	-2.5	19.2	-5.3	3.4	14.4
External balances (in billions of US\$)						
Merchandise trade balance	-7.8	-3.2	-8.2	-8.3	-5.1	-5.1
In percent of GDP	-4.7	-2.0	-5.0	-5.1	-3.1	-3.1
Current account balance	4.4	12.0	9.1	12.3	17.5	19.3
In percent of GDP	2.7	7.5	5.5	7.5	10.7	11.6
Foreign exchange reserves 2/						
Foreign exchange reserves (in billions of U.S. dollars, end of period)	89.6	96.3	107.6	111.2	111.9	104.0
(In months of retained imports)	17.1	19.8	18.0	20.4	21.9	20.3

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

1/ Fiscal year.

2/ Figures exclude trade financing.