

People's Republic of China—Hong Kong Special Administrative Region: 2005 Article IV Consultation--Staff Report; and 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 2005 Article IV consultation with the 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 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 25, 2005, with the officials of the 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 January 6, 2006. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 23, 2006 discussion of the staff report that concluded the Article IV consultation.

The document listed below has 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 2005 Article IV Consultation Discussions

Prepared by the Staff Representatives for the Consultation Discussions Held in 2005
In Respect of the Hong Kong Special Administrative Region

Approved by Wanda Tseng and Juha Kähkönen

January 6, 2006

- The consultation discussions were held in the Hong Kong Special Administrative Region of the People's Republic of China during October 13–25, 2005. The staff team comprised Mr. Aziz (Head), Messrs. Aitken, Goldsworthy and Leigh (all APD). Ms. Tseng participated in the concluding policy discussions. Mr. Gruenwald (Resident Representative) also participated in the mission. Messrs. Wang and Chen (OED) attended key meetings.
- The mission met with Financial Secretary Henry Tang, Chief Executive of the Hong Kong Monetary Authority Joseph Yam, Secretary for Financial Services and the Treasury Frederick Ma, Chairman of the Securities and Futures Commission Martin Wheatley, and other senior government officials and private sector representatives.
- Both the Executive Board and the staff have generally endorsed the authorities' macroeconomic policies and structural reforms. Directors have commended the authorities for their skillful conduct of economic policy in the face of external shocks, including in reining in the fiscal deficit. Directors and staff have noted that the LERS remained appropriate and reiterated their support for the authorities' commitment to the currency board. On the need to broaden the tax base, the staff and the authorities agree in principle, but the staff have deferred to the authorities on the timing of implementing measures to do so, such as introducing a Goods and Services Tax (GST).
- The authorities have indicated their intention, as in the past, to publish the staff report.
- The principal author of this report is Lamin Leigh.

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EXECUTIVE SUMMARY

State of the Economy and Outlook

Hong Kong SAR's economic expansion that began in mid-2003 has now been sustained for 9 consecutive quarters. Real GDP grew by about 7¼ percent (year-on-year) in the first three quarters of 2005, boosted, in part, by strong exports and to some extent private consumption. Inflation remained mild during the first half of 2005 and has increased modestly in recent months, mainly due to the pick up in housing rentals and higher import prices. Reflecting the economic expansion, the unemployment rate has fallen by more than 3 percentage points from its peak in 2003 to 5¼ percent in September-November. Real GDP growth is expected to moderate to about 5½ percent in 2006 with some easing of external demand. The risks to this central scenario are broadly balanced.

Policy Discussions

Given Hong Kong SAR's rules-based macroeconomic framework, short-term discretionary policy has played a relatively smaller role compared to long-term reforms. Thus, the mission's discussions were focused on the longer-term fiscal strategy and measures needed to foster robust and sustainable growth over the medium term.

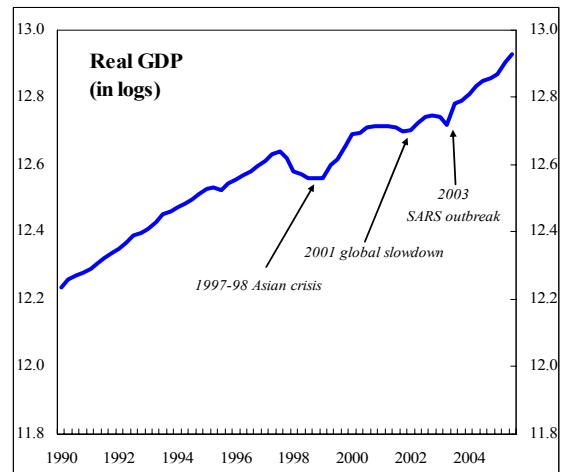
On fiscal policy, it is likely that the budget will return to balance in the current fiscal year, significantly ahead of schedule, because of buoyant revenues and continued expenditure restraint. With the objective of returning to budget balance nearly achieved, the staff encouraged the authorities to develop a longer-term fiscal strategy taking into account fiscal pressures that are likely to arise from an aging population. The staff also reiterated the need to broaden and stabilize the revenue base through the introduction of a goods and services tax (GST).

With regard to the exchange rate regime, the staff reiterated its support for the authorities' commitment to the linked exchange rate system (LERS). By removing the uncertainties about the extent to which the Hong Kong dollar could appreciate, the May 2005 refinements have successfully dampened speculative inflows related to market expectations of a renminbi appreciation and helped to keep financial markets calm following the changes in the renminbi regime in July.

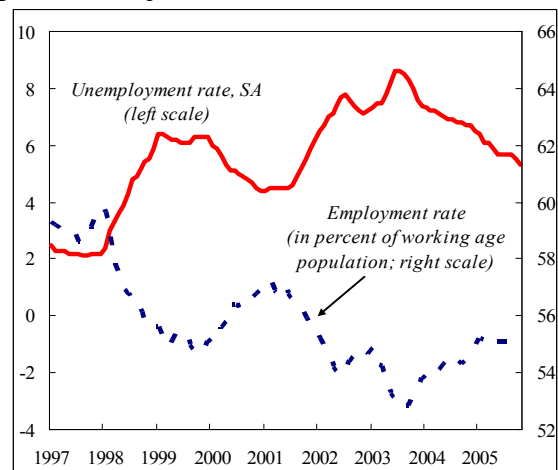
On structural policies, there was agreement that the importance of the financial sector for Hong Kong SAR reinforces the need to continue to strengthen its market infrastructure and supervisory systems in order to maintain financial stability. Over time, as Hong Kong's financial markets are expected to play a more direct role in Mainland China's financial intermediation, coordination of supervisory activities between the respective agencies will become increasingly important. Tackling the problem of long-term unemployment also remains a key policy priority.

I. INTRODUCTION

1. **Since the Asian crisis, Hong Kong SAR has undergone three sharp economic cycles, where incipient recoveries were prematurely cut short by shocks.** In the last cycle, the outbreak of Severe Acute Respiratory Syndrome (SARS) in Q2 2003 ended a hesitant recovery that began in late-2002. Output declined, unemployment rose, deflation intensified, and the Hong Kong dollar came under renewed downward pressures. The linked exchange rate system (LERS) precluded monetary policy from playing a supportive role, but countercyclical fiscal policy, continued structural reforms, and Hong Kong SAR's traditionally flexible product and labor markets helped to mitigate the impact of SARS. Another economic turnaround began taking root in Q3 2003. The rebound was initially driven by net exports and the confidence building effects of the Closer Economic Partnership Arrangement (CEPA) with the Mainland, later boosted by domestic demand in 2004.¹ Real GDP grew by about 8¼ percent in 2004, well above the annual average of about 4¾ percent over the past two decades, and the unemployment rate, which had reached 8.6 percent in mid-2003, declined steadily. Deflationary pressures receded and property prices, which had languished since 1998, rebounded.



2. **Ongoing structural changes have complicated adjustment to the shocks experienced in recent years.** Competitive pressures from low-cost Mainland producers have pushed Hong Kong to restructure into a predominantly service-based economy. The services industry is also undergoing changes that have led to the migration of some low-end service firms to the Mainland. Partly reflecting this restructuring, the unemployment rate has remained above its historical average, despite nine consecutive quarters of economic expansion.

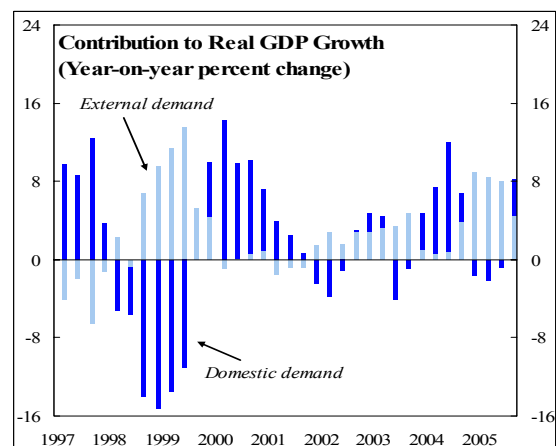
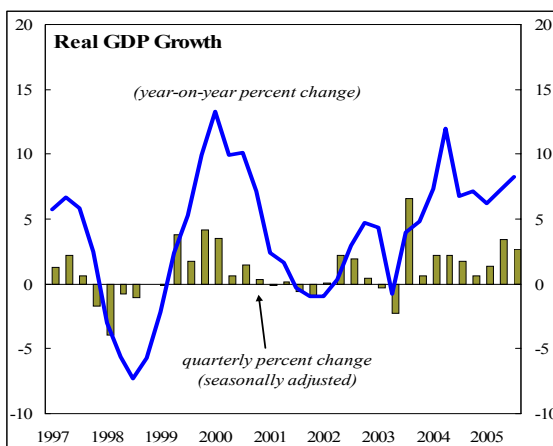


¹ CEPA I, a free trade agreement between the Mainland and Hong Kong SAR, that became effective in January 2004, also liberalized individual travel from selected cities in the Mainland to Hong Kong SAR. Since then, two other rounds of the trade agreement (CEPA II and III) have been agreed upon and it is being used as a framework to further deepen economic and financial relationship between the two economies.

3. **Amidst these economic changes, Hong Kong SAR witnessed a major political change in 2005.** In March, Mr. Tung Chee-Hwa—Hong Kong SAR’s first Chief Executive—resigned and was replaced by Mr. Donald Tsang. Mr. Tsang was selected as the new Chief Executive in July to serve out the remaining two years of Mr. Tung Chee-Hwa’s term which runs through end-June 2007.

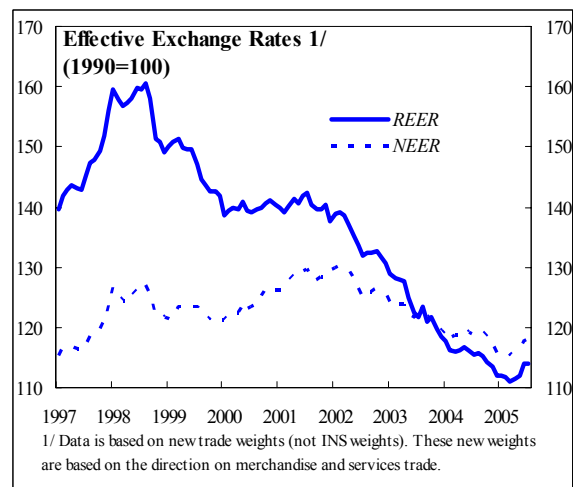
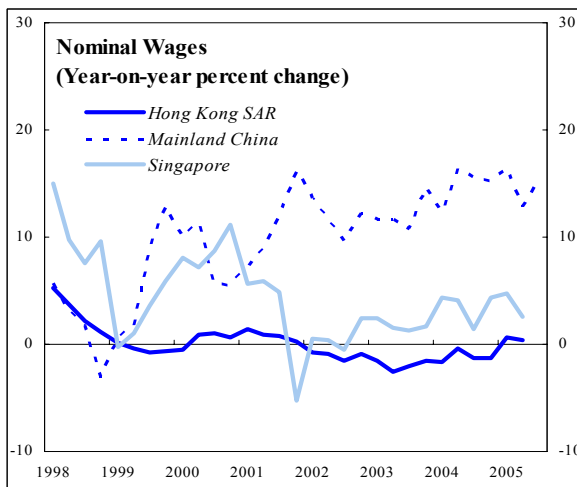
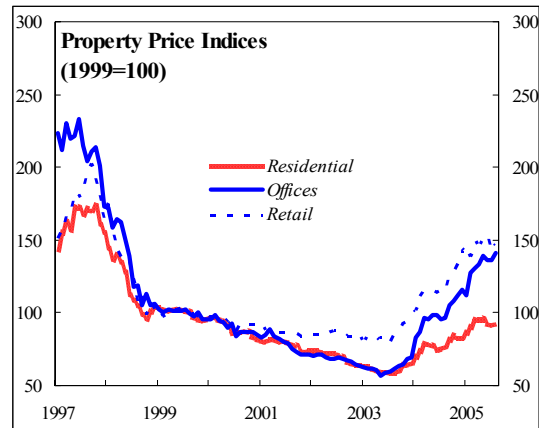
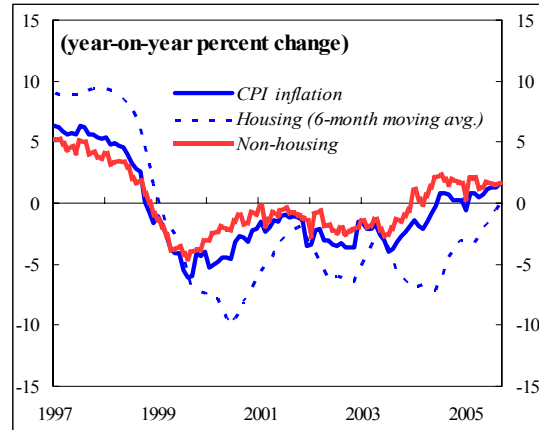
II. RECENT ECONOMIC DEVELOPMENTS: A RECOVERY TURNING INTO SUSTAINED EXPANSION

4. **An economic expansion that began in mid-2003 has now been sustained for 9 consecutive quarters.** While growth has moderated over the course of this recovery, it remains high, boosted by strong external demand for most of 2005. Real GDP grew by 7¼ percent (year-on-year) during the first three quarters of 2005, after registering an 8¼ percent growth in 2004. Strong Mainland-related re-exports (goods imported from the Mainland and subsequently exported by Hong Kong SAR without being further processed) and demand from the United States and Japan, have helped to offset soft domestic investment reflecting mainly the decline in construction output as well as the ongoing structural shift to more knowledge-based and service industries that requires much less capital investment than manufacturing. Although still robust, overall consumption growth has moderated in 2005, partly reflecting the recent rise in interest rates that have raised mortgage and consumer loan repayments. The unemployment rate has declined steadily to 5¼ percent (September-November 2005) and is now more than 3 percentage points lower than its peak in mid-2003, with strong job creation in the services sector. However, it remains high among low-skilled workers (about 8.6 percent in the manufacturing and construction sectors) due to continued loss of manufacturing and low-end services jobs to the lower-cost Mainland and decline in construction output.

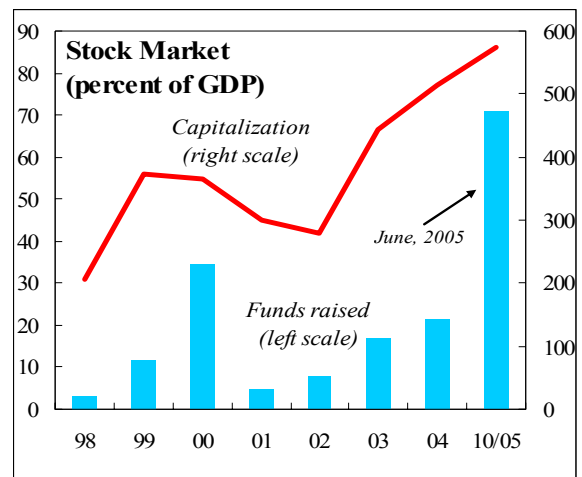
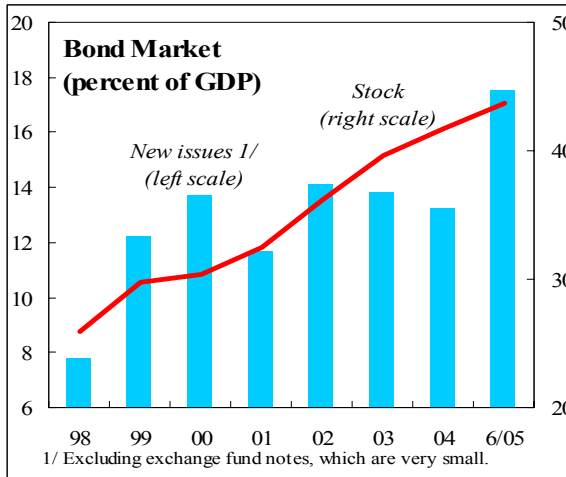
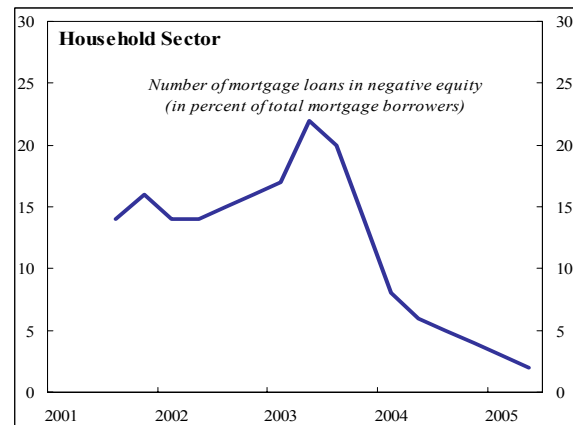
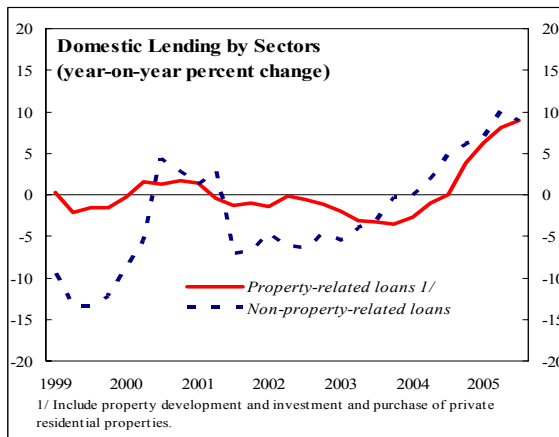


5. Unlike previous cycles in recent years, prices across all markets have recovered during this expansion:

- Inflation has remained positive since February 2005, marking the longest period in the last 6 years of continued price rise, albeit at a modest 1 percent average (year on year). While non-housing prices have been pushed up by higher import prices, housing rentals, which lagged the recovery in other prices given long lease contracts, have also risen in the last few months.
- Property prices, which have rebounded sharply since mid-2003, now appear to be stabilizing, partly reflecting recent increases in interest rates. However, property prices remain well below their pre-crisis peaks.
- Nominal wages, after declining for almost 4 straight years, have recently shown some signs of firming up. In the last two quarters, average nominal labour earnings rose by about 3 percent, signalling some tightening in the labour market. Wages for low-skilled jobs have also reverted to a slight increase.
- The Hong Kong dollar has also recently appreciated in real effective terms, but remains about 30 percent below its 1998 peak.

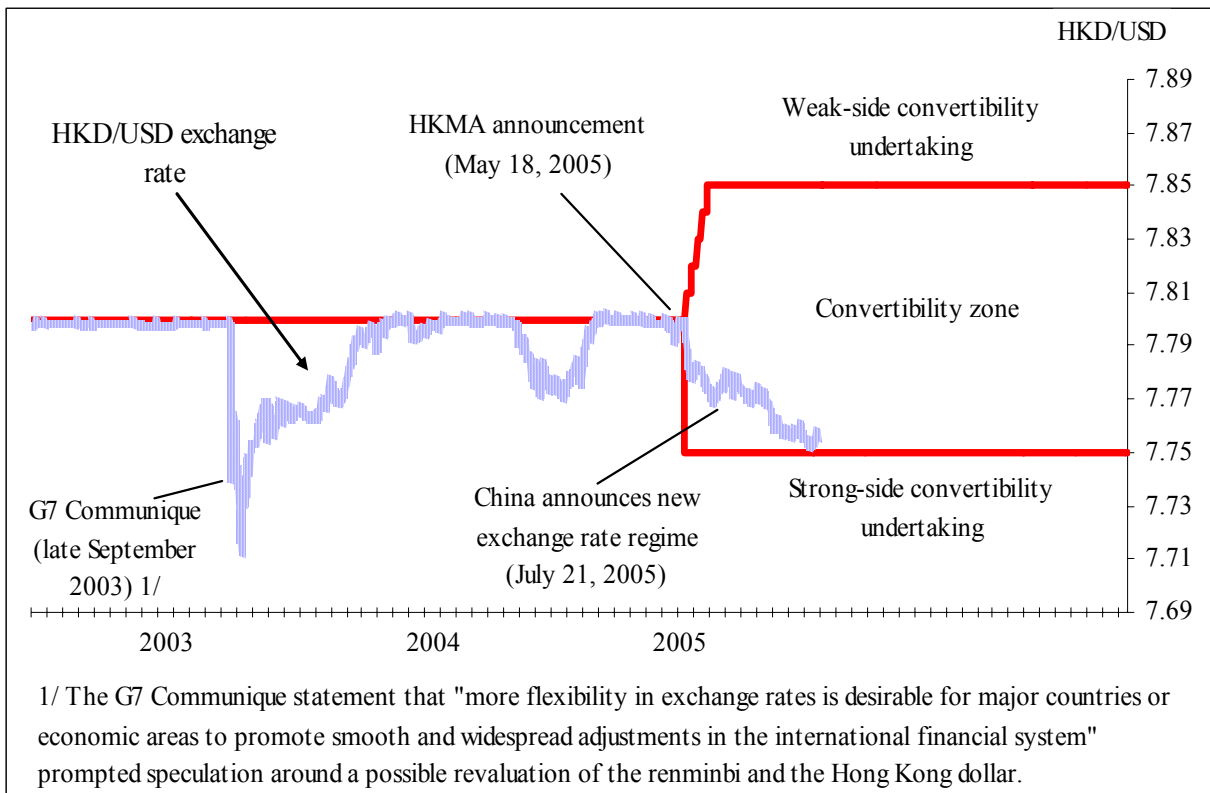


6. **The expansion has been accompanied by increased activity in financial markets.** Bank lending has continued to grow since its recovery in early 2004, except for mortgages and trade credit as corporates have relied on bond and equity finance. Similarly, activity in the local bond market has also increased. With the rise in asset prices, both the banking and household sectors' balance sheets have improved substantially. Residential mortgages in negative equity stood at about 2 percent of total mortgage borrowers at the end of September 2005, significantly below its peak of about 22 percent in mid-2003.

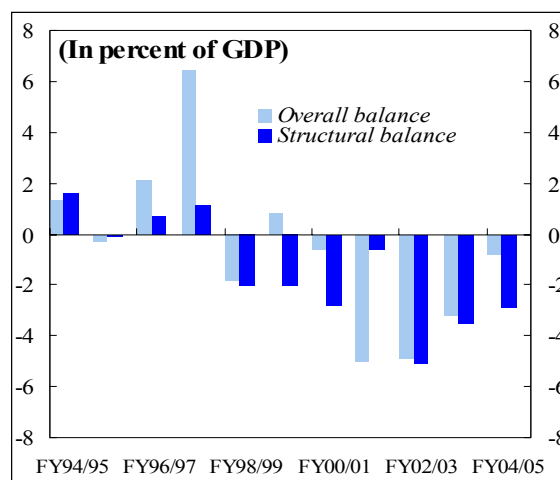


7. **The external position remains strong.** Strong export performance and moderate import growth reflecting soft domestic demand raised the current account surplus to about 10.5 percent of annual GDP in the first three quarters of 2005, up from 6.9 percent for the corresponding period in 2004. Official reserves have remained around the end-2004 level of US\$124 billion (covering about 23 percent of M3).

8. **The Hong Kong Monetary Authority (HKMA) refined the operations of the LERS in May—the first changes since September 1998.** For the first time since the introduction of the LERS in 1983, the HKMA explicitly committed to sell HK dollars at a pre-announced price (set at HK\$7.75/US\$), which is referred to as the *strong-side* convertibility undertaking. Previously, the HKMA had only committed to buy HK dollars at a pre-announced rate (the *weak-side* convertibility undertaking introduced in October 1998) and could sell Hong Kong dollars at any price. Following the refinements, the rate at which the HKMA is committed to buy Hong Kong dollars was gradually shifted to HK\$7.85/US\$. The two way convertibility undertakings are thus symmetric, at 500 pips around the linked rate of HK\$7.8/US\$. These measures were taken amidst intense capital inflows fueled by rumors of an impending change in China's exchange rate regime. The large capital inflows led to excess liquidity in the banking system, which, in turn, reduced Hong Kong SAR interest rates below U.S. rates. The May reforms have so far succeeded in significantly dampening speculative inflows, thereby re-establishing the traditional tight link between Hong Kong short-term rates and U.S. interest rates and have also helped to keep financial markets calm in the aftermath of the subsequent reforms to the renminbi regime in July. In recent months, the Hong Kong dollar has traded close to the strong-side convertibility undertaking (7.75) reflecting large IPO-related inflows.



9. **The outturn for the FY2004/05 fiscal deficit (excluding issuance of bonds and notes)—at about ¼ percent of GDP—was substantially better than the projected 5 percent of GDP.** Buoyant tax revenues (profits and income tax), higher-than-expected land sales and investment income, along with continued expenditure restraint (including civil service wage cuts) were the main contributors to the better performance. Fiscal reserves were equivalent to about 14 months of government expenditures (18 percent of GDP) at end-September 2005 broadly in line with the target announced in the FY2005/06 budget.



10. **Looking ahead, staff expects economic activity to moderate in the near term.** Real GDP growth is projected at 7 percent for 2005 and is expected to ease to about 5½ percent in 2006, reflecting somewhat slower export growth in China. Despite this moderation, inflation should continue to rise modestly as rents pick up and the labor market tightens. The risks to this outlook are broadly balanced. Given the general openness of the economy and the strong linkages with the Mainland, Hong Kong SAR's growth prospects depend crucially on external conditions and developments in China. On the upside, the growth momentum in the Mainland remains strong although a rise in protectionist sentiments in the Mainland's main trading partners pose some risk. On the domestic front, consumption and investment growth could be higher, reflecting higher asset prices, stronger household balance sheets, and significant increases in corporate profits. On the downside, a marked slowdown in global demand, related to higher oil prices or a more significant tightening in U.S. interest rates, or an Avian Flu pandemic, could threaten growth, particularly if this hurts Chinese exports.²

11. **Hong Kong SAR's medium-term growth prospects are favorable.** Increased trade and financial integration of China with the rest of the world should benefit Hong Kong SAR as the gateway to the Mainland. However, the economy will likely face increased competition from other regional financial centers. Thus, there is a need to strengthen the attractiveness of the economy as a regional services hub by maintaining its traditional strengths of flexible labor and product markets, strong legal and institutional framework and sound macroeconomic policies. The staff's illustrative medium-term scenario presented in Table 4 suggests that Hong Kong SAR's growth could average about

² For example, a sharp rise in U.S. interest rates could lower domestic consumption growth, particularly through its effect on households' balance sheets as most mortgages in Hong Kong SAR are based on flexible rates. Staff analysis suggests that a 100 basis point increase in the interest rate tends to reduce consumption by about 0.4 percent.

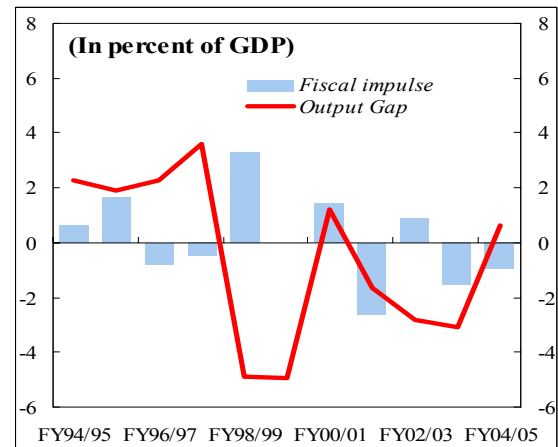
4½ percent annually if these efforts are successful, the labor market maintains strong productivity growth and China’s robust growth continues.

III. REPORT ON THE DISCUSSIONS

12. **Against the backdrop of favorable near-term prospects, this year’s discussions focused on the longer-term fiscal strategy and the structural measures needed to sustain high growth over the medium term.** The authorities and the staff concurred that, while the near-term outlook is positive and the budget is likely to return to balance in the current fiscal year, important policy challenges remain over the medium term most notably the aging of the population. Developing policy measures to mitigate the impact of the demographic changes on the economy and tackling the structural issues in the labor market are important in enhancing Hong Kong SAR’s external competitiveness and ensuring continued strong growth in the long run. The authorities and the staff also agreed that while the financial system remained robust, market infrastructure and supervisory systems need to be continually upgraded to ensure stability. Relatedly, there was broad agreement that the success of Hong Kong SAR as an international financial center hinged on its ability to play an increasing role in the Mainland’s financial intermediation.

A. Fiscal Policy—What Lies Ahead?

13. **The authorities have continued to take advantage of high growth to strengthen further the fiscal position.**³ The FY2005/06 budget targets a deficit of about ¾ percent of GDP, which is likely to be over performed, as budget estimates are based on conservative revenue projections. Staff analysis based on the data for the first six months of the current fiscal year show that the overall budget is likely to be balanced in FY2005/06 due to both strong revenue performance and continued expenditure restraint. Consequently, the original medium-term target of reaching a budget balance by FY2008/09 should be achieved significantly ahead of schedule.



14. **With the target of reaching a budget balance nearly achieved, the mission suggested that now would be an opportune time for the authorities to develop a longer-term fiscal strategy.** Like other advanced economies, Hong Kong SAR is facing demographic challenges (Box 1). Staff analysis suggests that under unchanged policies, aging could generate significant fiscal pressures over the longer run (mainly due to rising

³ The fiscal impulse is defined as the change in the structural balance from the previous year. In computing the structural budget balance, land sales, asset-related receipts and cyclical effects on tax revenue and expenditure are excluded.

health care costs). Old age-related spending for households could increase by about 8 percentage points of GDP by 2030, and in the absence of any change in either the health care delivery system or in the financing of health costs, public expenditure would rise significantly, with perceptible impact being felt from 2015 onwards.⁴ In addition, over the longer term, a shrinking of the working population because of aging could also lower the government's tax revenue. While these factors could lead to a significant decline in fiscal reserves, they are likely to be manageable. Publicly provided pension is very limited unlike in many other countries in a similar situation. The Mandatory Provident Fund (MPF) which was established in 2000 is the main pension vehicle, it is fully funded and privately managed, and will also provide a growing source of retirement income by 2030. Thus, under realistic scenarios where the current level of labor productivity is maintained and some of the increase in health costs is shared by the private sector (paragraph 15), fiscal reserves would decline but remain positive.⁵ Nevertheless, the staff pointed out that fiscal reserves underpin confidence in the predictability of Hong Kong SAR's traditional low-tax environment by providing assurance that the government can meet the challenges of aging-related pressures, as well as large unanticipated shocks as has been the case in the last decade. Thus, in developing such a longer-term fiscal strategy, consideration also needed to be given to the appropriate level of fiscal reserves.

15. The authorities underscored that meeting the challenges of population aging and expanding Hong Kong SAR's narrow tax base were key priorities that would shape fiscal strategy in the medium term. In his Policy Address this October, the Chief Executive emphasized the need for a comprehensive reform of the health care system and the government has recently published a discussion paper for public consultation which outlines reforms in this area. The staff supported the government's plans to encourage greater private sector participation in delivering health care services. The authorities pointed out that immigration policy could ease some of the impact of aging on the economy and public finances by increasing migration of younger skilled workers from abroad and encouraging retirees to relocate in the region while maintaining access to their old-age benefits in Hong Kong SAR. Alternative financing options are also under discussions including expanded use of private health insurance and an increase in mandatory old-age health care savings by adding a Medicare-type levy to the employee's contribution to the existing MPF system.⁶

⁴ At present about 95 percent of the in-patient health care cost is borne by the public finances which yields a very low burden-sharing effort by the private sector.

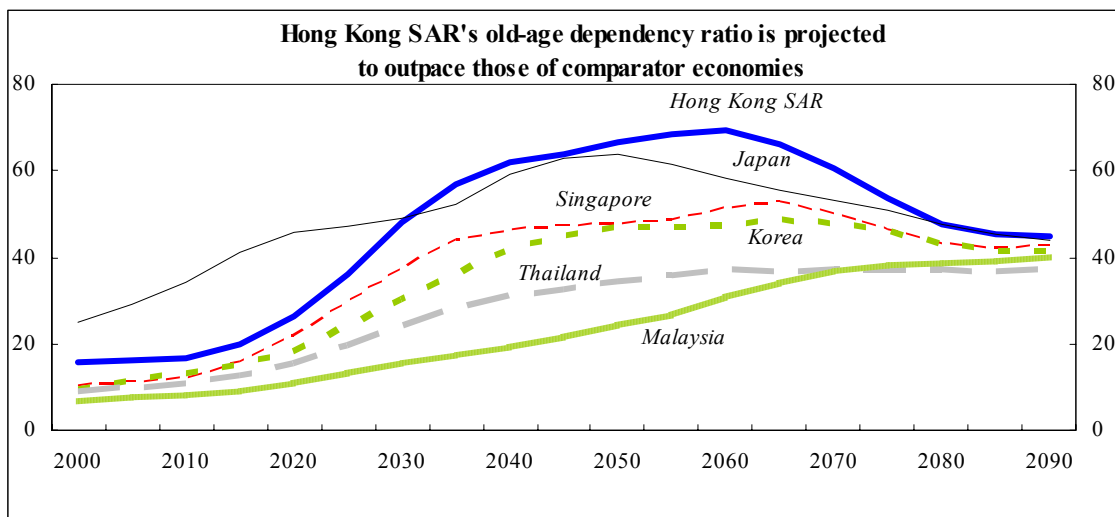
⁵ The Selected Issues Paper presents a detailed analysis of the macroeconomic impact of a rapidly aging population on the economy, including its impact on the public finances under various scenarios.

⁶ The Health and Medical Advisory Committee (HMDAC), the advisory body on long-term health care policies, will recommend health care financing options. The MPF contribution rate is currently set at 5 percent of the employee's income for both employers and employees and capped at HK\$1,000 per month.

Box 1: Impact of Aging

Hong Kong SAR's population is aging rapidly. While current old age dependency ratio (ratio of the number of old-age to the size of its working population) of 16 percent is low compared to other advanced and regional economies, it is projected to double by 2030 and exceed those of other Asian countries (including Japan) by 2050. This could affect the economy and public finances in several ways:

- Potential growth could decline unless there are large and sustained productivity gains;
- Growth in revenue from income-based taxes could slow down in line with GDP;
- There would be pressures on health expenditures from rising demand for old age health services;
- As a predominantly service-based economy, additional budgetary pressures could also arise from the need to upgrade the education system and quality of its workforce to remain competitive.



Source: World Development Indicators, World Bank. Dependency ratio levels (in percent) and defined as old-age dependents to working-age population.

Staff analysis show that aging could adversely affect growth and living standards in Hong Kong.

Staff simulations indicate that under unchanged policies real GDP per capita could decline by about 10 percentage points relative to the baseline of a stationary population. While higher labor productivity growth and increased migration of younger-skilled workers from the Mainland and elsewhere would attenuate the economic impact of aging, they would not offset it fully.

Aging would also put pressure on the public finances. Although the impact on public pensions is likely to be limited (paragraph 14), health care spending would rise as these services are largely government supplied. Due to the relative decline in the working population salary taxes could fall. The pressures on public finances could be worsened if non-tax revenues—mostly land sales and investment income—also slow down. Staff simulations indicate that even if productivity growth were to remain unchanged from its present levels, the overall fiscal deficit could be significantly higher than under a scenario of stationary population. To this end, as the demographic effects could start setting in as early as 2015 when the working population's support ratio peaks, there is a relatively narrow window of opportunity during the current decade to implement policies that could lessen the impact of aging. Among such policy measures is additional fiscal consolidation through a combination of expenditure restraint, a continuation of the ongoing reforms in health care provision (including introducing private health insurance system and raising user fees—with safeguards for the needy), and tax reforms.

16. **To broaden and create a more stable revenue base, the authorities are considering introducing a low-rate GST.** Hong Kong SAR's tax base is narrow, with low tax rates and more than half the working population outside the tax net.⁷ A substantial portion of non-tax revenue also accrues from land sales and investment income, which are notoriously volatile. To strengthen Hong Kong's public finances, the staff has for some time supported the introduction of a GST as an appropriate tax reform. The authorities' intention is to introduce a low-rate GST with few exemptions and compensate the poor and other low-income groups who could be adversely affected through targeted transfers. For this purpose, they are planning on carrying out extensive public consultations in 2006. The staff noted that, as Hong Kong SAR had no experience with any sales-type tax, setting up the needed administrative infrastructure could take time, making an early start to the process useful. The staff also cautioned against granting further tax concessions before the tax reforms and changes to the health care system had been made, since such concessions, unless taken with great care, could permanently increase the budget's reliance on more volatile non-tax revenue.

17. **More generally, the authorities emphasized that fiscal policy would remain anchored by the guidelines enshrined in the Basic Law.**⁸ The authorities pointed to the difficulty in determining an appropriate future target level of fiscal reserves, especially given the significant uncertainty surrounding the eventual impact of aging. The staff agreed that indeed there was no straight forward way of determining such a level of fiscal reserves and that much depended upon what was considered to be adequate to ensure continued confidence by the markets in the government's ability to meet higher and unanticipated spending pressures without significantly changing Hong Kong SAR's low-tax environment. Thus, in determining the appropriate level of fiscal reserves, consideration could be given to realistic provisions for the likely impact of aging on tax revenues and government spending and the volatility in non-tax revenue flows, and a buffer for unexpected negative shocks.

⁷ A GST rate of 5 percent (the current rate in Japan and Singapore) would probably increase the cost of the consumption basket of the poor by about 3.3 percent and yield revenues of about 1¾ percent of GDP. A commensurate upward adjustment in the benefits available under the Comprehensive Social Security Act (CSSA) could be an effective means to protect the vulnerable segments of the population.

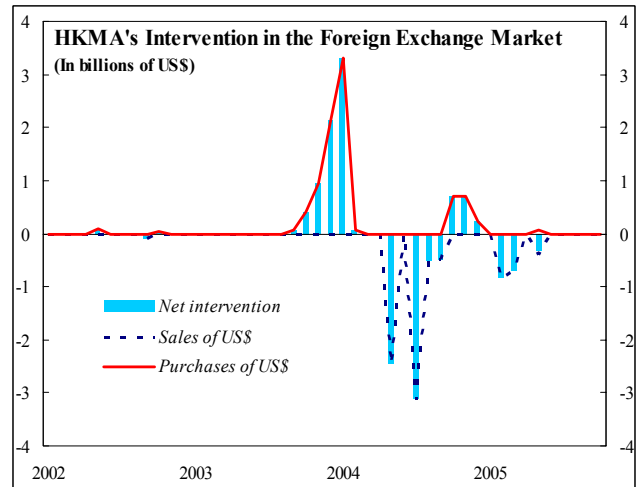
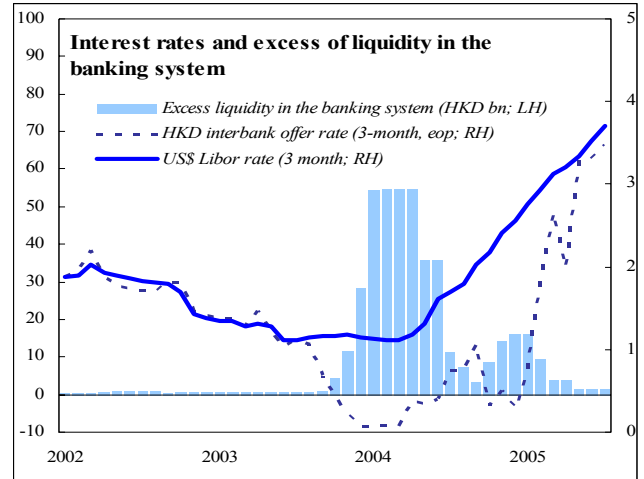
⁸ The Basic Law of Hong Kong SAR stipulates that the Hong Kong SAR Government shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product.

B. Exchange Rate Regime—A Stronger Currency Board

18. The staff reiterated its support for the authorities' commitment to the LERS.

The May 2005 refinements have removed uncertainties about the extent to which the

Hong Kong dollar could appreciate and had successfully dampened speculative inflows related to market expectations of a renminbi appreciation. More generally, the refinement measurements have promoted the smooth functioning of the money and foreign exchange markets in accordance with the Currency Board arrangements, with Hong Kong dollar interest rates closely tracking those for the US dollar after the refinements. The refinements have functioned well without any active money market operations by the HKMA.⁹ The high correlation that existed between the Hong Kong dollar and renminbi forward rates since late-2003 has also dissipated, and the mission's discussions with both market analysts and traders indicated that the Hong Kong dollar is no longer viewed as a proxy vehicle for trading the renminbi. Although not fully tested yet, the HKMA noted that the system appears to have been fortified by the refinements to withstand external pressures, for example, possible increased renminbi flexibility.¹⁰ As before, adjustment to larger or more lasting shocks will rely on the considerable flexibility with which the real exchange rate in Hong Kong SAR has adjusted to correct macroeconomic imbalances. Underlying the flexibility of the real exchange rate is the efficiency of Hong Kong SAR's domestic markets, which have repeatedly demonstrated their ability to adjust to external shocks through changes in interest rates, wages, asset, and product prices.

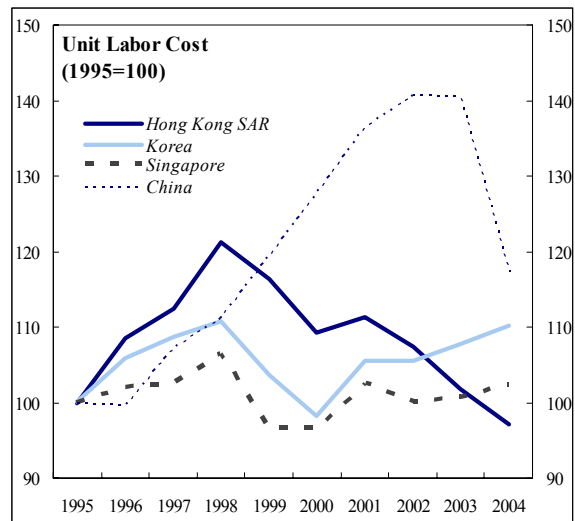


⁹ Under the currency board rules, the HKMA's intervention in the foreign exchange market are conducted passively and involve only the Hong Kong dollar and the U.S. dollar.

¹⁰ In this regard, the impact of a sizable renminbi appreciation will depend on the effect it has on China's exports. A decline in China's export growth would lower growth of Hong Kong SAR's re-exports but the improvement in the competitiveness of domestic exports would attenuate the effect on overall exports.

19. **The generalized deflation over the last few years has improved Hong Kong SAR's external competitiveness.** The decline in property prices and nominal wages has helped to lower unit labor costs and the real exchange rate. This has resulted in reduced

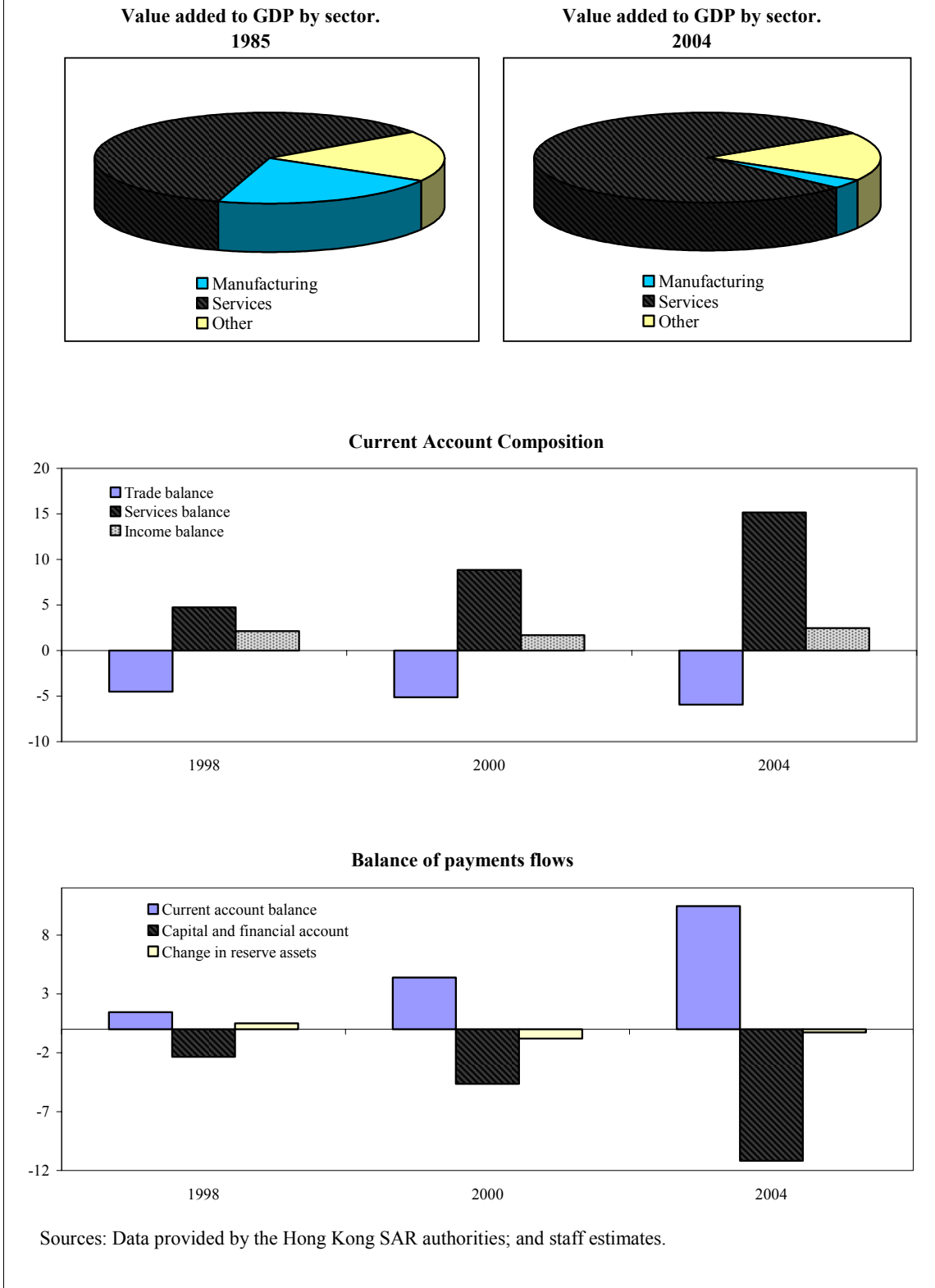
business costs, improving the attractiveness of Hong Kong SAR as a business hub and financial center and reflected in the rise in activity in these sectors. However, in the manufacturing and low-end services sectors, the reduction in Hong Kong's labor costs or depreciation in the real exchange rate does not appear to have materially narrowed the cost gap with the Mainland. In this context, the mission's discussions with textile exporters, who mostly produce high-end goods, indicated that the recent increase in textile export orders mainly reflected an attempt by buyers to hedge against the imposition of possible safeguard measures against Mainland exports by the U.S. and Europe. More generally, the recent upturn in almost all domestic prices suggest that the economy's adjustment to the adverse shocks of the last seven years may be finally over and that external competitiveness has been restored to a level that is consistent with economic fundamentals.



20. **Developments in the balance of payments over the medium term, however, would continue to be heavily influenced by the ongoing transformation of the economy (Figure 1).** Domestic investment has declined sharply over the past few years, while outward FDI has increased significantly, as investors have relocated Hong Kong manufacturing and low-end services units, and port facilities to the Mainland.¹¹ This has been mirrored in the balance of payments in the substantial increase in external services earnings. Over the medium term, this trend is unlikely to be reversed. Thus, the savings-investment gap would remain large, with broadly stable savings and low domestic investment and strong outward FDI. The trade balance would likely remain in deficit, but the current account would continue generating large surpluses, reflecting significant net earnings from foreign investment, trade and financial intermediation, and tourism. Thus, Hong Kong SAR's net international investment position (which is about 3½ times the size of its reserve asset holdings) is expected to increase significantly over the medium term.

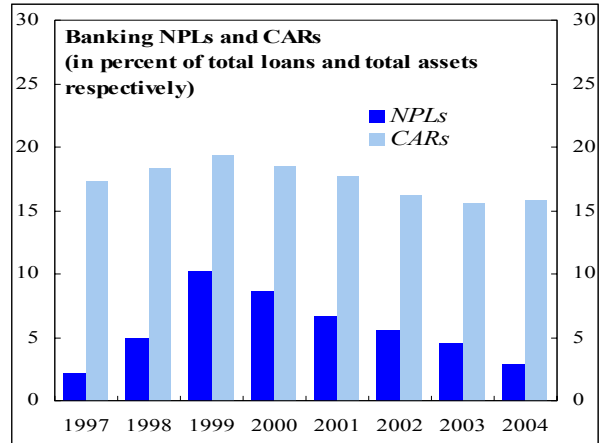
¹¹ Some of the FDI outflows may reflect investment “round-tripping” from the Mainland via Hong Kong SAR to take advantage of the favorable tax treatment for foreign investment in the Mainland, although these types of flows have declined in recent years (Figure 2).

Figure 1. Hong Kong SAR: Structural changes in the economy and the Balance of Payments dynamics (1985 - 2004)

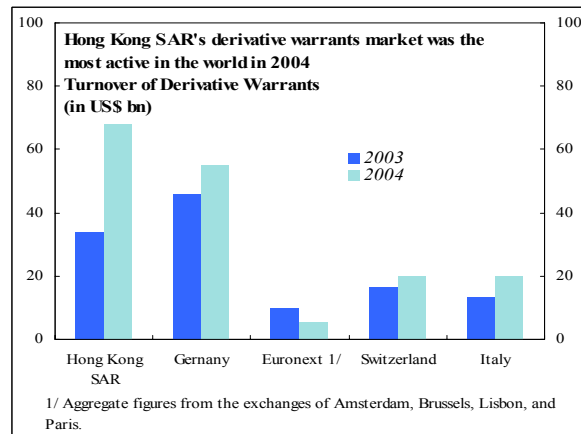
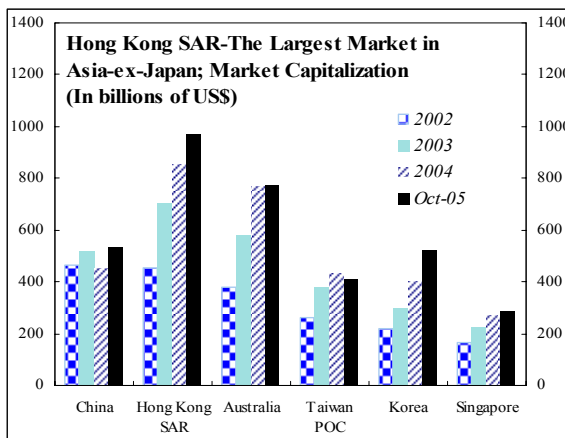


C. Structural Policies—Continuing to Reinvent the Economy

21. **The authorities and the staff agreed that while the financial system remained robust, market infrastructure and supervisory systems needed to be continually upgraded to ensure stability.** Banks remain well capitalized and non-performing loans have declined significantly following the recovery. Hong Kong banks having well weathered the large decline in asset prices in the aftermath of the Asian crisis, are now witnessing a rise in profitability with net write-back of debt provisions and increased non-interest income. The authorities have made significant progress toward the introduction of a deposit insurance scheme, which is planned to be launched in the second half of 2006. Preparations for adopting Basel II requirements are proceeding well with the amendment of the banking ordinance in July 2005 that provides statutory backing for it.



22. **In recent years, Hong Kong’s financial markets have grown rapidly.**¹² This has been fueled in part by increased listings by Mainland companies (the latest being the US\$9¼ billion IPO floated by China Construction Bank) and increased popularity of equity-derivative products. The staff and the authorities agreed that as growth in the size and sophistication of these markets continue, particularly derivatives, close surveillance would be critical to ensure that Hong Kong’s financial markets remain efficient and orderly. In this respect, the mission welcomed efforts by the Securities and Futures Commission (SFC) to review the current regulatory regime of the derivative warrants



¹² In November 2005, a retail renminbi non-deliverable forward (NDF) product was introduced in Hong Kong SAR, aiming at small and medium enterprises and retail customers to hedge their renminbi exposure. The government has also launched a retail programme for Exchange Fund Notes since 2004.

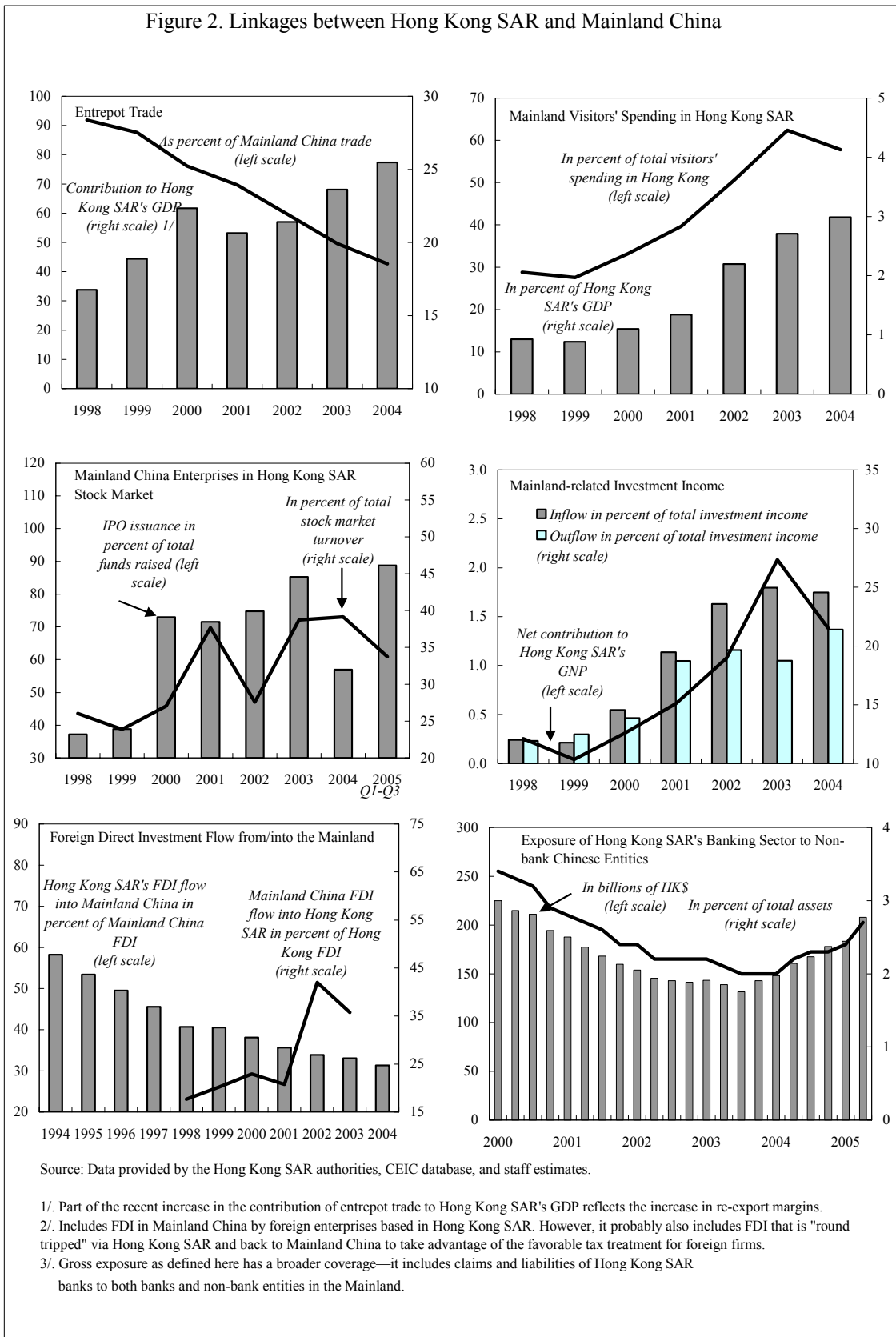
market and its current market practices in response to concerns recently raised by some market observers.¹³ Relatedly, the staff noted that cooperation between the Mainland and Hong Kong SAR's financial supervisors has advanced in banking, securities and insurance sectors and further coordination will become increasingly important as financial integration between the two economies intensifies.

23. **There was a broad consensus across the government and private sector that the continued success of Hong Kong SAR as an international financial center hinges on its ability to play an increasing role in the Mainland's financial intermediation.** Hong Kong's markets have long been actively used by Mainland firms to raise foreign capital (Figure 2), a trend that is likely to continue in the near future as Mainland financial markets themselves undergo reforms. However, going forward, most observers noted that the financial center's long-term future depended on the role it could play in intermediating the Mainland's large domestic savings and in renminbi risk management. The authorities in both economies are engaged in seeking out ways to increase the use of Hong Kong markets in renminbi intermediation and risk management. In this respect, the HKMA announced in November that agreement had been reached for the People's Bank of China to expand the clearing arrangement for renminbi services offered by banks in Hong Kong, by liberalizing deposit-taking, currency exchange, and remittances and credit card transactions in renminbi by bank customers and introducing use of renminbi checks.¹⁴ Recently, steps have also been taken to lower transactions costs for small and medium-scale Hong Kong enterprises with operations and exposure in the Mainland to make greater use of non-deliverable forward renminbi transactions in Hong Kong SAR. Both the authorities and the staff recognized that while progress in this area depended crucially upon the pace of financial liberalization in the Mainland, continuous improvement in cross-border linkages between payment, settlement, and clearing systems would be

¹³ Warrants are stock option-like derivatives that are issued by individual investment banks, securities houses or their affiliates to attract retail investors, who are interested in taking leveraged bets, through lower transactions costs. The SFC's review report concluded that such trading has not led to undue volatilities in the equity market. The Hong Kong Exchanges and Clearing (HKEx) which runs the stock and futures markets, is also reviewing the warrants market to further raise the market's transparency and increase public education on warrants given the large size of retail traders. Meanwhile, the HKEx is expected to launch callable bull/bear contracts (CBBCs) in early 2006. These instruments, like warrants, are structured products that track the performance of an underlying share, but are considered cheaper than warrants and better at tracking the prices of underlying shares more closely. A Selected Issues Paper (Chapter IV) reviews developments in derivatives markets in Hong Kong SAR.

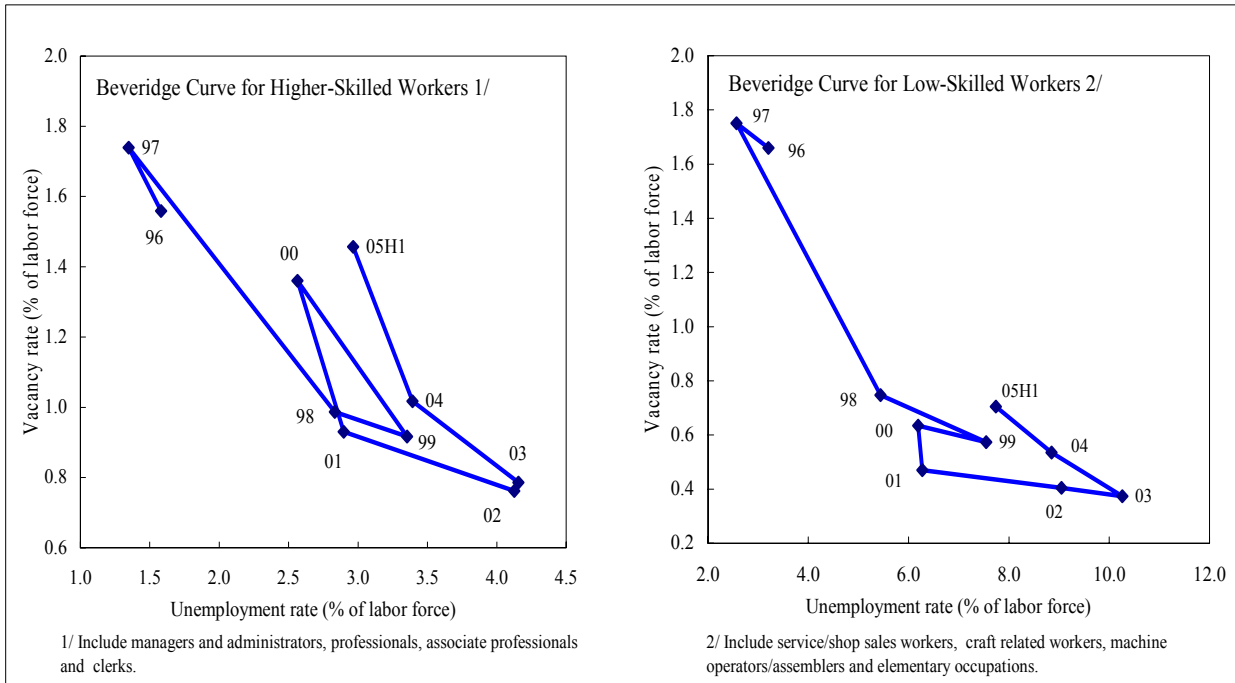
¹⁴ Under the recent measures, the PBC agreed to expand the clearing arrangement that it provides to: (1) allow Hong Kong designated merchants (with the definition of such also widened) to open renminbi deposit accounts; (2) allow Hong Kong residents to open renminbi accounts and make payments for consumer spending in Guangdong Province by checks; (3) raise the limit for exchange of renminbi cash and renminbi remittances by Hong Kong residents; and (4) remove the cap on credit limits for renminbi cards issued by participating banks.

Figure 2. Linkages between Hong Kong SAR and Mainland China



important to allow Mainland firms and households to better utilize Hong Kong SAR's financial infrastructure.

24. **Reducing the high level of unemployment among low-skilled workers remains a key priority of the government.** Relocation of manufacturing and low-end services jobs into Mainland China has contained the increase in demand for low-skilled workers. At the same time, the demand for higher-skilled workers has increased more distinctly.¹⁵ The authorities noted that their strategy to reduce unemployment among the low skilled has focused on programs to upgrade skills, retrain, and assist in job placement, reflecting its objective to provide assistance to the truly needy without impairing the traditional flexibility of Hong Kong SAR's labor market flexibility. There are no obvious nominal rigidities in the labor market (Box 2). Some success has been achieved in reducing unemployment, but the number of low-income welfare recipients (who receive support from the CSSA social security system) has continued to rise pointing to weak earnings in this segment of the labor market. The recently announced public works program should help to boost employment in the construction industry, which has been the worst affected sector. Relatedly, the Chief Executive's Policy Address called for a public debate on the appropriateness of introducing a statutory minimum wage and standard working hours.



¹⁵ Government projections indicate that there will be a surplus of 230,000 low-skilled workers and a shortfall of 100,000 highly skilled workers by 2007.

Box 2: Hong Kong SAR's Labor Market

Over the years, Hong Kong SAR's labor market has proven to be highly flexible. In contrast to most industrialized countries, there is no minimum-wage legislation for the domestic labor force, no public unemployment insurance scheme, and the tax wedge facing the unemployed is small. Support for the unemployed is rigorously means tested, while labor-market-related public expenditure focuses on retraining and job placement assistance. Furthermore, extensive use of performance-related compensation has helped to facilitate downward adjustment of wages during periods of cyclical weakness.

Nevertheless, while the unemployment rate has declined over the current economic expansion, it remains high in some low-skilled sectors. The high unemployment among the low-skilled partly reflects the relatively subdued construction sector and skills mismatch stemming from the relocation of manufacturing and low-end services jobs to the Mainland. In recent years, the government has had some success in reducing unemployment among the low-skilled by promoting tourism (Disneyland) and by investing significant resources in programs to upgrade skills, retrain, and assist in job placements.

Reflecting the high unemployment among the low-skilled, wage income among these workers has also remained low and the number of low-income earners on welfare has continued to rise.

Hong Kong SAR: Unemployment Rates of Major Sectors						
	2002	2003	2004	2005		
				Q1	Q2	Q3
Manufacturing	7.3	7.6	7.0	7.5	5.7	7.1
Construction	15.8	19.0	16.0	15.4	14.1	11.0
Trade and tourism	7.8	8.2	6.6	5.8	5.8	5.2
Transport	5.4	6.5	5.3	4.0	5.2	5.1
Financing	4.7	5.2	4.5	4.0	3.2	3.5
Personal services	3.2	3.5	3.4	2.8	2.6	2.6
Others	2.4	2.8	2.8	1.7	1.9	2.1
Overall	7.3	7.9	6.8	5.9	5.7	5.7

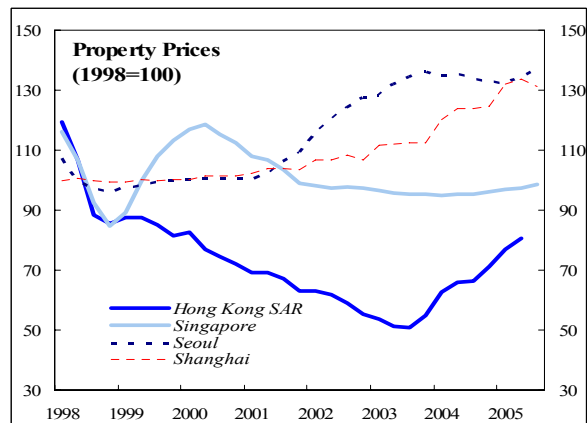
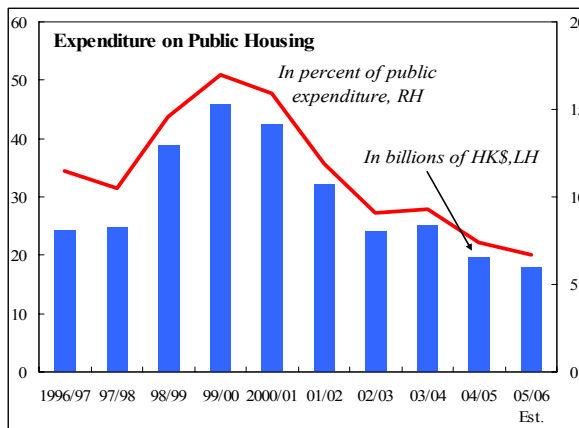
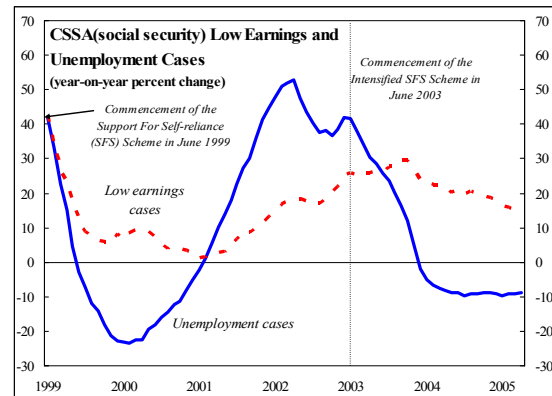
Source: Hong Kong SAR, Census and Statistics Department.

Against this backdrop, there is an ongoing debate in Hong Kong SAR on whether to introduce a statutory minimum wage and standard working hours. Numerous countries have adopted minimum wages to prevent labor income from falling below socially unacceptable levels. As such, the issue is closely tied to an economy's social compact. Whether minimum wages succeed in improving the incomes of the low skilled depends crucially on whether they adversely affect employment, which may happen if it is set at too high a level. A further consideration in Hong Kong SAR is that a statutory minimum wage could inhibit necessary downward adjustment in wages. Given the LERS, factor price flexibility (including wages) constitutes one important source of adjustment to shocks for the economy. If Hong Kong SAR does decide to introduce a minimum wage, it will be important to draw on the experience of the many OECD economies with minimum wage laws and do so in a manner that maintains much of the traditional elements of labor market flexibility. Key considerations include: the initial level relative to average wages; how it is adjusted over time (minimum wages that are linked to either price or wage inflation introduce greater rigidity into the market); the extent of differentiation by age (many countries have a lower rate for young people); how it interacts with the tax and in-work benefit systems, and public assistance to the unemployed and to the working poor.

The staff welcomed this call for an economy-wide discussion and noted that while such institutional changes were intrinsically related to the economy's social compact, it should be kept in mind that labor market flexibility is a key factor behind the Hong Kong's continued resilience to external shocks.

25. The property market plays a pivotal role in the economy and the general increase in real estate prices has once again brought to the fore the appropriate role of the government in the market.

The general price rise since mid-2003, which is comparatively higher than in some regional cities, reflects both improving fundamentals and greater speculative activity (Box 3). Overall affordability, although declining, remains above its long-run average. As the sole supplier of new land, the government's land policy is a key influence on prices. In recent years, the government has taken various steps to



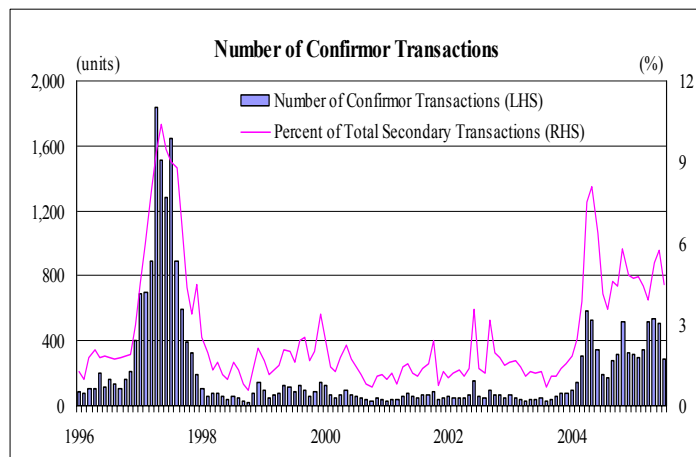
reduce its influence in an attempt to become a passive player in the market. The current Application List system for sale of new land is more market based. The staff noted that recent changes in the system appear to have induced greater market interest and the authorities should consider making further changes if the need arises.¹⁶

¹⁶ Under this system, the government announces in advance which lots will be available for sale by auction in the coming year. Previously, an interested party can trigger the auction of a lot by submitting a price bid that is at least equal to the government's reserve price (which is kept undisclosed). The land is then auctioned or tendered publicly to the highest bidder. During the first few months of 2005, a few developers complained about the lack of transparency of the application system and the fact that the reserve price is often set too high. In response, in June, the government announced that land auctions will now be triggered if a bid is at least equal to 80 percent of the government's undisclosed assessment of the open market value.

Box 3: Recent Property Market Developments

After declining for over five years, property prices have rebounded sharply since mid-2003 but they remain significantly below their peak of 1997. As of October 2005, real property prices were up by about 52 percent from their trough two years ago. While the recovery in prices is from a very low base – prices remain 44 percent below their peak level reached in mid-1997 – the speed of the rise has raised concerns about the risk of another bubble in the property market. Credit growth and transaction volumes have also increased markedly over the same period. A large part of the price increase has been concentrated in luxury housing, consistent with previous upturns in the property market. In recent months property prices and transaction volumes have stabilized, which is partly attributable to the rise in mortgage interest rates.

The recovery in property prices appears to be broadly in line with developments in demand and supply fundamentals. Analytic work done by staff in the selected issues paper, suggests that econometric models perform reasonably well in explaining property price changes, including the recent increase. The models highlight the role played by demand factors, such as high housing affordability, low interest rates, solid GDP growth, falling unemployment and a rise in rents. Supply factors are also likely to have contributed to the price recovery, with both residential land sales and public housing completions being below average levels. A rise in speculative activity, as measured by the number of confirmor transactions, (the sale of very recent purchases) may have added momentum to the recovery, although speculative activity remains well below the levels reached in 1997. Going forward, continued income growth and improvement in other fundamentals should help to attenuate the impact of rising interest rates on property prices.



While other countries have experienced distinct property price cycles, the frequency of the cycles in Hong Kong SAR is unusual. A cross-country comparison of property price changes indicates that the scale and, in particular, the frequency of property price swings in Hong Kong SAR is greater than that experienced elsewhere. Since 1990, there have been three episodes of price increases of over 20 per cent year-on-year and two episodes of declines of over 20 per cent. In contrast, the standard deviation of annual price changes in industrial countries is one-third of that of Hong Kong SAR, while Singapore is the only country in Asia whose property price volatility is comparable to Hong Kong SAR.

26. **The staff noted that Hong Kong SAR has one of the most open and flexible economies and lowering business costs will remain crucial to the economy's future.** In recent years, there have been calls for promoting domestic competition in some sectors. The authorities pointed out that the government has responded to these concerns and has continually reviewed its policies to ensure that anti-competitive behavior is minimized. In this regard, the staff welcomed the setting up of an independent committee to look into the existing competition policy, including any need for a general competition law.

D. Other Issues

27. **The authorities produce and disseminate a comprehensive set of economic statistics on a timely basis for surveillance purposes.** Hong Kong SAR is in observance of the Fund's Special Data Dissemination Standard (SDDS). Since June 2002, the authorities have published data on the international investment position and gross external debt. In 2004, Hong Kong SAR has for the first time reported Government Finance Statistics (GFS) data for publication in the 2003 GFS Yearbook. The authorities also publish data on the direction of services trade, which is important given its growing importance for economic activity.

28. **The authorities have made significant progress toward the implementation of the new AML/CFT framework.** The HKMA, SFC, and the Office of the Commissioner of Insurance have issued guidelines (that do not require changes in legislation) to their respective regulated entities to implement anti-money laundering standards. Preparation for legislative amendments to implement the remainder of the 40+9 recommendations of the Financial Action Task Force (FATF), which are international standards for AML/CFT, is underway with a view to be introduced in 2006/07.

IV. STAFF APPRAISAL

29. **The economic expansion that began in mid-2003 has now been sustained for nine consecutive quarters.** Growth remains robust, supported by strong Mainland-related exports. The continued expansion owes much to the favorable external environment, with judicious macroeconomic policies, continued structural reforms, and the confidence building effects of the Closer Economic Partnership Arrangement (CEPA) making significant contributions. Importantly, job creation has steadily gathered strength, which has brought down the unemployment rate quite significantly, although for low-skilled workers it remains relatively high. Reflecting the buoyant activity, inflation has picked up mildly, but remains well contained. Asset prices, which have rebounded sharply since mid-2003, now appear to be stabilizing.

30. **Looking ahead, staff expects economic activity to moderate in the near term with the risks to this outlook broadly balanced.** Despite this moderation in activity, inflation should rise modestly as rents pick up and the labor market tightens. Given the general openness of the economy and the strong linkages with the Mainland, Hong Kong SAR's growth prospects will continue to depend crucially on external conditions and developments in the Mainland.

31. **Sustaining strong growth over the medium term will also depend crucially on effectively meeting the challenges of integration with the Mainland.** The continued success of Hong Kong as an international financial center hinges upon its ability to assist in the Mainland's financial intermediation. Hong Kong is well positioned to play a significant role in this process given its sophisticated financial infrastructure, although progress in this area depends crucially upon the pace of financial liberalization in the Mainland. Cooperation and coordination with the Mainland's financial authorities, which have advanced well, will therefore become increasingly important. Given ongoing competition from other regional financial centers there is a continued need to bolster Hong Kong SAR's competitiveness by maintaining its traditional strengths—flexible product and factor markets, strong institutions—and sound macroeconomic policies.

32. **The staff commends the authorities for the continued strengthening of the fiscal position.** Based on current economic trends and reflecting the government's unstinted restraint on spending, the staff projects that the budget could return to balance in the current fiscal year, significantly ahead of schedule.

33. **With the target of reaching a budget balance nearly achieved, the staff believes that this is a good time to develop a longer-term fiscal strategy.** Like other advanced economies, Hong Kong SAR is facing demographic challenges. As the population ages, substantial pressures would likely be exerted on the public finances, especially through higher health care costs. Thus, the staff welcomes the priority given by the government to health care reform, including by encouraging greater private sector participation and considering alternative ways to finance old-age health costs. In formulating a longer-term fiscal strategy, consideration should also be given to the appropriate level of fiscal reserves, although admittedly such a determination is difficult. These reserves underpin confidence in the predictability of Hong Kong SAR's traditional low-tax environment by providing assurance that the government can meet the challenges of aging-related pressures, as well as large unanticipated shocks.

34. **Separately, there remains a need to broaden the tax base to help stabilize revenue.** Hong Kong SAR's tax base is narrow with more than half the working population outside the tax net. A substantial portion of non-tax revenue accrues from land sales and investment income that are very volatile. Thus, the staff welcomes the government's plans to begin public consultations on the feasibility of introducing a low-rate GST. This is an important tax reform and if implemented with minimal exemptions should greatly expand the tax base. Low-income families adversely affected by this tax reform could be compensated through targeted transfers. Given the long lead time required to implement such a new tax, an early start to the consultation process would be useful. Meanwhile, the staff would caution against further tax concessions, which, unless taken with great care, could permanently increase the budget's reliance on more volatile non-tax revenue.

35. **The May 2005 refinements have significantly strengthened the Linked Exchange Rate System (LERS).** The refinements have reduced the use of the Hong Kong dollar as a proxy hedge for the renminbi and helped to reestablish the traditional tight link

between Hong Kong SAR interest rates and U.S. rates. The LERS remains robust and the staff continues to support the authorities' commitment to it.

36. **The authorities rightly emphasize the need to continue strengthening the market infrastructure and supervisory systems in order to maintain financial stability.** The staff welcomes progress made on the introduction of a deposit protection scheme and preparations for adopting Basel II by banks. Growth in the size and sophistication of Hong Kong's financial markets and instruments is likely to expand and is desirable to maintain the vibrancy of the financial center. However, such developments also call for continued close market surveillance to ensure that financial markets remain efficient and orderly.

37. **The staff supports the government's strategy to reduce unemployment among low-skilled workers through programs that upgrade skills, retrain, and assist in job placement.** The recently announced public works program should help to boost employment in the construction industry, which has been the worst affected sector. Relatedly, the staff supports the call for a public debate on the appropriateness of introducing a statutory minimum wage and standard working hours. However, it should be kept in mind that as demonstrated in the last several years the flexibility of Hong Kong SAR's labor market is a key factor behind the economy's resilience to external shocks.

38. **Hong Kong SAR has one of the most open and flexible economies and lowering business costs will remain crucial to the economy's future.** Thus, the staff welcomes the setting up of an independent committee to look into the existing domestic competition policy, including any need for a general competition law.

39. **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.**

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 2002-2006

Nominal GDP (2004): US\$ 165.7 billion

Population (mid-2004): 6.9 million

GDP per capita (2004): US\$24,082

	2002	2003	2004	2005			Staff Proj.	
				Q1	Q2	Q3	2005	2006
Real GDP (percent change)	1.8	3.1	8.2	6.2	7.3	8.2	7.0	5.5
Domestic demand (contribution)	-0.7	0.1	4.5	-2.2	-0.7	3.7	1.8	2.0
Private consumption	-0.6	-0.6	3.8	2.5	1.6	2.5	1.2	1.3
Government consumption	0.2	0.2	0.1	-0.5	-0.2	-0.1	0.1	0.1
Gross fixed capital formation	-1.2	0.2	1.0	0.1	1.1	0.6	0.4	0.6
Inventories	0.9	0.3	-0.4	-4.3	-3.2	0.8	0.0	0.0
Net exports (contribution)	2.5	3.1	3.7	8.4	8.0	4.5	5.2	3.5
Industrial production	-9.8	-9.2	2.9	-0.6	-0.1	4.1	...	...
Retail sales	-2.6	-0.6	9.1	7.6	6.5	5.1	...	...
Inflation (percent change)								
Consumer prices	-3.0	-2.6	-0.4	0.4	0.8	1.4	1.2	1.5
GDP deflator	-3.5	-6.4	-3.3	-1.5	-0.7	-0.2	-0.5	1.3
Employment (percent change)	-0.6	-0.4	2.8	2.3	1.9	2.6	3.8	3.0
Unemployment rate (percent)	7.3	7.9	6.8	6.1	5.7	5.5	5.4	3.8
Real wages	1.3	0.2	-1.2	-0.5	-0.9	-0.7	...	...
Government budget (percent of GDP)								
Revenue	13.9	16.8	20.4	20.3	18.2	18.5	18.6	17.9
Expenditure	18.7	20.1	18.8	18.2	18.7	18.6	18.6	17.8
Consolidated budget balance	-4.8	-3.3	-0.3	2.1	-0.5	-0.1	0.0	0.1
Fiscal reserves at March 31	24.4	22.3	22.9	21.7	20.5	20.5	21.2	19.9
Money and credit (percent change, end-period)								
Narrow money (M1)	14.6	39.8	17.2	6.4	-2.1	-3.1	...	...
Broad money (M3)	-0.9	8.3	8.6	8.6	8.2	8.1	...	...
Loans for use in Hong Kong SAR	-2.6	-2.0	4.9	6.5	9.1	8.8	...	...
Interest rates (percent, end-period)								
Best lending rate	5.0	5.0	5.0	5.3	5.8	7.0	...	...
Three-month HIBOR	1.4	0.1	0.3	2.7	3.3	4.1	...	...
Asset prices								
Hang Seng stock index (July 31, 1964=100)	9321	12576	14230	13517	14201	15429	...	...
Hang Seng stock index (percent change)	-18.2	34.9	13.2	6.6	15.6	17.6	...	...
Residential property prices (percent change)	-11.2	-11.9	26.6	22.1	22.4	20.1	...	...
Merchandise trade (percent change) 1/								
Export value	5.4	11.7	15.9	10.6	12.5	12.5	11.1	8.9
Import value	3.3	11.5	16.9	8.1	10.1	11.5	9.0	7.5
External balances (percent of GDP)								
Merchandise trade balance	-3.1	-3.6	-5.6	-6.1	-5.9	-2.0	-2.6	-0.4
Current account balance	7.6	10.4	9.6	10.4	9.4	11.6	10.2	10.3
Foreign exchange reserves 2/								
In billions of U.S. dollars, end of period	111.9	118.4	123.6	122.4	122.0	122.7	123.8	124.8
In months of retained imports	22.6	23.2	21.1	20.3	20.1	20.2	...	...
In percent of broad money (M3)	24.5	23.8	22.9	22.8	22.6	22.3	...	...
Exchange rate								
Linked rate (fixed)								
Market rate (HK\$/US\$1, period average)								
Real effective rate (period average, Jan. 2000=100)								

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

Staff projections are consistent with the latest WEO submission.

1/ Current month and previous two months compared with the same period of previous year.

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

Table 2. Hong Kong SAR: Consolidated Government Account, FY2002-FY2009 1/
(In percent of GDP)

	FY02/03	FY03/04	FY04/05	FY04/05 4/	FY05/06	FY06/07	FY07/08	FY08/09	FY09/10
	Actual	Actual	Budget	Actual	Budget	Proj.	Proj.	Proj.	Proj.
Revenue	13.9	16.8	15.3	18.5	17.7	18.7	17.8	16.7	15.8
Tax	8.9	10.4	10.2	11.7	11.3	14.6	13.8	12.7	11.8
Earnings and profits tax	5.7	6.5	6.5	7.5	7.5	...	...	...	...
Stamp duties	0.6	0.9	0.9	1.2	1.2	...	...	...	...
Nontax	5.0	5.0	5.1	6.7	6.4	4.0	4.0	4.0	4.0
of which: Land sales and Land Fund Revenue	0.9	0.4	0.9	2.5	2.4	0.9	0.5	0.5	0.4
Investment income	1.4	2.1	1.0	1.1	1.1	1.2	1.0	1.0	1.0
Privatization and asset sales	0.0	1.2	0.9	0.5	0.4	1.8	1.1	1.0	0.9
Expenditure	18.7	20.1	20.6	18.8	18.5	18.6	16.3	15.0	14.1
Current	15.5	16.0	15.8	14.9	14.5	15.6	13.5	12.2	11.3
Capital	3.2	4.1	4.9	3.9	4.1	2.9	2.8	2.8	2.8
Equity injections	0.2	0.3	0.6	0.5	0.4	0.5	0.3	0.4	0.3
Other capital	3.0	3.7	4.4	3.4	3.7	2.5	2.5	2.4	14.1
Primary balance 2/	-6.2	-5.4	-6.3	-1.4	-1.8	-1.2	0.4	0.8	0.8
Overall Balance	-4.8	-3.3	-5.4	-0.3	-0.8	0.0	1.4	1.8	1.8
Structural balance 3/	-5.1	-3.5	-2.5	-2.9	-2.1	-1.9	0.4	0.6	0.7
Fiscal reserves	24.4	22.3	17.6	22.9	20.1	21.4	19.5	20.0	20.5
(in percent of annual expenditure)	130.2	111.3	84.1	122.2	109.0	115.1	120.0	131.0	140.0

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

1/ Fiscal year begins April 1.

2/ Balance excluding investment income.

3/ 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, privatization receipts, equity injections, and the impact of cyclical fluctuations.

4/ FY2006-10 projections are based on the authorities' medium-term fiscal consolidation framework as announced in the FY2005/06 budget.

Table 3. Hong Kong SAR: Standard Vulnerability Indicators

	2000	2001	2002	2003	2004	2005-latest
Public Sector						
Fiscal deficit (in percent of GDP)	-0.6	-4.9	-4.8	-3.3	1.7	-0.1 Sept
Accumulated fiscal surplus (in percent of GDP)	32.7	28.7	24.4	22.3	22.9	20.5 Oct
External Sector						
Total Export volume (percent change)	17.1	-3.3	8.6	14.0	15.3	11.4 Jan-Sep
Domestic exports	7.5	-10.2	-11.3	-7.4	2.4	0.0 Jan-Sep
Reexports	18.5	-2.4	10.9	16.1	16.3	12.1 Jan-Sep
Total Import volume (percent change)	18.1	-2.0	7.8	12.8	14.1	7.6 Jan-Sep
Current account (in billions of US\$)	7.0	9.8	12.4	16.5	15.9	13.6 Q1-Q3
Net equity inflow (in billions of US\$)	29.4	-23.5	-14.4	-4.2	-28.5	-12.2 Q1-Q3
Gross official reserves (in billions of US\$)	107.6	111.2	111.9	118.4	123.6	121.9 Oct
In months of retained imports	18.0	20.4	22.6	23.2	21.1	20.1 Oct
In percent of monetary base	389.0	376.9	354.0	313.6	325.2	339.6 Oct
In percent of broad money 1/	23.0	24.4	24.8	24.1	23.1	22.1 Oct
In percent of Hong Kong dollar M3	41.9	43.0	43.5	43.3	43.3	41.3 Oct
Short-term debt (in billions of US\$) 2/	...	...	28.7	31.2	38.6	40.2
In percent of gross reserves	...	...	25.6	26.3	31.2	32.4
1-yr forward exchange rate premium (in pips, annual average)	-35	53	139	34	-705	-504 Jan-Oct
Real exchange rate (percent change)	-4.8	-0.1	-4.0	-7.0	-5.5	-2.5 Oct
Financial Sector						
HIBOR(3M)-LIBOR (3M) (in basis points)	-53.0	4.0	9.0	-104.0	-227.0	-19.0 Nov
Hang Seng Index (percent change, end-year)	-11.0	-24.5	-18.2	34.9	13.2	4.5 Dec
Residential property prices (percent change, end-year)	-14.5	-9.8	-12.2	0.9	27.4	5.3 Dec
Banking Sector 3/						
Deposit-loans ratio 4/	143.3	155.9	159.8	175.3	179.3	172.5 Oct
Domestic credit growth	2.3	-3.8	-2.6	-2.0	4.9	9.4 Oct
Real credit growth	6.3	-2.3	0.4	0.6	5.3	7.4 Oct
Capital adequacy ratio 5/	17.8	16.5	15.7	15.3	15.4	15.3 Sep
Nonperforming loans (in percent of total loans) 6, 7/	7.3	6.5	5.0	3.9	2.2	1.5 Sep
Net interest margin (in percent of interest-bearing assets) 7/	2.1	2.0	2.1	1.9	1.7	1.7 Q1-Q3
Return on assets (post-tax) 7/	1.2	1.0	1.2	1.2	1.4	1.0 Jan-Jun
Net open spot position (in billions of US\$)	25.7	24.8	18.4	16.1	28.3	23.7 Sep
Net open forward position (in billions of US\$)	-18.8	-14.8	-6.9	-6.6	-24.6	-21.8 Sep
Exposure to the Mainland (in percent of total assets)	3.3	3.2	2.1	2.8	3.6	4.2 Sep
Exposure to property sector (in percent of domestic credit)	49.2	50.7	51.8	50.9	50.4	50.3 Sep
Contagion Indicator						
HKS-Renminbi forward exchange rate correlation (daily)	-0.06	0.12	-0.12	0.9	0.8	0.3 Nov
Hang Seng-NASDAQ correlation (daily)	0.74	0.92	0.78	0.9	0.5	0.7 Nov

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

1/ Broad Money refers to M2.

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

3/ For all authorized institutions, unless otherwise specified.

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

5/ For all locally incorporated authorized institutions.

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

7/ 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. Hong Kong SAR: Medium-term Macroeconomic Framework

	Staff Projections								
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Real GDP (percent change)	1.8	3.1	8.2	7.0	5.5	4.5	4.5	4.5	4.5
Contribution									
Real domestic demand	-0.7	0.1	4.5	1.8	2.0	3.2	3.2	3.7	3.7
Private consumption	-0.6	-0.6	3.8	1.2	1.3	2.0	2.0	2.5	2.6
Government consumption	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Gross fixed capital formation	-1.2	0.2	1.0	0.4	0.6	1.0	1.1	1.1	1.1
Inventories	0.9	0.3	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Net Exports	2.5	3.1	3.7	5.2	3.5	1.3	1.3	0.8	0.8
Output gap (in percent of potential)	-2.8	-3.1	0.6	2.5	2.6	1.8	1.3	0.7	0.0
Growth rates									
Real domestic demand	-0.7	0.1	4.9	2.0	2.4	3.9	3.9	4.5	3.9
Private consumption	-1.0	-1.0	6.8	2.2	2.5	4.0	4.0	5.0	5.1
Government consumption	2.5	1.9	0.7	1.0	1.1	1.0	1.0	1.0	1.0
Gross fixed capital formation	-4.5	0.9	4.1	1.8	2.6	4.7	4.7	4.7	4.7
Saving and investment (percent of GDP)									
Gross national saving	30.4	32.3	31.9	32.3	31.8	31.3	31.1	31.0	31.0
Gross investment	22.8	21.9	22.0	21.9	21.5	21.6	21.6	21.6	21.6
Saving-investment balance	7.6	10.4	9.9	10.2	10.3	9.7	9.5	9.5	9.4
Inflation (percent change)									
Consumer prices	-3.0	-2.6	-0.4	1.2	1.5	1.8	2.1	2.4	2.5
GDP deflator	-3.5	-6.4	-3.3	-0.5	1.3	2.0	2.4	2.7	2.7
Employment (percent change)									
Unemployment rate (percent)	-0.6	-0.4	2.8	3.8	3.0	2.4	2.4	2.4	2.4
Real wages	7.3	7.9	6.8	5.4	3.8	3.8	2.9	2.0	1.6
	1.3	0.2	-1.2	...	...	...	...	...	...
Government budget (percent of GDP) 1/									
Revenue	13.9	16.8	20.4	18.5	17.6	17.4	16.3	15.6	14.9
Expenditure	18.7	20.1	18.8	18.4	17.5	16.0	14.7	13.8	13.1
Consolidated budget balance	-4.8	-3.3	-0.3	0.0	0.1	1.4	1.8	1.8	1.8
Accumulated fiscal reserves (end-March)	24.4	22.3	22.9	21.2	19.9	20.2	20.5	20.7	20.6
Merchandise trade (percent change)									
Export volume	8.6	14.0	15.3	9.8	8.3	6.8	6.8	6.5	6.7
Domestic exports	-11.3	-7.4	2.4	-3.0	-2.0	-1.0	-1.0	-1.0	-1.0
Reexports	10.9	16.1	16.3	10.6	8.9	7.2	7.2	6.9	6.8
Import volume	7.8	12.8	14.1	6.8	6.8	6.8	6.8	6.8	6.8
Export value	5.4	11.7	15.9	11.1	8.9	8.2	8.3	7.9	7.9
Import value	3.3	11.5	16.9	9.0	7.5	8.2	8.2	7.9	7.9
External balances (in billions of US\$)									
Trade balance	-5.1	-5.8	-9.3	-4.5	-0.8	-0.9	-0.7	-0.8	-1.2
In percent of GDP	-3.1	-3.6	-5.6	-2.6	-0.4	-0.5	-0.3	-0.4	-0.5
Exports of goods	200	225	260	289	315	341	369	398.5	429.9
Imports of goods	205	230	270	294	316	342	370	399.4	431.0
Current account	12.4	16.5	16.4	17.8	19.2	19.4	20.3	21.8	23.0
In percent of GDP	7.6	10.4	9.6	10.2	10.3	9.7	9.5	9.5	9.4
Foreign exchange reserves (end-year)	111.9	118.4	123.6	123.8	124.8	125.9	126.9	127.9	127.9
In percent of GDP	68.4	74.5	74.4	70.8	66.8	63.2	59.5	55.9	52.4

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

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

Table 5. Hong Kong SAR: Medium-term Balance of Payments (2002-2010)

	2002	2003	2004 Actual	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.
(In billions of US dollars)									
Current account	12.4	16.5	15.9	17.8	19.1	19.4	20.2	21.7	23.0
Goods Balance	-5.1	-5.8	-9.3	-4.5	-0.7	-0.9	-0.7	-0.8	-1.2
Services balance	18.6	20.4	24.2	27.2	29.5	32.1	34.9	37.9	38.5
Income Balance	0.7	3.7	3.0	-2.0	-6.0	-8.2	-10.3	-11.7	-10.7
Transfer balance	-1.9	-1.8	-2.0	-2.9	-3.6	-3.6	-3.7	-3.7	-3.7
Capital and Financial Account	-19.4	-23.0	-23.7	-9.2	-19.1	-19.4	-20.3	-21.7	-23.0
Capital Account	-2.0	-1.1	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Financial Account	-17.4	-21.9	-23.4	-9.0	-18.9	-19.2	-20.1	-21.6	-22.9
Net Direct investment	-7.8	8.1	-11.7	-6.8	-7.4	-8.4	-9.8	-10.8	-12.1
Portfolio investment	-38.8	-34.0	-39.3	-25.1	-28.5	-27.9	-27.9	-28.6	-28.8
Financial derivatives	6.6	10.0	5.7	10.5	10.0	10.4	10.7	11.0	11.3
Other investment	20.2	-5.1	25.2	12.6	7.9	8.0	7.9	7.8	7.8
Reserve assets (net change)	2.4	-1.0	-3.3	-0.2	-1.0	-1.0	-1.0	-1.0	-1.0
Net errors and omissions	7.0	6.5	7.8	-8.5	0.0	0.0	0.0	0.0	0.0
(In percent of GDP)									
Current account	7.6	10.4	9.6	10.2	10.3	9.7	9.5	9.5	9.4
Capital and Financial Account	-11.8	-14.5	-14.3	-5.3	-10.2	-9.7	-9.5	-9.5	-9.4
Capital Account	-1.2	-0.7	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Financial Account	-10.6	-13.9	-14.1	-5.1	-10.1	-9.6	-9.4	-9.4	-9.4
Net errors and omissions	4.3	4.1	4.7	-4.9	0.0	0.0	0.0	0.0	0.0

Sources: Hong Kong SAR authorities and staff estimates.

HONG KONG SAR—FUND RELATIONS

I. Membership Status

As a Special Administrative Region of the People's Republic of China, Hong Kong SAR is not a member of the Fund. However, annual consultation discussions have been held with the Hong Kong SAR authorities since October 1990, and the staff also holds discussions with the authorities in connection with the Fund'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 Hong Kong Monetary Authority (HKMA) refined the operations of the LERS in May—the first changes since August 1998. For the first time since the introduction of the LERS in 1983, the HKMA explicitly committed to sell HK dollars at a pre-announced price (set at HK\$7.75/US\$), which is referred to as the strong-side convertibility undertaking. Previously, the HKMA had only committed to buy HK dollars at a pre-announced rate (the weak-side convertibility undertaking introduced in October 1998) and could sell HK dollars at any price. After the refinements, the weak-side convertibility undertaking has been shifted to HK\$7.85/US\$, such that the two convertibility undertakings would be symmetric around HK\$7.8/US\$. 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. Paul Gruenwald has served as the Resident Representative since August 2003.

HONG KONG SAR—STATISTICAL ISSUES

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

In 2004, Hong Kong SAR published comprehensive international investment position statistics for the reference periods 2002 and 2003. It also publishes quarterly external debt statistics less than one quarter after the end of the reference quarter, according to the recommendations given in the *External Debt Statistics: Guide for Compilers and Users*.

Hong Kong reports data for publication in the *GFS Yearbook*, but no data have been provided for publication in *IFS*. In January 2004, the authorities published their preliminary version of the accrual-based fiscal accounts starting with the FY2002/03 fiscal data, which does not strictly follow the Fund's *Government Finance Statistics Manual (GFSM 2001)*.

HONG KONG SAR: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF DECEMBER 5, 2005

	Date of latest observation	Date received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of publication ⁶
Exchange Rates	12/5/05	12/5/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	10/31/05	11/30/05	M	M	M
Reserve/Base Money	10/05	11/05	M	M	M
Broad Money	09/05	11/05	M	M	M
Central Bank Balance Sheet	10/05	11/05	M	M	M
Consolidated Balance Sheet of the Banking System	09/05	10/05	M	M	M
Interest Rates ²	12/5/05	12/5/05	D	D	D
Consumer Price Index	10/05	11/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴					
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	08/05	10/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵					
External Current Account Balance	06/05	10/05	Q	Q	Q
Exports and Imports of Goods and Services	09/05	11/05	Q	Q	Q
GDP/GNP	09/05	11/05	Q	Q	Q
Gross External Debt	06/05	09/05	Q	Q	Q

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

²Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³Foreign, domestic bank, and domestic nonbank financing.

⁴The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵Including currency and maturity composition.

⁶Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with the People's Republic of China—Hong Kong Special Administrative Region

On January 23, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the People's Republic of China—Hong Kong Special Administrative Region.¹

Background

Hong Kong SAR's real GDP grew by about 7¼ percent (year-on-year) in the first three quarters of 2005, from 8¼ percent in 2004, boosted, in part, by strong Mainland-related exports. The economic expansion that has been sustained for nine consecutive quarters has strengthened the macroeconomic outlook for Hong Kong SAR. The continued robust growth owes much to the favorable external environment, with judicious macroeconomic policies, continued structural reforms, and the confidence building effects of the Closer Economic Partnership Arrangement (CEPA) with the Mainland making significant contributions. Importantly, job creation has steadily gathered strength, which has brought down the unemployment rate quite significantly, although for low-skilled workers it remains relatively high. Reflecting the buoyant activity, inflation has picked up mildly, but remains well contained. Asset prices, which have rebounded sharply since mid-2003, now appear to be stabilizing.

The authorities have continued to take advantage of high growth to further strengthen the fiscal position. The outturn for the FY2004/05 deficit (excluding issuance of bonds and notes)

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.

at ¼ percent of GDP—was substantially better than the projected 5 percent of GDP. Buoyant tax revenues (profits and income tax), higher-than-expected land sales and investment income, along with continued expenditure restraint (including civil service wage cuts) were the main contributors to the better performance. Fiscal reserves were equivalent to about 23 percent of GDP (at end-FY2004/05), but remained below its pre-crisis level of 34 percent of GDP. The FY2005/06 budget targets a deficit of about ¾ percent of GDP. Based on current economic trends and reflecting the government's unstinted restraint on spending, the staff projects that the budget could return to balance in the current fiscal year, significantly ahead of schedule.

Looking ahead, staff expects economic activity to moderate in the near term with real GDP growth projected to about 5½ percent in 2006 with some easing of external demand. The risks to this outlook are broadly balanced. Despite this moderation in activity, inflation should rise modestly as rents pick up and the labor market tightens. Given the general openness of the economy and the strong linkages with the Mainland, Hong Kong SAR's growth prospects will continue to depend crucially on external conditions and developments in the Mainland. If global demand weakens significantly, Hong Kong SAR's current driver of growth—net exports—could be threatened. On the upside, consumption and investment growth could be higher, reflecting higher asset prices, stronger household balance sheets, and sizeable increases in corporate profits.

Sustaining strong growth over the medium term will also depend crucially on effectively meeting the challenges of integration with the Mainland. The continued success of Hong Kong as an international financial center hinges upon its ability to assist in the Mainland's financial intermediation. Hong Kong is well positioned to play a significant role in this process in view of its sophisticated financial infrastructure, although progress in this area depends crucially upon the pace of financial liberalization in the Mainland. Cooperation and coordination with the Mainland's financial authorities, which have advanced well, will therefore become increasingly important.

Executive Board Assessment

Executive Directors commended the Hong Kong SAR authorities on their skillful macroeconomic management in the face of a series of external shocks over the last few years. Along with improved external conditions and continued structural reforms, macroeconomic policies have helped to sustain the economic expansion—for nine consecutive quarters—while inflation is moderate and the external sector remains strong.

Looking ahead, Directors noted that sustaining growth over the medium term will require that the challenges of economic integration with the Mainland be met effectively. In particular, Hong Kong SAR will need to remain competitive by maintaining its traditional strengths—namely, flexible product and factor markets and sound macroeconomic policies—as well as by seeking out new areas of growth, including an increased role in Mainland financial intermediation.

Directors commended the authorities on the continued improvement in the fiscal position. They noted that expenditure restraint, supported by robust economic activity, is likely to return the budget to balance this fiscal year, well ahead of schedule.

With the government's current fiscal target nearly achieved, Directors were encouraged by the authorities' increased focus on longer-term issues. Hong Kong SAR's rapidly aging population is likely to exert substantial pressure on public finances, especially through rising health care costs. Accordingly, the government's attention to health care reform is timely. Directors observed that, in formulating a longer-term fiscal strategy, consideration should also be given to the appropriate level of fiscal reserves. Directors stressed the importance of broadening Hong Kong SAR's tax base to stabilize the volatility of its revenues. In this regard, they welcomed the authorities' plans to press ahead with public consultation on the feasibility of a low-rate goods and services tax, which should be broadly based and implemented with minimal exemptions. Directors noted that low-income families adversely affected by the tax could be assisted through targeted transfers.

Directors commended the Hong Kong Monetary Authority on its management of the Linked Exchange Rate System and supported the authorities' commitment to the arrangement. They noted that the May 2005 refinements to the currency board had reduced uncertainties that had led to speculation, and further strengthened the system. Directors observed that adjustment to large or prolonged shocks will need to rely on the flexibility of Hong Kong SAR's real exchange rate. This will depend on the efficiency of its domestic markets, as reflected in changes in interest rates, wages, and asset and product prices.

Directors welcomed the initiatives undertaken to strengthen Hong Kong SAR's financial market infrastructure and supervisory systems. In particular, they welcomed the progress toward the introduction of a deposit protection scheme, the preparation for the implementation of Basel II by banks, and the establishment of a Financial Reporting Council. They also welcomed the expanded scope for transactions in renminbi in Hong Kong SAR. Directors considered that the growing size and sophistication of Hong Kong SAR's financial markets and instruments will contribute to maintaining Hong Kong's vibrancy as a financial center, while also requiring continued close surveillance to ensure that markets remain efficient and orderly. In this context, Directors welcomed the close cooperation with the financial authorities on the Mainland. Directors were encouraged by the significant steps taken towards the implementation of the anti-money laundering and combating the financing of terrorism (AML/CFT) framework and looked forward to continued progress in this area.

Directors supported the authorities' strategy to reduce unemployment among low-skilled workers through training programs and job placement assistance. Directors noted the recent call for a debate on the appropriateness of introducing a statutory minimum wage and standard working hours, while emphasizing the importance of maintaining the flexibility of Hong Kong SAR's markets that has served to underpin the economy's resilience to external shocks. In this regard, Directors also welcomed the establishment of a committee to review existing domestic competition policy and the possible role of a general competition law.

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

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

	2002	2003	2004	2005 Proj.	2006
Real GDP (percent change)	1.8	3.1	8.2	7.0	5.5
Real domestic demand (contribution)	-0.7	0.1	4.5	1.8	2.0
Foreign balance (contribution)	2.5	3.1	3.7	5.2	3.5
Inflation (percent change)					
Consumer prices	-3.0	-2.6	-0.4	1.2	1.5
GDP deflator	-3.5	-6.4	-3.3	-0.5	1.3
Employment (percent change)	-0.6	-0.4	2.8	3.8	3.0
Unemployment rate (percent)	7.3	7.9	6.8	5.4	3.8
Real wages	1.3	0.2	-1.2	...	...
Government budget (percent of GDP) 1/					
Revenue	13.9	16.8	20.4	18.6	17.9
Expenditure	18.7	20.1	18.8	18.6	17.8
Consolidated budget balance	-4.8	-3.3	-0.3	0.0	0.1
External balances (in billions of US\$)					
Merchandise trade balance	-5.1	-5.8	-9.3	-4.5	-0.8
(In percent of GDP)	-3.1	-3.6	-5.6	-2.6	-0.4
Current account balance	12.4	16.5	16.4	17.8	19.2
(In percent of GDP)	7.6	10.4	9.6	10.2	10.3
Foreign exchange reserves					
Foreign exchange reserves (in billions of US\$, end of period)	111.9	118.4	123.6	123.8	124.8
(In percent of GDP)	68.4	74.5	74.4	70.8	66.8

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

1/ Fiscal year begins April 1.