HONG KONG SAR: PRELIMINARY CONCLUSIONS OF THE IMF MISSION
November 7, 2007

I. ECONOMIC DEVELOPMENTS AND OUTLOOK

1 **After growing at 7½ percent annually over the past three years, the pace of activity has remained fairly robust.** Domestic demand has resumed as the major driver of activity, supported by growing incomes and rising asset prices. Importantly, job creation has continued to improve across all sectors, bringing the unemployment rate to its lowest level in more than nine years. Inflation, even after accounting for one-off budgetary measures, is modest. This overall robust economic environment owes a lot to skillful macroeconomic management, the underlying flexibility of Hong Kong's markets, and the continued integration with the Mainland.

2. **Looking ahead, we expect growth of 5½–6 percent this year, slowing to below 5 percent next year.** The slowdown reflects a weaker external outlook, although domestic demand should remain supportive. Major near-term risks are a more-than-expected deterioration in U.S. and European demand, a sudden reversal in equity market sentiment, and further international financial turbulence if the impact of the subprime turmoil spreads. Over the medium term, growth should average around 5 percent, especially if the evolving financial integration with the Mainland is managed well and competitive pressures from other regional financial centers withstood.

II. HONG KONG DOLLAR AND MONEY MARKET DEVELOPMENTS

3. **The mission maintains its support for the authorities' commitment to the Linked Exchange Rate System (LERS).** Since the May 2005 refinements and until recently, the HKD had floated inside the trading band with rare interventions and the system coped well with periodic stresses: the large IPO issuances of late last year; speculative pressures when the renminbi-dollar exchange rate crossed the HKD linked rate early this year; and the global subprime turmoil this August. A confluence of events in the past month or so—including cuts in Fed funds rate that prompted the unwinding of long U.S. dollar positions; bunching of oversubscribed IPOs; and strong demand for Mainland-related equities—had raised HKD interest rates above comparable USD rates, while at the same time pushed the HKD to the strong side of the trading band. This prompted the HKMA to intervene in the past few weeks, first actively, and then passively in the past weeks, as required under the LERS. The injection of liquidity has eased interest rates below USD rates and moved the HKD away from the strong-side limit.

4. **These episodes underscore the general resilience of the refined LERS.** That said, uncertainties regarding investor expectations about U.S. and Mainland financial assets and exchange rate movements, capital inflows from the Mainland,

and the timing and size of future IPO-related liquidity demand, along with more cautious interbank lending in the wake of the subprime turmoil appear to have created anomalies in the relationship between the money and exchange rate markets. In the coming months such market uncertainties and volatility could persist. The authorities could consider reinforcing the link between changes in the aggregate balance and HKD interest rates, as well as look to improve the management of liquidity within the financial system. Doing so could help to avoid further episodic anomalies between the HKD exchange rate and interest rate movements, which is a potential source of market speculation about the longevity of the LERS.

5. **From a competitive perspective, the real value of the Hong Kong dollar appears to be in line with economic fundamentals.** While the current account surplus has increased in recent years, much of this reflects a secular decline in domestic investment rate as the Hong Kong economy transformed itself from a manufacturing center to a largely financial and services hub, with large outward investments. At the same time, domestic saving has remained high in the face of the coming aging of the workforce and the strengthening of Hong Kong's status as an international financial centre. That said, the mission expects the current account surplus to decline over the medium term as infrastructure and other construction related investment, which have been relatively compressed since 1998, pick up.

6. **As in the past, market flexibility remains key to the success of the LERS and Hong Kong SAR's competitiveness.** Indeed the planned general Competition Law, which the IMF has long supported, will help to strengthen it. During its public consultation, some have argued that this would place onerous regulatory burden on businesses. In this regard, experiences of other advanced countries with such laws provide lessons as to how to minimize bureaucratic and regulatory burden while ensuring fair competition. Separately, the government is looking into legislating a mandatory minimum wage for cleaning workers and security guards. A mandatory minimum wage could be part of a social compact, but needs to be properly designed so that employment is not unduly affected. That said, the LERS and the institutional constraints on the use of fiscal policy have placed much of the burden of economic adjustment on the flexibility of nominal wages and other prices, particularly in the downward direction. For this reason, the authorities should carefully balance labor market flexibility with wage protection and consider alternative measures, such as expanding in-work benefits including through eligibility requirements and the level of support.

III. EXPANDING THE FINANCIAL CENTER

7. **The mission welcomes the initiatives taken by the Hong Kong SAR and Mainland authorities to deepen financial integration, which will clearly benefit both economies.** Progress on the financial services action agenda, which was developed by the Economic Summit on "China's 11^{th} Five Year Plan and the Development of Hong Kong" earlier this year, is well underway. Hong Kong SAR banks have established strategic interests in the Mainland and Mainland fund management companies will be allowed to establish subsidiaries in the SAR starting from 2008. The Mainland's QDII scheme has been expanded to equities, while modalities for allowing Mainland individuals to invest in Hong Kong securities are being worked out. Other steps could include the trading of Hong Kong financial instruments in Mainland exchanges, and expanding renminbi bond

issuance in Hong Kong SAR to Chinese non-financial institutions and allowing Mainland institutions and individuals to invest in them. At the same time, leveraging Hong Kong SAR's first-mover advantage is equally important, and the authorities are attracting more listings of equities from overseas jurisdictions and planning the introduction of new financial product areas, including Islamic finance and trading of commodities derivatives. Given the coming aging of both the Hong Kong and Mainland workforces, the mission also sees potential for expansion of aging-related products such as annuities.

8. **The competitiveness of the Hong Kong financial center also depends on continued enhancement of its strong reputation for supervision and governance.** The financial center remains robust, with banks profitable and well capitalized. Partly reflecting this and Hong Kong SAR's strong supervision, exposures to subprime and other structured securities appear to be low across the banking and asset management industries. Continued monitoring of exposures and valuation of these products is important as global fallout from the subprime turmoil could endure. Further regulatory enhancements have also taken place, such as the introduction of the regulatory framework for all the three-pillars of the Basel II capital standards and the smooth implementation of the standardized approaches under the framework and the strengthening of cross-border regulatory cooperation. The rapid rise in valuation and turnover of equities, related structured products and derivatives, and margin financing, calls for continued close monitoring of cross-market risks, especially given global financial market uncertainties. In this regard, the increased coordination among Hong Kong regulators should help to detect early signs of stress.

IV. FISCAL POLICY AND CHALLENGES

9. **The fiscal stance appears appropriate given the moderation in growth.** This year's budget targets a smaller surplus, reflecting a number of one-off factors, but given economic and financial market developments so far, the outturn is likely to be much stronger. The Chief Executive's Policy Address proposed a number of new initiatives, including a refocusing on infrastructure spending, which is important to enhance competitiveness and support medium term growth. Looking ahead, next year's budget may need to respond if growth slows significantly more than expected.

10. **Over the medium term, Hong Kong SAR continues to face the twin challenges of high revenue volatility and rising aging-related spending pressures.** In this regard, the mission welcomes the new arrangement to smooth income earned on fiscal reserves and the use of a reserves target to anchor medium-term fiscal policy. Nonetheless, broadening the tax base remains important to further limit revenue volatility. Last year's public consultation helped to focus attention on this issue and the government could explore alternatives—such as broadening the base of the salaries tax—in the coming years. Healthcare costs could rise substantially in the future as the population ages and the mission looks forward to the consultation proposals on healthcare reforms. While greater involvement of the private sector in healthcare delivery and financing is likely to be important, adequately covering the most vulnerable segments of the population under the publicly-provided health care system will continue to be needed to avoid contingent fiscal risks. Measures (including tax-related) should be considered to encourage a move to broad-based medical insurance and savings plan for old-age coverage. Given such considerations, it might be appropriate to reconsider the

scope and timing of the proposed cuts in salaries and profits tax in the context of the new health-care financing mechanisms.

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The IMF mission team would like to express its deep appreciation to the Hong Kong SAR authorities for their gracious hospitality and for the productive discussions.