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**People’s Republic of China—Hong Kong Special Administrative Region: 2010 Article IV Consultation Discussions—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion**

In the context of the 2010 Article IV consultation discussions with Hong Kong SAR, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation discussions, prepared by a staff team of the IMF, following discussions that ended on October 28, 2010, with the officials of the People’s Republic of China—Hong Kong SAR on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 5, 2010. 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.
- Staff statements updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 22, 2010 discussion of the staff report that concluded the Article IV consultation discussions.

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 2010 Article IV Consultation Discussions**

Prepared by the Staff Representatives for the 2010 Consultation Discussions with the  
People's Republic of China—Hong Kong Special Administrative Region

Approved by Nigel Chalk and Tamim Bayoumi

November 5, 2010

**Context:** Two potent forces continue to influence Hong Kong SAR's prospects: the unprecedented monetary policy easing in the United States and the solid domestic recovery, in part driven by spillovers from the Mainland. While the substantial expansion of the monetary base—which began in 2008—has stopped, the banking system remains exceptionally liquid and credit growth is now beginning to pick up. Despite the government's efforts—with tighter lending standards, higher real estate transaction taxes, and an increased supply of land—property prices continue to rise.

**Main Issues:**

- The most pressing challenge over the near term will be to ensure that the ongoing acceleration of property price inflation does not translate into financial risks or unduly amplify the macroeconomic cycle.
- The government should continue to proactively deploy countervailing prudential regulations—to ensure the quality of bank credit remains high—and put in place a sufficiently counter-cyclical budget in the coming fiscal year. However, given the scale of the underlying forces at work—including the strong economic recovery, an improving labor market, and very loose monetary conditions—such policies will, at best, only be able to mitigate the amplitude of the unfolding macroeconomic and asset price cycle.
- Over a longer horizon, policies will need to ensure that Hong Kong SAR can fully capitalize on its unique status as an offshore renminbi center and adapt to the ongoing changes in the global financial regulatory environment.

**Mission.** A staff team consisting of N. Chalk (Head), A. Ahuja and S. Barnett (APD) visited Hong Kong SAR, October 18–28, 2010. Messrs. Luo, and Yung (OED) participated in the discussions.

**Exchange arrangement.** Currency board with a trading band of HK\$7.75–7.85 per U.S. dollar.

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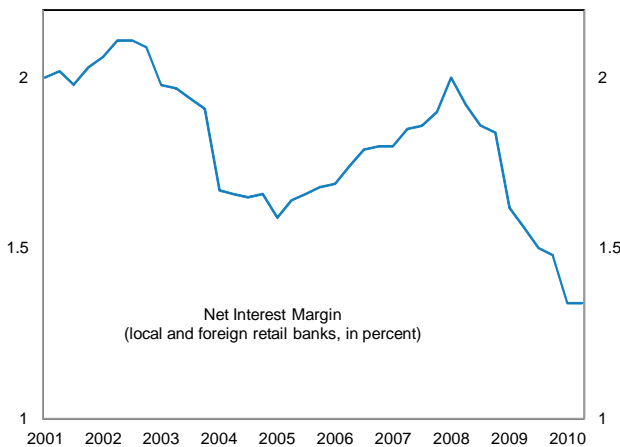
## I. A RESURGENT ECONOMY

1. **Growth.** The economy is recovering briskly with all demand components resuming a strong growth trajectory (Figure 1). Growth is likely to reach 6¾ percent this year and moderate to 5-5½ percent in 2011. Net exports have been buoyed by vigorous growth in the Mainland and the ongoing global recovery. Investment has benefited from the implementation of various multi-year public infrastructure projects and private spending on machinery and equipment has picked up. At the same time, consumption bounced back as labor markets improved and confidence returned. The predominant near-term risks to the outlook are from a weaker external environment, notably an increase in European sovereign risks or a renewed slowdown in the United States. If realized, these risks would spill into Hong Kong SAR through both trade and financial channels.

2. **Inflation.** Inflation has rebounded from the lows seen in 2009, driven by higher costs for utilities and certain services (such as education, tourism, and transportation). In the coming months, higher property prices will begin to feed through into the housing component of the consumer price index. These price pressures will become increasingly visible in the coming months with inflation expected to reach around 5 percent by end-2011.

3. **Banking system.** Hong Kong banks have withstood well the financial market volatility of the past year. Despite the compression of net interest margins, profits have risen due to higher fee, trading, and investment income. Capital levels are well in excess of regulatory requirements, average loan-to-deposit ratios are low, and liquidity ratios are very high. At the end of 2010, the temporary blanket deposit guarantee will expire; this should have little impact on the banking system with the increase in the protection limit of the Deposit Protection Scheme from HK\$100,000 to HK\$500,000 starting from January 1, 2011.

*Net interest margins have declined since the onset of the global financial crisis*



**Banking System Indicators**  
(end-June 2010, in percent)

NPL ratios	
Special mention loans	1.53
Classified loans	0.96
CAR	16.2
Tier 1 capital	12.6
Loan-to-deposit ratio 1/	
Total	61.3
HK\$	77.6
Liquidity ratio	40.9

1/ End September 2010.





































































