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### **IMF Executive Board Concludes 2016 Article IV Consultation with People’s Republic of China—Macao Special Administrative Region**

On February 13, 2017 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions<sup>1</sup> with Macao Special Administrative Region (SAR), and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.<sup>2</sup>

In the 15 years after the return to Chinese sovereignty in 1999, Macao SAR averaged real GDP growth of 10.6 percent. The remarkable growth was due in large part to the de jure monopoly on gaming within China and the rapid rise in the Mainland’s consumer spending power. However, the economic boom came to an abrupt end in 2014 with gaming exports falling by a cumulative 50 percent. The main driver of the contraction was a sharp fall in the high-end or “VIP” casino business. This development mirrored trends in luxury markets in Hong Kong SAR and came amid a sustained anti-corruption campaign on the Mainland.

The sharp fall in exports led output to fall by one-third in cumulative terms but the spillovers to the broader economy were surprisingly limited. Unemployment has remained below 2 percent, median real wages have stabilized but remained up 7 percent over end-2014 levels, and nonperforming loans in the financial sector continue to hover around zero. The primary source of this resilience is that even though average spending per tourist fell sharply, the number of tourists was basically stable keeping capacity utilization relatively high. As a result, most of the contraction in revenues was absorbed in the form of lower extraordinary profits rather than reduced employment.

The recent correction in exports has underscored the urgency of transitioning to a more diversified economic model. Fortunately, Macao SAR enters this transition from a position of

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<sup>1</sup> 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.

<sup>2</sup> The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

strength as there are significant buffers. First, due to high taxes on the gaming sector and discipline on public spending, Macao SAR has zero gross public debt and fiscal reserves equal to 95 percent of GDP. And second, after 15 years of double-digit current account surpluses, foreign exchange reserves are roughly US\$ 19 billion or around 100 percent of pataca M2.

Real output is expected to contract for a third consecutive year in 2016. However, external demand has begun to recover with gaming revenues posting six consecutive months of positive annual growth. In 2017, a low base will help increase growth above 2 percent despite continued weak domestic demand. Further out, Macao SAR is well-positioned to record sustainable growth in the mid-single digits. In addition to its still highly valuable gaming monopoly within China, Macao SAR is an established tourist destination with significant geographic proximity to—and cultural affinity with—Mainland China. Moreover, Macao SAR is now investing aggressively in non-gaming tourism and financial services.

### **Executive Board Assessment**

The recent external shock underscores the importance of the authorities' strategy to transition to a more diversified economic model. The speed and size of the recent fall in external demand is a reminder of how narrow the export base had become during the boom years. Though the non-gaming economy was remarkably resilient, such volatility can undermine long-run growth by increasing macroeconomic uncertainty. In this regard, the authorities' strategy to diversify to mass-market gaming, non-gaming tourism, and financial services is important.

Fortunately, Macao SAR enters this transition from a position of strength. Prudent fiscal policy during the boom years has left the public sector with zero debt and almost 100 percent of GDP in fiscal reserves. Meanwhile, the high national savings rate has helped Macao SAR recorded repeated double digit current account surpluses and accumulate substantial foreign assets, reinforcing the credibility of the currency board.

In the near term, there is no need for further discretionary fiscal loosening given the closing output gap. Though the public sector has continued to record budget surpluses, the authorities appropriately loosened fiscal policy substantially during the recent downturn. Partly as a result of this approach, the output gap, measured by an array of methods is now closing. In this regard, the authorities should avoid substantial further discretionary loosening in fiscal policy to avoid overstimulating the economy.

Looking further ahead, the authorities should establish a medium-term framework to anchor fiscal policy and ensure long-run solvency. Taxing the economic rents of the gaming monopoly has left Macao SAR with abundant fiscal reserves. This provides a substantial opportunity to invest in human capital and close any infrastructure gaps. Though there is not an urgent concern, the authorities should establish long-run projections to better understand how much of the fiscal resources are accounted for, particularly with respect to future pension obligations.

With respect to the real estate market, there is no clear need to loosen macroprudential regulations. Macroprudential regulations specific to the housing market should be relaxed when there is a risk of a spiral of falling house prices, falling mortgage credit, and increased defaults. Current information—including healthy bank balance sheets and recovering prices—suggests this threshold has not been met. To the degree there is a social objective of increasing housing accessibility, this is best addressed by increasing the supply of market-priced units and providing targeted transfers to the most vulnerable.

The financial sector remains strong. Soundness indicators regarding asset quality, earnings, and liquidity remain remarkably robust given the size of the fall in output. This reflects the nature of the correction (which fell disproportionately on gaming operator profits) and the prudence of regulations in recent years. The sheer size of the sector—particularly the supervisory challenge of monitoring the liquidity and quality of foreign assets—does warrant ongoing attention. But the nature of these—largely branches to related parties—suggests risks are contained.

The currency board regime continues to serve Macao SAR well, with price flexibility an increasingly important supporting factor. The phenomenal growth in the export sector since the return to Chinese sovereignty suggests that exchange rate competitiveness has not been a limiting factor. However, during much of this period, Macao SAR was depreciating against the RMB as a result of the peg, indirectly, to the U.S. dollar. With China now accounting for two-thirds of tourists and balance of payments pressures raising the potential for depreciation, external competitiveness may be more of an issue. In this regard, downward price flexibility, as displayed recently by the hotel sector, will likely be increasingly important.

## Selected Economic and Financial Indicators

	2010	2011	2012	2013	2014	2015	2016	2017
								Proj.
	(Annual percentage change, unless otherwise specified)							
<b>National accounts</b>								
Real GDP	25.3	21.7	9.2	11.2	-1.2	-21.5	-4.0	2.8
Total domestic demand	-0.4	13.9	10.3	6.5	16.7	2.8	-6.4	-2.4
Consumption	5.4	9.9	7.1	6.4	6.0	2.7	-0.3	1.1
Investment	-12.0	23.6	17.0	6.8	36.3	3.0	-14.8	-8.0
Net exports 1/	25.5	15.4	4.9	8.5	-7.9	-22.9	-0.1	4.2
Exports	39.7	25.7	10.5	13.2	-4.5	-26.7	-4.6	4.9
Imports	16.7	22.0	14.3	10.7	12.5	0.6	-8.8	-1.0
Gross capital formation (in percent of GDP)	13.3	13.8	14.7	14.1	19.6	25.1	22.3	20.0
National savings (in percent of GDP)	52.7	54.6	54.0	54.3	53.8	50.5	49.4	49.5
<b>Prices and employment</b>								
Headline inflation (average)	2.8	5.8	6.1	5.5	6.0	4.6	2.2	2.0
Terms of trade	-0.6	1.0	-1.8	0.0	0.2	0.8	0.0	0.0
Housing prices	33.5	33.6	38.4	42.6	22.0	-13.0	...	...
Median monthly employment earnings	5.9	11.1	13.0	6.2	10.8	12.8	...	...
Unemployment rate (annual average)	2.8	2.6	2.0	1.8	1.7	1.8	1.9	2.0
	(In percent of GDP, unless otherwise specified)							
<b>Fiscal accounts</b>								
General government balance	19.5	24.8	24.1	27.0	24.0	13.7	5.1	7.5
Budgetary central government balance								
Revenue	34.8	38.3	37.6	36.6	35.2	30.0	26.1	27.5
Expenditure	16.7	16.1	15.6	13.1	14.6	21.3	25.0	22.0
Extra-budgetary funds balance	0.4	1.4	1.0	1.0	0.9	0.6	0.0	0.0
Social security funds balance	0.9	1.3	1.3	2.5	2.5	4.5	4.1	2.0
Total public debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fiscal reserve fund 2/	...	...	29.2	41.0	55.7	95.2	124.6	128.8
<b>Balance of payments</b>								
Current account	39.4	41.0	39.3	40.2	34.2	25.4	27.1	29.5
Goods	-20.2	-21.1	-21.0	-20.5	-21.4	-25.5	-23.8	-22.6
Services	75.3	79.4	79.0	80.7	74.7	64.7	64.0	65.3
Income	-15.7	-17.2	-18.8	-20.0	-19.1	-13.8	-13.1	-13.2
Financial account	-5.8	-6.3	-34.6	-35.4	-22.7	-5.4	-22.1	-22.3
FDI	14.0	3.9	6.0	3.0	1.9	1.3	1.4	1.4
Portfolio investment	-3.0	-5.1	-6.7	-24.1	-10.2	-26.9	-8.2	-7.3
Financial derivatives	0.0	-0.1	0.3	1.2	0.6	0.8	0.8	0.8
Other investment	-16.7	-5.0	-34.3	-15.4	-14.9	19.4	-16.0	-17.1
Errors and omissions	-15.4	-10.6	4.1	-6.0	-11.4	-14.9	0.0	0.0
Reserve asset	18.3	27.7	8.8	-1.1	0.1	5.1	5.1	7.2
Foreign exchange reserves (in billions of US dollars) 2/	23.7	34.0	16.6	16.1	16.4	18.9	...	...
Gross external debt	113.1	127.8	119.2	120.1	133.5	199.2	189.9	191.9

	(Annual percentage change)							
Financial sector								
Loans	31.6	31.2	26.2	31.4	29.0	10.3	...	...
Resident	29.3	28.5	18.4	29.6	31.8	14.8	...	...
Mortgages	45.6	25.3	29.2	25.9	19.9	10.1	...	...
Others	21.6	30.3	12.5	32.0	39.0	17.1	...	...
Nonresident	34.4	34.3	34.6	33.2	26.4	6.0	...	...
Interest rates								
Discount window base rate (level, %, eop)	0.5	0.5	0.5	0.5	0.5	0.8		
Saving deposit rate (level, %, average)	0.0	0.0	0.0	0.0	0.0	0.0	...	...
MAIBOR 3-month (level, %, eop)	0.3	0.4	0.4	0.4	0.4	0.4	...	...
Tourism								
Visitor arrivals	14.8	12.2	0.3	4.4	7.5	-2.6	...	...
Gaming revenue	57.5	41.9	13.4	18.6	-2.5	-34.3	...	...
Exchange rate								
MOP per USD, period average	0.2	0.2	-0.4	0.0	0.0	0.0	...	...
Nominal effective exchange rate (average, +=appreciation)	-0.8	-5.0	1.7	-0.1	0.6	7.0	...	...
Real effective exchange rate (average, +=appreciation)	-0.2	-3.1	5.4	3.5	4.4	10.5	...	...
<i>Memorandum items:</i>								
Nominal GDP (in millions of US dollars)	28,123.7	36,708.0	43,031.8	51,552.4	55,347.8	45,415.0	44,071.0	45,689.1
Per capita GDP (in thousands of US dollars)	50.9	65.9	73.9	84.9	87.0	70.2	67.0	68.3

Sources: CEIC; Haver Analytics; IMF, International Financial Statistics; national authorities; and IMF staff estimates.

1/ Contribution to annual growth in percentage points.

2/ Fiscal reserve fund was established on January 1, 2012 with a transfer from foreign exchange reserves.