People's Republic of China—Hong Kong Special Administrative Region:
Preliminary Staff Concluding Statement of the 2015 Article IV Consultation Discussions

November 12, 2015

The economy is entering a potentially testing period ahead, but the risks are manageable with the strong buffers in place. A continuation of prudent fiscal management, robust regulatory oversight of the financial system, and the Linked Exchange Rate System (LERS) will help deal with near-term challenges while laying the foundations for steady growth and healthy job creation into the medium-term.

1. ***Context.*** Despite being repeatedly buffeted by powerful global cross-currents, Hong Kong SAR's economy has grown steadily in recent years. Real GDP is about 25 percent higher than the global financial crisis trough in 2009 Q1; employment has expanded close to 9 percent since then, with net job creation over 300,000; and the unemployment rate has declined to 3.3 percent.

2. ***Outlook.*** Growth is expected at around 2 ¼ percent this year. Domestic demand, particularly private consumption on the back of a tight labor market, is the principal source of momentum in the economy. Supportive fiscal policy is providing additional lift. Weaker-than-expected global demand and the trade slowdown have acted in the opposite direction, with net exports likely to subtract from overall growth. Next year, growth is expected to pick up to 2 ½ percent, with a lower drag from external demand projected to reinforce resilient domestic demand. Consumer price inflation is expected to ease to under 3 percent this year (from 4.4 percent in 2014) on lower import costs related to weaker commodity prices. Consistent with the projected modest pick-up in real activity in 2016, inflation will likely remain below 3 percent next year.

3. ***External assessment.*** The REER and external position are broadly in line with fundamentals and desirable policies. The REER has appreciated about 10 percent relative to the 2014 average, and 17 percent since end-2012, a product of the link to the U.S. dollar and relatively higher inflation in Hong Kong SAR compared to trading partners. The current account balance has stabilized in the range of 1½ -2 percent of GDP over this time (and is projected to increase to around 3 ½ percent over the medium term as global demand recovers). These developments also reflect, in part, structural changes in the economy of Mainland China.

4. ***Buffers.*** Thanks to deft policy management and ahead-of-the-curve regulatory standards, Hong Kong SAR has built strong buffers. Budget over-performance in recent years has lifted fiscal reserves to 35 percent of GDP, or about 24 months of total government expenditure. Banks – the cornerstone of Hong Kong SAR's status as a premier global financial center – are capitalized in excess of Basel III levels, and have increased their reliance on stable funding sources while improving the liquidity profile of their assets in recent years. The resilience of the economy and financial system was displayed during the summer months, when markets continued to function in orderly fashion despite higher volatility in equity prices and currencies.

5. ***The main challenges ahead*** are three-fold. The economy is entering a potentially testing period with interest rates - tracking the U.S. Federal Reserve's imminent liftoff - poised to increase for the first time in seven years. The run-up in property prices over the past year raises the probability of a correction (with some signs now evident of a pause in momentum). Financial and real activity spillovers from Mainland China may re-emerge. Overall, considering the buffers in place in Hong Kong SAR, these risks are manageable provided (i) interest rates rise at the modest anticipated pace based on the Fed (FOMC) forecasts; and (ii) the ongoing adjustment in Mainland China's growth to a slower but more sustainable path remains orderly.

- **a.** *The impact of rising interest rates.* The pace of increase envisaged in the FOMC forecasts should not dent private spending in Hong Kong SAR significantly. Risks however stem from a faster-than-anticipated increase in rates, should global portfolios rebalance appreciably in the aftermath of the Fed liftoff. A sharp spike in debt service and rollover costs could restrain consumer and corporate spending and act as a drag on overall activity in Hong Kong SAR.

- **b.** *Property market.* After a lull in 2013-14, property prices renewed their upswing in the past 18 months. There are early signs now of another pause, with momentum in the secondary market for residential property beginning to wane. If interest rates were to rise faster than expected, demand pressures may abate in response to the higher cost of borrowing, thereby softening prices and slowing transactions volumes. While banking exposures have been contained by the successive rounds of macroprudential measures, there is nevertheless the risk that a correction could set off an adverse spiral from negative wealth effects and lower collateral values to weaker household and corporate spending, slower credit growth, and back to prices.

- **c.** *Exposures to real and financial stress in Mainland China.* Closer integration with Mainland China has delivered several benefits to Hong Kong SAR, particularly by way of an appreciable boost to tourism and financial services and the offshore RMB business in the last five years. Hong Kong SAR remains well placed to act as the leading platform to intermediate two-way flows in and out of the Mainland as it opens its capital account. At the same time, the deepening linkages through tourism, cross-border bank lending, issuance of RMB and USD securities in Hong Kong SAR by Mainland entities, and equity market connect schemes also create more channels for transmitting shocks from the Mainland.

6. ***Fiscal policy.*** As the sole lever of counter-cyclical macro policy in Hong Kong SAR, the fiscal stance carries the burden of supporting aggregate demand. This year’s budget incorporates a range of counter-cyclical measures for households and small businesses, including tax relief, SME financing support, property rates waivers, and additional allowances for the vulnerable. Based on projections provided in the current budget, staff analysis suggests that the 2016/17 fiscal year's stance is expected to deliver a boost to activity of around 1 percent of GDP over and beyond the effect of automatic stabilizers. The projected stance strikes the right balance between providing near-term macro relief and budgeting for the medium-term needs of an aging society. In the event that high frequency indicators in 2015 Q4 and early 2016 point to a significant weakening of activity, the FY2016/17 budget should proactively provide even greater support than currently envisaged, with an emphasis on expanded relief measures for vulnerable households (extra allowances for the elderly and physically challenged; lower thresholds for providing rental relief to families in public housing; additional property rates waivers), small businesses (tax relief, subsidized / concessionary access to funding through credit guarantee schemes), and accelerated urban renewal and infrastructure spending where possible.

7. ***Long term fiscal challenges.*** Beyond cyclical considerations, there is a need to address the long-term fiscal challenges presented by an aging population and shrinking workforce in the future, as laid out in the 2014 report by the Working Group on Long Term Fiscal Planning. Planned initiatives such as the Low-income Working Family Allowance Scheme will incentivize labor force participation and help mitigate rising dependency burdens, while the proposed Future Fund will create a mechanism for raising long-term investment returns of the fiscal reserves, thereby generating additional resources to cope with demographic change.

8. ***Property sector policies.*** Property prices in Hong Kong SAR have been on a rising trajectory for over a decade now, as demand pressures have hit up against supply constraints. The government’s reaffirmation through the 2014 Long Term Housing Strategy to identify additional housing sites and expand supply will provide respite to affordability concerns over the medium-term. In the interim, the Buyer’s Stamp Duty, Special Stamp Duty and doubled ad valorem stamp duty will help filter out speculative transactions and thereby exercise restraint on excess demand. Adjustments to these duties could be considered in the event of a sustained decline in transactions volumes with the potential to generate adverse spillovers to the broader economy. Mortgage loan origination standards have been appropriately strengthened through seven rounds of macroprudential measures since 2009, encompassing tighter loan-to-value and debt service-to-income ceilings and risk-weight floors on property loans. These measures have limited leveraged exposures to the property price run up without impairing the banking system's key function of expanding credit commensurate to the needs of the real economy. Further use of tools such as regulatory reserves / provisioning specifically related to property loans, or higher risk weights, could also be considered as needed. Adjustments to the property-related counter-cyclical macroprudential measures should be made based mainly on evolving financial stability risks.

9. ***Financial sector policies.*** Hong Kong SAR has a strong track record of filling regulatory and data gaps, assessing systemic risks, and strengthening financial institutions' loss absorption buffers in a pre-emptive manner. The authorities have also provided infrastructure support for healthy market development, for instance in offshore RMB services. In line with the recommendations of the 2014 Financial Sector Assessment Program, important progress has been made with regard to establishing an independent authority for the insurance sector; crisis management and recovery plans for financial market infrastructures; and cross-border cooperation across the banking, insurance, and securities regulators. Areas that warrant further attention include – completing the process underway for enacting legislation on a comprehensive recovery and resolution framework; continuing to strengthen the oversight regime for securities markets, broker dealers and asset managers as their business model evolves with new channels connecting Hong Kong SAR and Mainland markets; and fully implementing a risk-based capital regime for insurance groups.

10. ***Exchange rate regime.*** The Linked Exchange Rate System (LERS) remains the best arrangement for Hong Kong SAR and serves as an anchor of stability for this small open economy with a globally integrated financial services industry. The smooth functioning of the LERS derives from the robust institutional, legal and policy framework in place in Hong Kong SAR; the ample fiscal reserves available to cushion the economy from adverse shocks; the healthy financial system that can accommodate large portfolio adjustments; and, more generally, flexible asset, goods, and labor markets that can adjust quickly to ensure misalignments in the real effective exchange rate (REER) do not persist. Vulnerabilities in the international investment position are low, with net foreign assets close to 330 percent of GDP and foreign exchange reserves around 120 percent of GDP. The reserves are adequate for precautionary purposes and have been accumulated in a non-discretionary manner as part of the normal functioning of the currency board during times of foreign currency inflows.

11. ***Contingencies.*** The attributes from which Hong Kong SAR's small open economy derives its dynamism – an international trading and tourism hub and a premier financial center – also leave it exposed to large global economic forces beyond its control and place a premium on contingency planning. In the low probability event that a sharper-than-expected slowdown on the Mainland coincides with a turbulent turn in global financial markets following the Fed liftoff, a range of measures may need to be deployed to forestall a deep slide in activity in Hong Kong SAR – large and proactive fiscal stimulus; expanded credit guarantees for SME loans; together with loosening of macroprudential policies. The enhanced framework in deposit protection and provision of liquidity assistance to banks would buttress banking stability. The experience of 2008/09 suggests that a comprehensive policy response can contain the domestic fallout of a large global shock and quickly set the economy back on track.

In closing, the mission would like to thank the Hong Kong SAR authorities for their kind hospitality and for the productive nature of our discussions.