Peoples Republic of China—Hong Kong Special Administrative Region:
Staff Concluding Statement of the 2016 Article IV Consultation Discussions

November 3, 2016

The vibrant Hong Kong SAR economy has been supported by low interest rates and Mainland China's growth over the past decade. But the external environment is more challenging with the U.S. rate cycle edging up, global trade growth tepid and Mainland China rebalancing. The economy is well placed to tackle the risks with strong policy frameworks, including the Linked Exchange Rate System(LERS), robust oversight of the financial system, and ample buffers. In the near term, there is scope for fiscal policy to support growth. Over the longer term, sustaining potential growth requires policies to lessen the adverse economic and fiscal effects of aging.

Testing times after a decade of robust growth

1. **Context.** As the key trading and financial gateway between Mainland China and the rest of the world, Hong Kong SAR's economic cycle is driven by global financial conditions and has become increasingly linked with Mainland China. With positive Mainland China spillovers, growth was relatively robust over the past decade, unemployment remained low, credit grew rapidly, and house prices for the mass market nearly tripled between 2008 and 2015. But growth has slowed below potential since 2015, as an anemic global trade environment and a sharp downturn in tourism arrivals from Mainland China depressed retail spending, private investment and exports.

2. **Outlook.** With soft external conditions and the housing market at an advanced stage of the cycle, the growth recovery may be gradual. Growth is expected to be around 1.5 percent in 2016, gently rising to 1.9 percent next year as consumption is supported by a resilient labor market, and as global growth slowly picks up. Over the medium-term, potential growth is expected to settle at around 2.5 to 3 percent. Aging pressures weaken the structural fiscal position after 2021; requiring long-term fiscal planning to alleviate the decline.

3. **Strong buffers.** Prudent fiscal policy and intensive supervision of the financial system have built buffers that can be drawn on to weather a less favorable environment. Fiscal reserves amount to 35 percent of GDP or 23 months of expenditures and the net international investment positon is positive at 355 percent of GDP. The banks are capitalized well above Basel III levels; liquidity cover and the use of stable funding sources have increased. The Linked Exchange Rate System (LERS) provides a credible anchor for a small open economy with a large globally integrated financial services industry exposed to cross-border flows. Wage and price flexibility allow the economy to adapt quickly to cyclical conditions and structural change.

4. **Three downside risks cloud the outlook:**

- *Rising interest rates and global market volatility.* A gradual, anticipated increase in interest rates should not unduly dampen domestic demand**.** But a steeper-than-expected U.S. rate cycle or tightening of global financial conditions may have a bigger-than-usual adverse impact against a backdrop of high household debt with floating-rate mortgages. Separately, while market volatility has abated post-Brexit, with high financial sector connections, Hong Kong SAR would inevitably face spillovers from shocks to U.K. or European banks.

- *Stresses from exposures in Mainland China.* There is large potential for further growth from growing connections with Mainland China. At the same time, these linkages through trade, tourism, and finance (through lending to Mainland corporates, offshore renminbi (RMB) activity, securities issuance and asset management) create channels for the transmission of shocks. New channels are also opening up with the Mutual Recognition of Funds and the forthcoming Shenzhen-Hong Kong Stock Connect.

- *Property market.* After a welcome and orderly cooling since late 2015, house prices have begun to rise again and are close to previous highs. With stretched valuations, there is the risk of an accelerated price adjustment should interest rates rise faster than expected. Although the financial system would be resilient to such an adjustment, there is a risk to the real economy from an adverse spiral of negative wealth effects, lower collateral values, slower credit growth, and weaker household and corporate spending.

With strong buffers, these risks can be tackled provided that :(i) interest rates rise at a moderate anticipated pace, and (ii) Mainland China's transition to a more sustainable growth path remains orderly.

Policies to support the recovery

5. **Fiscal policy**. As the main demand management lever, fiscal policy needs to strike a balance between supporting aggregate demand and preserving a buffer for the longer-run challenge posed by aging. In the near term, with a significant and persistent output gap, a difficult external environment, plus weak automatic stabilizers, there is a case for further fiscal

impetus. The planned impulse in the 2016-17 Budget is appropriate, but if it undershoots (as a result of either overachievement of revenues or underachievement of expenditures), and growth remains weak, additional stimulus will be needed in fiscal year 2017-18. Aligning short-term fiscal measures to long-term goals and shifting spending forward would help ensure that cyclical support does not exacerbate the long-term fiscal trend (paragraph 9). To the extent feasible, measures could include increased capital expenditure on housing supply and supporting infrastructure, plus targeted measures to address aging, promote labor force participation and innovation.

Protecting financial system resilience

6. **The robust regulatory and supervisory framework should limit the build-up of systemic vulnerabilities.** The authorities have a track record as a standard setter in regulation and supervision, and in addressing data gaps. Substantial progress has been made on implementing the IMF's 2014 Financial Sector Assessment Program recommendations, including establishing an independent insurance authority, strengthened standards for securities listing, and legislation for a resolution framework for financial institutions to implement the Financial Stability Board's Key Attributes. The Hong Kong Monetary Authority (HKMA) has stepped up guidance and monitoring of bank lending activities, including to Mainland China; is closely checking liquidity risks; and is encouraging banks to reinforce cyber security. Coordination among Government and regulators in the Financial Stability Committee promotes discussion of risks that could transmit across the financial system. The authorities have close links with Mainland regulators and are active in international fora, including participating in supervisory colleges for cross-border banking and insurance groups, including global systemically important financial institutions, and in crisis management groups. Areas for continued attention include further enhancing stress testing and reviewing financial institutions' plans in response to stress events.

7. **Maintaining property-related measures.** With house prices rising again, the three-pronged approach to limit risks in the property market—boosting housing supply, macroprudential measures to limit stability risks, and stamp duties to contain speculative activity—should remain in place. Stamp duties have helped contain speculative and external demand and curbed demand from buyers who do not need mortgages. Strict counter-cyclical macroprudential measures (on loan to value and debt service to income ratios) have contained bank exposure to the property boom. HKMA's advice that banks should scrutinize the risks associated with their lending to property developers is appropriate.

8. **Contingencies**. As a trading hub and global financial center, the economy is inevitably exposed to global external shocks, placing a premium on contingency planning. If large adverse shocks materialize, a comprehensive and coordinated approach similar to the 2008/9 response would be appropriate: including large fiscal stimulus, a loosening of macroprudential policies, small and medium-sized enterprises credit guarantees, emergency liquidity provision and close international supervisory coordination. Global regulatory reforms and the recently introduced

resolution framework for financial institutions in Hong Kong SAR should strengthen the ability to respond.

Securing long-term potential

9. **Longer-term fiscal policy action.** Although the fiscal position is currently comfortable, an aging population will lead to structural deficits emerging within a decade. Early follow through on the recommendations of the 2014 Report on Long-Term Fiscal Planning—reprioritizing expenditures, raising revenues and managing assets—would help alleviate the fiscal impact of aging. The authorities have begun to undertake some fundamental expenditure reviews, plus ten-year projections for capital works projects in critical areas. Measures to help broaden the tax base may also be needed. Producing independent updates on the long-term fiscal projections every three/five years would help demonstrate progress and communicate the need for action.

10. **Labor force participation**. Addressing inequality and raising labor force participation (particularly among female and older workers) would support inclusive and sustainable growth. Openness to foreign workers also contributes to a flexible economy. Policies, including the Low Income Working Family Allowance Scheme, are targeted to encourage those on low incomes to stay in or reconnect to the workforce. The minimum wage has helped boost labor supply without damaging flexibility and a further moderate increase could be accommodated. Working hours and overtime pay policy could also encourage participation of lower-paid workers, but would need to take into account other pressures on the labor market.

11. **Building on Hong Kong SAR's role as a global financial center.** Hong Kong SAR has advantages of geographical location, a skilled and educated workforce, high legal standards, and a common language with its main trading partners. Leveraging its existing strong positon as a regional financial hub, opportunities can be tapped from Mainland China's growth, global integration and capital account liberalization. As well as maintaining its position as the leading RMB offshore center, the authorities have a strategy of developing the asset management industry, encouraging corporate treasury centers to domicile in Hong Kong SAR and enabling healthy development of Fintech without compromising consumer and investor protection. The HKMA's Infrastructure Financing Facilitation Office will help cement Hong Kong SAR's role as a financing center for regional infrastructure investment. There is also scope to further develop professional services exports. Innovation should continue to be encouraged by strong regulation and supervision over the whole financial system.

12. **Tackling the housing shortage**. The *Long-Term Housing Strategy* and *Hong Kong 2030+* demonstrate the authorities' commitment to address the housing supply shortage in an integrated manner by guiding land, planning and infrastructure development and addressing urban renewal. To the extent feasible, bringing forward investment plans would support the economy and alleviate bottlenecks.

Preserving strengths

13. **Exchange rate regime.** The LERS is the best arrangement for Hong Kong SAR, backed by credibility built up over three decades and tested through crises. It serves as an anchor for stability of the small open economy with a large, globally integrated financial services industry. The LERS is underpinned by the flexible economy, ample reserves buffers and strong financial regulation and supervision. The link to the U.S. dollar is appropriate, since the economy is a conduit for global trade and financial flows between advanced economies and Mainland China rather than just responding to fluctuations in the Mainland economy. The external position is broadly in line with medium-term fundamentals and desirable policies.

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