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IMF Executive Board Concludes 2016 Article IV Consultation Discussions with People's Republic of China—Hong Kong Special Administrative Region

On January 6, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions¹ with Hong Kong Special Administrative Region (SAR), and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.²

With a soft global trade environment and a downturn in tourism arrivals from Mainland China, Hong Kong SAR's growth rate is expected to have slowed to 1½ percent in 2016. Growth is likely to pick up modestly to about 2 percent in 2017, with private consumption continuing to be a main driver supported by a steady labor market. The current account surplus remained below 3 percent of GDP, and is projected to improve to around 3½ percent over the medium term as the global economy recovers.

With a more challenging external environment, with the U.S. rate cycle moving up, global trade growth tepid and Mainland China rebalancing, the growth recovery may be gradual. Over the longer term aging pressures may weaken the structural fiscal position, requiring fiscal planning to alleviate the decline; and a housing supply shortage also needs to be tackled.

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 position is positive at 355 percent of GDP. The banks are capitalized well above Basel III levels; liquidity cover and the use of stable funding 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.

Executive Board Assessment

¹ 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.

² 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.

In concluding the 2016 Article IV consultation with Hong Kong Special Administrative Region (SAR), Executive Directors endorsed staff's appraisal, as follows:

Growth and outlook. Growth has slowed since 2015 and the external outlook is more challenging with the U.S. rate cycle is edging up, global trade growth tepid and mainland China rebalancing. With soft external conditions, the growth recovery is likely to be gradual with the output gap closing slowly. Over the medium term population aging pressures may affect potential growth and weaken the structural fiscal position. On the upside, the economy is highly flexible and large potential can be tapped from the further development of Hong Kong SAR as a global financial center. Strong policy frameworks and ample buffers are in place to weather a less favorable environment. Prudent fiscal policy and intensive supervision of the financial system have built buffers that can be drawn on when needed. The Linked Exchange Rate System (LERS), provides a credible anchor for a small open economy with a large globally integrated financial services industry.

There are three main risks. Growing economic linkages mean that changes in mainland China's growth prospects spill over to Hong Kong SAR's financial and real sectors. With a large globally integrated financial sector and a currency board arrangement, the economy is exposed to U.S. developments and global market volatility. The property market is also a source of downside risk. With strong buffers in place these risks are manageable and should not adversely affect the economy provided that, as anticipated, interest rates rise at a moderate pace and mainland China's transition to a more sustainable growth path remains orderly.

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, and weak automatic stabilizers, there is a case for further fiscal impetus which can be removed as the economy recovers. The planned impulse in the 2016–17 Budget is appropriate but if it undershoots 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.

Long-term fiscal challenges. Early follow-through on the recommendations of the 2014 Report on Long-Term Fiscal Planning—reviewing and reprioritizing expenditures to measures that boost labor participation and support growth, raising revenues and managing assets would help alleviate the fiscal impact of aging. Measures to broaden the tax base may also be needed. The aim for balance and keeping overall government expenditure growth in line with GDP growth over the medium term is appropriate, while taking early action to alleviate the structural deficit problem. A drawdown of the fiscal reserves could be accommodated as the economy adjusts, but a positive fiscal buffer is desirable to cope with adverse shocks, provide room for countercyclical fiscal policy, and sustain confidence.

Property market measures. With renewed signs of overheating in the property market, the three pronged approach to limiting risks—boosting housing supply, macroprudential measures to limit stability risks, and stamp duties to contain speculative activity and external demand— is well placed. Current macroprudential settings have done their job of limiting financial system exposure to the asset

price boom and LTV and DSR settings should remain unchanged. Stamp duties can be an effective part of the toolkit to stem excessive price increases and speculation in the real estate market. As the distorting costs of duties become more significant the higher they are, they should be rolled back once the trend has shifted toward reduced price and speculative pressures.

Housing supply. The Long-Term Housing Strategy and Hong Kong 2030+ are aimed at addressing the housing shortage in an integrated manner by guiding land, planning and infrastructure development. Accelerating plans to increase supply, speeding up processes, making land available, bringing forward public investment would be a double win—tackling the housing problem and supporting the economy at a time of soft growth.

Financial sector policies. The robust regulatory and supervisory framework should help limit the buildup of systemic vulnerabilities. The authorities have a track record as a global standard setter in regulation and supervision and in addressing data gaps. Substantial progress has been made on implementing the 2014 FSAP recommendations. An independent insurance authority has been established, strengthened standards for securities listing have been implemented, and legislation has been put in place for a resolution framework for financial institutions which is designed to implement the Financial Stability Board's Key Attributes. There is substantial coordination among government and regulators domestically, there are close links with mainland regulators and the authorities are active in international fora, including in supervisory colleges for cross border banking and insurance groups, on 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.

Exchange rate regime and external position. The LERS remains the best arrangement for Hong Kong SAR backed by the credibility built up over three decades and tested through crises. The LERS is underpinned by the flexible economy, ample reserves buffers and strong financial regulation and supervision. Wage and price flexibility allows the economy to adapt quickly to cyclical conditions and structural change. The external position is broadly in line with medium-term fundamentals and desirable policies.

Contingency planning. As a trading hub and global financial center, the economy is inevitably exposed to global external shocks. In the event of an adverse shock, a comprehensive and coordinated policy approach similar to the 2008/9 response would be appropriate: including large fiscal stimulus, loosening of macroprudential policies, expanded credit guarantees, emergency liquidity provision and close international supervisory coordination. The recently introduced crisis resolution framework is strengthening the ability to respond to strains in the banking, corporate and household sectors

Table. Hong Kong SAR: Selected Economic and Financial Indicators, 2011–21

| | 2011 | 2012 | 2013 | 2014 | 2015 | Proj. | | | | | |
|---|------|------|------|------|------|-------|------|------|------|------|------|
| | | | | | | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
| NATIONAL ACCOUNTS | | | | | | | | | | | |
| Real GDP (percent change) | 4.8 | 1.7 | 3.1 | 2.7 | 2.4 | 1.5 | 1.9 | 2.4 | 3.0 | 3.0 | 3.1 |
| Contribution | | | | | | | | | | | |
| Domestic demand | 6.1 | 3.7 | 4.0 | 2.9 | 1.6 | 2.2 | 2.4 | 2.4 | 3.4 | 3.6 | 3.7 |
| Private consumption | 5.2 | 2.6 | 3.0 | 2.2 | 3.1 | 0.8 | 1.3 | 1.8 | 2.5 | 2.6 | 2.6 |
| Government consumption | 0.2 | 0.3 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| Gross fixed capital formation | 2.2 | 1.6 | 0.7 | 0.0 | -0.5 | -0.2 | 0.2 | 0.3 | 0.5 | 0.6 | 0.8 |
| Inventories | -1.5 | -0.8 | 0.1 | 0.4 | -1.3 | 1.4 | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net exports | -1.3 | -2.0 | -0.9 | -0.2 | 0.8 | -0.7 | -0.5 | 0.0 | -0.3 | -0.5 | -0.6 |
| Potential GDP growth | 3.4 | 3.1 | 3.0 | 2.8 | 2.7 | 2.7 | 2.7 | 2.7 | 2.6 | 2.5 | 2.5 |
| Output gap (in percent of potential) | 1.5 | 0.1 | 0.2 | 0.1 | -0.2 | -1.2 | -2.0 | -2.2 | -1.8 | -1.2 | -0.5 |
| Saving and investment (percent of GDP) | | | | | | | | | | | |
| Gross national saving | 29.7 | 26.8 | 25.5 | 25.1 | 24.8 | 25.4 | 25.7 | 25.6 | 25.3 | 25.1 | 25.0 |
| Gross domestic investment | 24.1 | 25.2 | 24.0 | 23.8 | 21.7 | 22.7 | 22.8 | 22.3 | 22.0 | 21.7 | 21.6 |
| Saving-investment balance | 5.6 | 1.6 | 1.5 | 1.3 | 3.1 | 2.8 | 2.9 | 3.2 | 3.3 | 3.4 | 3.4 |
| LABOR MARKET | | | | | | | | | | | |
| Employment (percent change) | 2.9 | 2.4 | 1.8 | 0.6 | 0.8 | 0.5 | 0.9 | 0.7 | 0.7 | 0.8 | 0.7 |
| Unemployment rate (percent, period average) | 3.4 | 3.3 | 3.4 | 3.3 | 3.3 | 3.3 | 3.2 | 3.2 | 3.2 | 3.1 | 3.1 |
| Real wages (percent change) | 2.7 | 1.6 | 0.1 | -2.4 | 0.6 | 0.6 | 0.9 | 1.1 | 1.3 | 1.5 | 1.6 |
| PRICES | | | | | | | | | | | |
| Inflation (percent change) | | | | | | | | | | | |
| Consumer prices | 5.3 | 4.1 | 4.3 | 4.4 | 3.0 | 2.5 | 2.6 | 2.7 | 2.8 | 2.9 | 3.0 |
| GDP deflator | 3.9 | 3.5 | 1.8 | 2.9 | 3.6 | 1.8 | 2.0 | 2.1 | 1.4 | 1.3 | 1.6 |
| GENERAL GOVERNMENT | | | | | | | | | | | |
| Consolidated budget balance | 3.8 | 3.2 | 1.0 | 3.7 | 0.6 | 1.6 | 1.5 | 0.1 | 0.6 | 1.4 | 1.4 |
| Revenue | 22.6 | 21.7 | 21.3 | 21.2 | 18.8 | 21.1 | 20.4 | 20.3 | 20.3 | 20.3 | 20.3 |
| Expenditure | 18.8 | 18.5 | 20.3 | 17.5 | 18.2 | 19.5 | 18.9 | 20.2 | 19.7 | 18.9 | 18.9 |
| Fiscal reserves as of March 31 | 34.6 | 36.0 | 35.3 | 36.7 | 35.2 | 35.6 | 35.8 | 34.3 | 33.4 | 33.4 | 33.2 |
| FINANCIAL | | | | | | | | | | | |
| Interest rates (percent, end-period) | | | | | | | | | | | |
| Best lending rate 1/ | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | ... | ... | ... | ... | ... |
| Three-month HIBOR 1/ | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.6 | ... | ... | ... | ... | ... |
| 10-year Treasury bond yield 1/ | 1.5 | 0.9 | 2.7 | 2.0 | 1.7 | 1.2 | ... | ... | ... | ... | ... |
| MACRO-FINANCIAL | | | | | | | | | | | |
| Loans for use in Hong Kong SAR (not including trade financing) 2/ | 12.5 | 7.0 | 10.6 | 13.5 | 6.3 | 6.3 | 4.0 | 4.5 | 5.5 | 6.0 | 6.0 |
| House prices (end of period, percent change) | 11.1 | 25.7 | 7.7 | 13.5 | 2.4 | -4.0 | -5.0 | -3.0 | -3.0 | 0.0 | 2.0 |
| Mortgage payment to income ratio 3/ | 39.9 | 43.6 | 45.7 | 44.7 | 48.9 | 44.3 | 46.4 | 47.1 | 47.4 | 45.4 | 43.5 |

| | | | | | | | | | | | |
|--|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Household debt (in percent of GDP) | 58.4 | 60.6 | 61.9 | 64.9 | 66.5 | 64.4 | 61.2 | 59.4 | 57.6 | 57.6 | 58.7 |
| Non-financial corporate debt (in percent of GDP) | 175.5 | 195.7 | 212.1 | 224.6 | 213.7 | 205.7 | 202.8 | 198.4 | 197.0 | 196.1 | 198.0 |
| Hang Seng stock index (percent change) 4/ | -20.0 | 22.9 | 2.9 | 1.3 | -7.2 | 1.3 | ... | ... | ... | ... | ... |
| EXTERNAL SECTOR | | | | | | | | | | | |
| Merchandise trade (percent change) | | | | | | | | | | | |
| Export volume | 3.5 | 1.9 | 6.5 | 0.8 | -1.9 | 0.3 | 2.1 | 2.7 | 2.8 | 2.6 | 2.6 |
| Domestic exports | -0.6 | 10.1 | -1.6 | 2.3 | -12.9 | 14.2 | 2.1 | 2.7 | 2.8 | 2.6 | 2.6 |
| Reexports | 3.6 | 1.7 | 6.8 | 0.8 | -1.6 | 0.6 | 2.1 | 2.7 | 2.8 | 2.6 | 2.6 |
| Import volume | 4.7 | 3.0 | 7.2 | 0.9 | -2.7 | -0.3 | 2.6 | 2.7 | 2.9 | 2.8 | 2.8 |
| Export value | 11.5 | 5.0 | 6.3 | 1.6 | -2.5 | 0.4 | 2.8 | 3.9 | 3.7 | 3.2 | 2.8 |
| Import value | 13.3 | 7.0 | 6.8 | 1.7 | -4.1 | 0.3 | 3.7 | 3.9 | 4.0 | 3.6 | 3.4 |
| Terms of trade | -0.1 | 0.1 | 0.4 | 0.1 | 0.5 | -0.4 | -0.3 | 0.0 | -0.2 | -0.2 | -0.3 |
| Current account balance (percent of GDP) 5/ | 5.6 | 1.6 | 1.5 | 1.3 | 3.1 | 2.8 | 2.9 | 3.2 | 3.3 | 3.4 | 3.4 |
| Foreign exchange reserves 5/ | | | | | | | | | | | |
| In billions of U.S. dollars, end-of-period | 285.4 | 317.4 | 311.2 | 328.5 | 358.8 | 390.1 | 418.9 | 431.3 | 446.2 | 457.8 | 466.7 |
| In percent of GDP | 114.6 | 121.3 | 112.9 | 112.8 | 116.1 | 122.0 | 126.3 | 124.2 | 122.8 | 119.6 | 115.7 |
| Net international investment position (percent of GDP) | 285.5 | 274.5 | 274.9 | 298.9 | 316.6 | 309.0 | 300.3 | 290.3 | 281.3 | 272.9 | 264.0 |
| Linked rate (fixed) | | | | | | | | | | | |
| Market rate (HK\$/US\$1, period average) | 7.784 | 7.756 | 7.756 | 7.754 | 7.752 | 7.757 | ... | ... | ... | ... | ... |
| Real effective rate (period average, 2010=100) | 96.6 | 98.7 | 102.2 | 105.6 | 113.9 | 117.3 | ... | ... | ... | ... | ... |

Sources: CEIC; HKSAR Census and Statistics Department; and IMF staff estimates.

1/ For 2016, average for the first 10 months.

2/ For 2016, as of September.

3/ CentaData, HIBOR-based for all households.

4/ For 2016, as of October.

5/ Data published using the Balance of Payments Statistics Manual 6 (BPM6) format.