INTERNATIONAL MONETARY FUND

People's Republic of China—Hong Kong Special Administrative Region: Staff Concluding Statement of the 2017 Article IV Consultation Discussions

November 3, 2017

The Hong Kong SAR economy has gathered momentum since the second half of 2016 and over the course of 2017, in line with the global economic recovery. The macroeconomic outlook has improved significantly and a robust recovery is expected to continue. Nevertheless, the outlook faces multiple challenges, both external and domestic. Hong Kong SAR is well placed to navigate through these challenges given the strong buffers and robust policy frameworks in place, including ample fiscal reserves, strong financial regulatory and supervisory frameworks, and the Linked Exchange Rate System, which serves as an anchor of stability. Policies should aim to further build buffers and use them effectively, if needed, to secure sustainable growth over the medium term.

While the near-term growth outlook has improved, risks remain tilted to the downside.

1. **Context.** Hong Kong SAR has successfully navigated challenging global tides over the last decade. Growth has been supported by low global interest rates and Hong Kong SAR's role as a trading and financial gateway between Mainland China and the rest of the world. Momentum accelerated since mid-2016 and over the course of 2017 amid the global recovery, robust Mainland China growth, booming housing prices, and rebounding credit growth. The labor market remained tight, with the unemployment rate edging down. However, housing prices more than tripled over the past decade, leading to deteriorating housing affordability. Also, while income inequality has narrowed slightly, it remains high.

2. **Outlook**. The strong growth momentum is expected to continue in the near term. Growth picked up strongly in 2017, amid robust domestic demand and recovering external demand. Annual growth is projected to rise to 3½ percent in 2017 and remain strong at 2⅔ percent in 2018, up from 2 percent in 2016. Consumption is projected to continue to be supported by a tight labor market; investment is expected to remain strong, with major infrastructure and housing projects in the pipeline. Inflation remains contained at below 2 percent. Over the medium term,

with the continued gradual global recovery and orderly monetary tightening in the U.S., Hong Kong SAR is projected to grow at about 3 percent, its medium-term potential growth.

3. **Risks**. The balance of risks has improved since last year. Stronger-than-expected global growth and faster-than-anticipated implementation of reforms in Mainland China could further improve Hong Kong SAR's growth outlook. Also, Mainland China's Belt and Road Initiative (BRI), which aims to foster global and regional cooperation in infrastructure, trade and finance, and plans for the development of the Guangdong-Hong Kong SAR-Macao SAR Bay Area create opportunities for Hong Kong SAR over the medium term, given its unique position as a gateway to Mainland China and as a global financial center. Even so, overall risks are still tilted to the downside, from both external and domestic sources. These include:

- **Correction in property prices.** Despite a series of government measures, property prices rose by 15 percent (yoy in September), amid the demand-supply imbalance. IMF staff analysis suggests that the degree of overvaluation has increased . Also, the sensitivity of households' debt service burden to interest rate changes remains high as a significant portion of new mortgages are on floating rates and indexed to the Hibor. In addition, a disorderly housing market adjustment could have a significant impact on private consumption through negative wealth effects. Furthermore, even though banks' balance sheets are currently strong, a disorderly housing price correction could trigger an adverse feedback loop between house prices, debt servicing ability and lower consumption, which would result in weakening growth leading to second round effects on banks' balance sheets.
- **Tighter-than-expected global financial conditions.** Financial conditions could tighten more than expected if volatility jumps as a result of monetary policy surprises in the U.S. or Euro Area. Unanticipated tightening in financial conditions would weigh on domestic demand and create financial stress in Hong Kong SAR given its highly globally-integrated financial sector.
- **Disorderly adjustment in Mainland China.** This would hit the tourism, trading and logistics industries, which account more than a quarter of GDP and employment in Hong Kong SAR. While Hong Kong SAR has benefitted from deepening financial linkages, new spillover channels for volatility and financial stress have been created, including the high and rising exposure of the banking system to Mainland China (currently assessed to be manageable).
- **Retreat from cross-border integration.** The risk of a shift toward inward-looking policies, including protectionism, is rising in many advanced economies. Such policy shifts would reduce cross-border flows of trade, investment, and labor, which could dampen productivity and global growth. Hong Kong SAR would be negatively affected due to its high degree of openness.

4. **Buffers.** Strong policy frameworks and ample buffers have been built and strengthened over the last decade, which will help to weather challenges.

- **External**. Vulnerabilities in the international investment position are low with large net foreign assets and foreign exchange reserves;
- **Fiscal**. Conservative fiscal management over the past decades and strong real estate-related revenues have helped build buffers, with fiscal reserves amounting to about 25 months of total government expenditure and gross government debt of less than 0.1 percent of GDP; and

- **Banks.** Banks have built up strong capital buffers and ample liquidity, well above international standards, and asset quality remains very strong, thanks to enhanced regulatory and supervisory frameworks. Policy efforts have enhanced resilience of the banking system to property price shocks with progressive tightening of macroprudential measures since 2009.

POLICY RECOMMENDATIONS

Continuing to ensure long-term fiscal sustainability while increasing short-term flexibility

5. **The current fiscal stance is assessed to be appropriate and additional fiscal stimulus is not needed due to the economy's cyclical position.** Fiscal policy continued to be conservative in FY16/17 with a larger-than-expected fiscal surplus (of 4½ percent of GDP). IMF staff projects the fiscal surplus in FY17/18 to narrow to 2¼ percent of GDP, which is appropriate despite the near-zero output gap, because its composition mostly reflects carry over of delayed implementation of infrastructure and land supply projects from the previous year and strengthening of social safety nets. As a robust recovery is expected to continue in the near term with a close-to-zero output gap, there is little need for additional fiscal stimulus in FY18/19 and beyond, and several temporary tax relief measures could be phased out.

6. **There would be benefits from greater short-term fiscal countercylicality in the face of negative shocks.** As the main demand management tool under the currency board arrangement, fiscal policy should support aggregate demand to a greater extent when cyclical conditions worsen and tighten otherwise. The current fiscal rule of adherence to at least budget balance should be implemented flexibly and symmetrically over the cycle, rather than every year. In particular, if downside risks materialize, the government should actively use fiscal policy to support domestic demand. Short-term countercyclical measures should be aligned with long-term goals to ensure they do not exacerbate unfavorable long-term fiscal trends.

7. **The authorities should consider possible adjustments to the fiscal framework in the face of medium- to long-term challenges to ensure fiscal sustainability.** Aging will lead to higher pension and healthcare spending (estimated to rise by 2 percentage points of GDP by 2030), as well as social spending. Also, education and capital spending should be preserved as investment in both physical and "soft" infrastructure is essential to maintain and boost competitiveness. In addition, revenues could decline by at least 3 percentage points of GDP as the real estate market stabilizes. A structural deficit will emerge by 2030 unless additional revenues are mobilized or social safety nets are scaled back significantly, with associated social and economic costs. Thus, the authorities should consider policy options to preserve the sound fiscal position, including:

- **Expenditure reprioritization.** Efforts to rein in non-essential expenditure growth through expenditure reviews and reprioritizing overall spending should continue but are likely insufficient to offset the additional long-term spending needs.

- **Revenue mobilization while maintaining competitiveness.** The emergence of structural deficits over the long term requires early analysis and consideration of options to raise revenues while maintaining competitiveness. Options identified through international benchmarking, relative to other global financial centers, include: (i) introducing/raising indirect taxes (such as VAT and excises) to avoid overreliance on direct taxation; and, (ii) increasing top marginal income tax rates modestly. In this context, the establishment of the new tax policy unit to review possible broadening of the tax base is welcome. This unit should study the relative distributional, efficiency and growth impacts of these and other revenue measures for the medium to long term.

Deflating the housing boom safely by continuing to use the current three-pronged approach

8. Amid the booming and overvalued property market, sustained increases in housing supply are critical to resolving the structural supply-demand imbalance. Housing supply has been rising with the implementation of the government's Long-Term Housing Strategy, which was adopted in 2014. To complement this, the government is finalizing Hong Kong 2030+, which is a longer-term development strategy to provide land and housing on a more sustainable basis. However, given various obstacles to further increasing supply in the near term, including the lack of ready sites and relevant development restrictions, it appears that it will be difficult to meet the ten-year housing supply target set under the Strategy in practice. Thus, there is benefit to expediting the process for identifying land and building sites, together with conducting the relevant environmental, transport, and community facility assessments.

9. Macroprudential measures have been effective in building buffers in the financial system against possible housing market adjustments. These policies have helped limit financial system exposure to the housing boom and strengthened banks' mortgage loan origination standards. As housing prices continue to rise and a disorderly adjustment could pose significant macro-financial risks, these measures should remain in place to protect the financial system. However, amid tight prudential regulations on banks, property developers, which receive financing from banks, have been rapidly increasing lending to households, though their share relative to banks' mortgage lending remains low. Adjusting macroprudential measures should be considered based on evolving financial stability risks.

10. **Stamp duties have helped contain house prices by curbing excess demand, especially by cash buyers.** IMF staff analysis shows that stamp duties have been effective in stemming price increases. By doing so, these measures have also helped contain household leverage and systemic risk. However, high stamp duty rates may render the housing market less liquid. Moreover, the Buyer's Stamp Duty and the Double Ad-Valorem Stamp Duty are assessed to be capital flow management measures and macro-prudential measures under the IMF's Institutional View on the Liberalization and Management of Capital Flows. Specifically, while they are intended to contain housing price overvaluation and systemic financial risk, they discriminate between residents and non-residents. Both stamp duties are assessed to be appropriate because: (i) they were put in place amid a surge of capital flows into the property market; (ii) they were not used to substitute for necessary macroeconomic adjustment; and (iii) additional tightening of macro-prudential policies by the HKMA, which does not apply to cash buyers, could exacerbate leakages to non-bank financial institutions and property developers that are outside the regulatory perimeter. While assessed to be appropriate, going forward, once systemic risks from the housing market dissipate, both stamp duties should be phased out and replaced with alternative non-discriminatory measures. In addition, the authorities could phase out mortgage interest deductibility as it boosts demand for housing and encourages higher leverage.

Preserving an anchor of stability

11. The Linked Exchange Rate System (LERS) remains the best arrangement for Hong Kong SAR. The U.S. dollar is still the most commonly used international currency in trade and financial transactions and Hong Kong SAR's economic cycles and financial conditions are, to a large extent, influenced by the U.S. and the global economic/financial environment. The currency board arrangement has been supported by the flexible economy, ample fiscal and reserve buffers, and strong financial regulation and supervision. LERS anchors the stability of Hong Kong SAR's highly-open economy with its large and globally integrated financial sector. Over the medium term, as U.S. monetary policy normalizes, the HK dollar could resume real appreciation in line with the U.S. dollar, raising concerns of diminishing competitiveness. Hong Kong SAR's flexible product and labor markets should allow rapid adjustment and help ensure that departures from the equilibrium REER do not persist. The external position in 2016 is assessed to be broadly consistent with medium-term fundamentals and desirable policy settings.

Maintaining financial stability

12. **The financial system is well placed to cope with challenges thanks to the robust regulatory and supervisory framework.** Potential systemic vulnerabilities and regulatory arbitrage are closely monitored and addressed through coordination among the government and the regulators in the Financial Stability Committee, close dialogue with the Mainland China regulators, and active participation in global fora. Banks have ample loss-absorption buffers and limited vulnerability to short-term funding. Mainland China-related exposures are being closely monitored and IMF staff assesses the risks as manageable. Considering the large credit-to-GDP gap (estimated at 35 percent by the Bank for International Settlements), the introduction and progressive increase of the countercyclical capital buffer (CCyB) is appropriate. Substantial progress has also been made in implementing the 2014 FSAP recommendations, including a comprehensive framework for recovery and resolution, which commenced operation in July 2017.

13. **The authorities' continued strengthening of the regulatory and supervisory framework is welcome and crucial for maintaining financial stability.** Further strengthening the oversight regime for non-bank institutions (including securities markets, broker dealers and asset managers) would prevent risks, including those arising from new channels connecting Hong Kong SAR and Mainland China. To mitigate risks stemming from property developers' lending to households, the HKMA further tightened capital requirements for banks that lend to property developers with high mortgage lending-to-equity ratios. Recent efforts to enhance coordination among different regulators, including coordination platforms for fintech businesses, is a welcome development. High standards for securities listing should be maintained for financial stability. The development of the new risk-based capital regime for insurance companies is in "Phase 2", focusing on detailed rules for quantitative requirements. Continued close and regular monitoring of risks arising from Mainland China exposures will allow Hong Kong SAR to reap the benefits of closer integration while mitigating potential risks. Enhanced oversight of cybersecurity risks by the authorities is welcome.

14. **Hong Kong SAR is working to, and should continue to, tap new opportunities as a global financial center.** Leveraging its position as a well-established international financial center with comparative advantages such as skilled labor, high legal standards and common languages with its main trading partners, the authorities are further developing the asset management industry as well as encouraging corporate treasury centers to domicile in Hong Kong SAR. It is well positioned to contribute to, and benefit from, increasing regional connectivity and cooperation in investment, trade, and finance (including under the BRI and the Guangdong-Hong Kong SAR-Macao SAR Bay Area), as it can provide a platform for developing multiple channels for funding. To do so, the HKMA's establishment of the Infrastructure Financing Facilitation Office is welcome.

15. **The authorities need to balance carefully the tradeoff between greater efficiency and maintaining stability in the face of rapid developments in fintech.** The authorities' support for fintech business developments through various channels, including establishing the Fintech Facilitation Office, the Fintech Innovation Hub, a central bank digital currency project, closer cross-border collaboration with Singapore and Shenzhen on fintech development (including the recently-announced initiative with Singapore on Distributed Ledger Technology-based trade finance platform), is welcome and will help enhance its role as a key global financial center. Technological progress can promote the development and adoption of new financial services as well as affect the existing market structure. But, financial regulation must adapt to remain effective and ensure that risks to stability and integrity—including from cyberattacks, money-laundering and terrorism financing—can be effectively managed while not unduly stifling innovation. The authorities are using "regulatory sandboxes", which allow firms to test new technologies and business models in a controlled environment and enable regulators to address potential risks from new technologies without curbing innovation. Going forward, the authorities should continue to review and enhance the regulatory framework for fintech to ensure that it remains effective.

Ensuring sustained and inclusive growth

16. **The authorities have taken steps to address high inequality and prepare for the needs of an aging population.** They have introduced several policies, and spending on social welfare, housing and health has increased to around 33 percent of public spending. Provision of public housing, amid deteriorating housing affordability, has long been a policy priority as almost half of all households live in subsidized housing. The statutory minimum wage, introduced in 2011 and increased three times, has helped boost labor supply without damaging wage flexibility. The plans to enhance the Low-Income Working Family Allowance Scheme, including by boosting monthly payments and relaxing the income and working hour requirements, are welcome. The authorities are moving forward to enhance the existing multi-pillar retirement protection system, including strengthening social security for the elderly with more financial needs and developing financial products to convert assets into stable post-retirement income.

17. **The authorities should continue to promote sharing the benefits of economic growth.** Changes to the Mandatory Provident Fund system, including the abolition of the arrangement for "offsetting" severance payment and long service payment, should be implemented. Working hours policy should strike a balance between equity and inducing labor force participation while not compromising competitiveness, especially the flexible labor market. In the context of reviewing the existing social safety net, consideration should be given to consolidating and strengthening means-testing of the programs geared to serve the elderly. In view of the projected decline in the labor force over the medium term, consideration should be given to providing childcare for young children, which will boost female labor force participation, as well as increase fertility.

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 the discussions