People's Republic of China—Hong Kong Special Administrative Region
Preliminary Conclusions of the 2012 Article IV Mission

November 17, 2012

1. *Growth*. Global economic weakness is impacting Hong Kong SAR and real GDP growth is projected to slow to 1¼ percent this year. The slowdown is being driven by trade developments, with net exports expected to subtract 1¾ percentage points from growth. However, domestic demand is proving resilient owing to a supportive fiscal stance and continued strength in the labor market. Unemployment is expected to remain low, especially in the low-skilled segment, reflecting buoyant activity in tourism-related sectors and construction. Next year, GDP growth is expected to recover to around 3 percent as the drag from net exports abates.

2. *Prices*. In line with the cooling economy, consumer price pressures have eased. This has been helped by declining food inflation, tracking developments in the Mainland. Inflation is expected to remain moderate, averaging 3¾ percent this year and 3½ percent next year. After a short respite late last year, the run-up in property prices has resumed, defying the general slowdown in economic activity. Housing prices have increased 20 percent so far this year and are now double the trough of 2008. The price increase in the mass market has been particularly pronounced of late, which is exacerbating affordability concerns. A combination of limited supply of new housing, strong demand from local and non-local purchasers, and low interest rates imported from the United States has been driving up prices.

3. *Domestic risk*. The sharp run-up in house prices raises the risk of an abrupt correction. In past episodes, the banking system has proven resilient to a substantial downswing in real estate prices. Nevertheless, the property sector represents half of outstanding loans for use in Hong Kong SAR, with additional risks coming from the use of real estate as collateral. A sharp price correction would lead to falling collateral values and negative wealth effects, which could trigger an adverse feedback loop between economic activity, bank lending, and the property market. While the probability of a correction large enough to generate major macroeconomic and financial consequences is fairly low in the near term, the property sector is the main source of domestic economic risk.

4. *Property market policies*. Policies on a variety of fronts are needed to contain macroeconomic and financial risks from the housing market. The authorities have taken appropriate macro-prudential measures to help safeguard the banking system, such as progressively tightening loan-to-value and debt service ratios. These measures should continue to be fine-tuned in line with evolving risks. If needed, additional measures, including higher risk weights or regulatory reserves, could be deployed. Macro-prudential measures should, however, remain focused on safeguarding financial stability, while other policies can best be used to address broader concerns about demand-supply imbalances and affordability. The recently adopted Buyer's Stamp Duty and extension of the Special Stamp Duty should help dampen housing demand and, as the full impact becomes apparent, these stamp duties could be adjusted accordingly. Improving affordability ultimately hinges on a sufficient provision of new housing. Therefore, the government's efforts to ensure a steady and adequate supply going forward, including through public housing, are welcome, although the impact may be limited in the short run given planning and construction lags.

5. *Fiscal policy*. This year's budget is providing some welcome counter-cyclical support to the economy. Measures include waiving rates, subsidies for electricity, increased transfers, additional capital spending, tax relief, and reductions in fees. Given the economic outlook, next year's budget should continue to be tilted toward supporting growth, consistent with a modest positive stimulus. The stimulus should be temporary and could include reductions of public housing rents or tax relief for households. Measures targeted at lower-income households, in addition to boosting growth, could also have social benefits.

6. *Income inequality*. Fostering inclusive growth is an ongoing concern. Hong Kong SAR's economic flexibility and reliance on free-market principles are sources of economic strength and resilience which, however, can also result in income inequality given the importance of skill-based wage premiums. Moreover, the high and rising cost of housing is straining the budget of many lower- and middle-income families. The authorities have implemented an array of measures—including the statutory minimum wage and planned increases in public housing—geared toward improving the living standards of lower-income households. Weight should continue to be placed on policies to reinforce the existing social welfare programs and provide support and opportunities to lower-income households.

7. *Financial developments*. Bank credit growth, a key concern in recent years, has decelerated significantly in line with slowing economic activity, tighter macro-prudential policy, and less new lending to the Mainland. Hong Kong SAR's banking system remains well capitalized, putting it in a good place to start implementing Basel III capital standards next year. Although IPO activity has been slow this year, the equity market has rebounded recently. Meanwhile, corporate bond issuance has been strong. This includes issuance by local companies who have increasingly used capital markets as the supply of longer-term bank lending has tightened.

8. *Financial integration with the Mainland*. Hong Kong SAR is benefiting from the ongoing financial integration with the Mainland and should continue to build on its competitive advantage. Over the past few years, claims on the Mainland have grown significantly and accounted for 28 percent of Hong Kong SAR banks' total claims as of end-June 2012. To identify emerging risks, the Hong Kong Monetary Authority (HKMA) should continue to stress test and closely monitor banks' exposures, including through close cooperation with the Mainland authorities, and to ensure that banks maintain prudent underwriting standards and hold adequate buffers that reflect the specific risks from Mainland-related exposures. The ongoing opening of the Mainland's capital account and expanded international use of RMB provide further opportunities for Hong Kong SAR. To consolidate Hong Kong SAR's first-mover advantage, the authorities should continue to develop the RMB financial infrastructure.

9. *Risks from global shocks*. As a small and highly open economy, Hong Kong SAR is exposed to global shocks. A renewed intensification of the euro area crisis and the U.S. fiscal cliff are the main external risks, with potentially large spillover effects through the trade channel. A hard landing in the Mainland, although a low-probability risk, could also have a significant impact on Hong Kong SAR's economy. If any of these shocks materialize, Hong Kong SAR should undertake a rapid fiscal stimulus that aims to support domestic demand while helping to shield low-income and vulnerable households. Options include tax relief for households, increased direct transfers to poor and vulnerable households, extended support for smaller enterprises (which are important for employment), and accelerated public infrastructure spending where possible.

10. *Financial spillovers*. As a financial center, Hong Kong SAR would feel the impact of a global financial shock. Bank distress elsewhere in the world could spill over into Hong Kong SAR, with shocks emanating in the United States or the Mainland having the largest potential impact. In the event of a large shock, liquidity can be provided using the discount window, foreign exchange swaps, term repos, and other suitable tools, such as the RMB liquidity facility. The existing Deposit Protection Scheme should be sufficient to provide confidence to depositors. If needed as a last resort, the broad-based guarantee of deposits introduced after the fallout of Lehman could be reconsidered, in coordination with other jurisdictions. Preventing market dislocation in Hong Kong SAR would help limit the contagion arising from a global shock.

11. *Exchange rate regime*. The Linked Exchange Rate System (LERS) is a transparent, credible, and effective exchange rate regime and warrants continued support as the best arrangement for Hong Kong SAR. The recent purchase of U.S. dollars by the HKMA amid fresh capital inflows is part of the normal functioning of the LERS. Hong Kong SAR has an economic system that adjusts to the changing environment through movements in nominal wages and prices. The preconditions to sustain such a system—including a strong fiscal position, robust and proactive financial oversight, and flexible labor, product, and asset markets—are in place. Hong Kong SAR's economic flexibility facilitates a quick and effective adjustment of the real exchange rate so as to avoid sizable or persistent misalignments.

12. *External assessment*. The currency and external position are assessed to be broadly in line with fundamentals. Hong Kong SAR's current account surplus has fallen substantially since the global financial crisis and is expected to be under 5 percent of GDP this year, compared to 15 percent of GDP in 2008. Over the medium-term, as global growth recovers and integration with the Mainland deepens, the current account surplus is projected to rise to around 7 percent of GDP. A structural current account surplus of this magnitude is assessed as being consistent with Hong Kong SAR's status as an international financial center.

13. *Managing volatility*. Hong Kong SAR's economy is relatively volatile, which is not surprising given its high degree of openness to trade and capital flows. The absence of an independent monetary policy means that fiscal policy is the main tool for demand management. Since automatic stabilizers are lower than in other advanced economies (a consequence of Hong Kong SAR's small government), a heavier burden is put on discretionary policy. Overall, Hong Kong SAR's fiscal policy has been effective in reducing output volatility thanks to the active use of discretion. Nevertheless, fiscal policy in many other advanced economies has been more counter-cyclical, which suggests that consideration could be given to using discretion even more actively. To prevent an erosion of fiscal discipline, however, it would be critical to ensure that policies are applied symmetrically through the business cycle. Hong Kong SAR's history of fiscal prudence, which has built fiscal reserves to over 30 percent of GDP, provides an important backbone to the economy.

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.