



People's Republic of China—Hong Kong Special Administrative Region
Preliminary Conclusions of the 2014 Article IV Mission
March 10, 2014

Growth is improving, aided by the global recovery, but risks remain. The policy priority is to reinforce the economy's resilience through continuation of robust and proactive financial oversight, sound fiscal management, and the Linked Exchange Rate System (LERS).

Recent development and outlook. After a slowdown in 2012 amidst weak global conditions, Hong Kong SAR's growth has recovered to 2.9 percent in 2013, as resilient domestic demand helped offset the continued drag from net exports. As the global recovery takes hold, external demand is forecast to improve and lift growth to around 3¾ percent in 2014, while domestic demand remains solid. The labor market has remained strong, with unemployment slightly above 3 percent. Inflation is expected to remain at around 4 percent, given the slow pass-through of housing costs.

Managing risks and spillovers. Hong Kong SAR is a small and highly open economy and, as such, is heavily influenced by global developments. An orderly exit from unconventional monetary policy in the U.S. would tighten domestic liquidity conditions, but any negative effects could be outweighed by the benefit of a stronger U.S. economy. However, negative spillovers could prevail if exit is associated with increased volatility in capital flows and financial markets. Closer integration with the Mainland presents both downside and upside risks. Successful transformation of China's economy could slow near-term growth, but would offer significant benefits over the medium and long term. However, any adverse developments in China could damage confidence and have a negative impact through the trade and financial channels. The main domestic risk is a disorderly correction in property prices, which could trigger an adverse feedback loop between economic activity, bank lending, household balance sheets, and the property market.

Financial sector issues. The IMF's Financial Sector Assessment Program (FSAP) conducted in 2013-14 finds that Hong Kong SAR's financial system is well regulated and supervised—at the global forefront in many areas—in line with the needs of a major global financial center and resilient to likely shocks.

- ***Regulation and supervision.*** Main areas for improvement include the financial sector resolution regime and insurance sector regulation and supervision. As a financial center, it is also important for the authorities to maintain their active international engagement to effectively manage cross-border challenges and comply with evolving international standards. Continued market infrastructure development while

maintaining a high standard of regulation and supervision would also help sustain Hong Kong SAR's competitiveness in the growing offshore RMB business.

- *Mainland exposure.* Credit growth has been rapid since 2010 and, in recent years, due mainly to rising Mainland exposure. Banks' exposure to non-bank Mainland entities has grown significantly in recent years. A broader concept of non-bank Mainland China exposure (NBMCE) has risen to 19 percent of total assets. NBMCE includes exposures to resident Mainland affiliates for use outside of Hong Kong SAR (including the Mainland and elsewhere), lending of Hong Kong SAR bank subsidiaries in Mainland China, and borrowing by foreign companies' for use in the Mainland. While deepening integration suggests that financial linkages will continue to grow, the large exposure requires close monitoring and cooperation with Mainland supervisors.
- *Risks and resilience.* The FSAP stress tests conclude that the banking system is well positioned to absorb losses in adverse scenarios, which combine lower domestic and global growth, including in China, with higher U.S. interest rates and asset price shocks. The banking system is also resilient to changes in liquidity conditions.
- *Macroprudential measures.* The authorities have proactively implemented measures that have contributed to safeguarding financial stability. These include active management of required loan-to-value (LTV) ratios and household debt service ratios.

Property market policies. A long-run solution to housing hinges on ensuring adequate supply in the market. Therefore, the recently announced plan to increase housing supply, including public housing, is welcome and will help address concerns about inequality. However, this will take years and, in the meantime, the counter-cyclical prudential and fiscal measures deployed during the upswing can facilitate an orderly adjustment in the market while safeguarding financial stability. The unwinding of the counter-cyclical prudential measures should be linked to the dissipation of systemic financial sector risks. The fiscal measures (stamp duties) could be eased in line with the normalization of the market, with a faster reduction in the event of a sharp correction.

Fiscal policy. Fiscal prudence is a cornerstone of the policy framework that has been so important to Hong Kong SAR's resilience and success. Fund staff supports casting fiscal policy in a long-term framework, as done by the recent Working Group on Long-Term Fiscal Planning, to help anchor the discussion about how to balance spending to address aging and inequality, preserving low taxes, and the necessity of maintaining fiscal prudence. In this context, there may be scope to strengthen social programs through a reprioritization of spending and efficiency gains in existing programs. In line with the improved economic outlook, the 2014/15 budget has an appropriate unwinding of stimulus, including a reduction in one-off measures.

Exchange rate. The Linked Exchange Rate System (LERS) is the best arrangement for Hong Kong SAR. The LERS, backed by credibility built-up over three decades, is a transparent and effective regime. Combined with robust and proactive financial supervision and regulation, prudent fiscal management, and flexible markets, the LERS has worked well to help Hong

Kong SAR successfully weather changing global conditions. Staff assess that the external position is broadly consistent with medium-term fundamentals and desirable policy settings.

We would like to express our gratitude to the Hong Kong SAR authorities for their kind hospitality and for the productive nature of our discussions.