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IMF Executive Board Concludes 2017 Article IV Consultation Discussions with People's Republic of China—Hong Kong Special Administrative Region

On January 10, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions¹ with Hong Kong Special Administrative Region (SAR).

Economic activity in Hong Kong SAR has gained momentum since the second half of 2016 amid robust domestic demand and recovering external demand, and growth is projected to have risen by 3.7 percent in 2017, up from 2 percent in 2016. The strong growth momentum is expected to continue in the near term with annual growth of 2.8 percent in 2018. Consumption is projected to continue to be supported by a tight labor market and investment is expected to remain strong, with major infrastructure and housing projects in the pipeline. The economy is expected to continue to grow at about 3 percent over the medium term, close to its potential.

Despite increasing rates amid rising US rates, overall financial conditions remain accommodative, with average funding costs remaining low and stable while credit growth picking up to around 21 percent (y/y) in October 2017. Residential property prices resumed rising since mid-2016 and rose by 24 percent between March 2016 and June 2017 before stabilizing more recently. Amid the continued housing market boom, the authorities maintained the three-pronged approach of boosting house supply and tightening macroprudential measures and stamp duties on transactions to maintain financial stability.

The authorities continued to strengthen the regulatory and supervisory framework in the financial sector, including close monitoring of potential systemic vulnerabilities and regulatory arbitrage as well as coordination among the government and the regulators and close dialogue with Mainland China regulators. Leveraging its position as a well-established international financial center with comparative advantages, Hong Kong SAR continues to tap new

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.

opportunities as a global financial center, including supporting fintech business development through various initiatives.

Nevertheless, the outlook faces multiple challenges, both external and domestic, including from tighter global financial conditions, possible bumps in Mainland China's ongoing transition, retreat from cross-border integration, a potential adjustment following the current housing boom, as well as long-term challenges from rapid population aging. Strong policy frameworks and ample buffers help it navigate these challenges. Despite large and volatile capital flows, external vulnerabilities are low with large net foreign assets and foreign exchange reserves. Conservative fiscal management over the past decades have helped build large buffers, with fiscal reserves amounting to about 25 months of total government expenditure. Banks have also 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. 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 Assessment²

Executive Directors commended the authorities for sound policy management and building strong fiscal and financial buffers. Growth has accelerated since mid-2016 supported by the global recovery, robust Mainland China growth, booming housing prices, and rebounding credit growth. Directors noted, however, that the economy faces risks related to tighter global financial conditions, possible bumps in Mainland China's ongoing transition, a retreat from cross-border integration, and a potential disorderly adjustment following the current housing boom. They agreed that with strong policy frameworks and ample buffers Hong Kong SAR is well-equipped to weather the challenges ahead. Directors encouraged the authorities to stay vigilant and to use the economy's strong position to safeguard macroeconomic and financial stability.

Directors agreed that the current fiscal stance is appropriate and additional fiscal stimulus is not required amid strengthening growth. They recommended that the current fiscal rule be implemented flexibly and symmetrically over the cycle. If downside risks materialize, Directors recommended using fiscal policy and short-term countercyclical measures aligned with long-term goals to ensure they do not exacerbate unfavorable long-term fiscal trends. They welcomed efforts to boost economic growth to meet increasing demands on public expenditure. To address long-term challenge of increasing aging-related spending, Directors encouraged the authorities to consider tax reform options to boost revenues while maintaining the economy's competitiveness and flexibility.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Directors supported the authorities' three-pronged approach to limiting risks in the housing market. They underscored that restoring balance in the housing market should be a policy priority. Directors encouraged the authorities to continue their efforts to increase housing supply. They noted that macro-prudential measures have been effective in building buffers in the financial system and any adjustment of macroprudential measures should be based on evolving financial stability risks. Most Directors noted that, once housing market risks dissipate, the Buyer's Stamp Duty and the Doubled Ad-Valorem Stamp Duty/New Residential Stamp Duty should be phased out and replaced with alternative measures.

Directors commended the authorities' continued efforts to strengthen the regulatory and supervisory framework for financial stability. They welcomed the close monitoring of risks arising from Mainland China exposures, which is key for Hong Kong SAR to reap the benefits of closer integration while mitigating potential risks. Directors commended the substantial progress in implementing the 2014 FSAP recommendations. They encouraged the authorities to balance carefully the tradeoff between greater efficiency and maintaining stability in the face of rapid developments in fintech.

Directors noted that Hong Kong SAR's external position is broadly consistent with medium-term fundamentals and desirable policy settings. They considered that the Linked Exchange Rate System remains the best arrangement for Hong Kong SAR and serves as an anchor of stability for the highly-open economy with a globally-integrated financial services industry.

Directors commended the authorities for recent steps to increase inclusiveness, including boosting spending on social welfare and health, and plans to enhance the Low-Income Working Family Allowance Scheme. They encouraged continued efforts to promote inclusiveness and strengthen labor force participation.

Hong Kong SAR: Selected Economic and Financial Indicators, 2012-22

	2012	2013	2014	2015	2016	Proj.					
	2017	2018	2019	2020	2021	2022					
NATIONAL ACCOUNTS											
Real GDP (percent change)	1.7	3.1	2.8	2.4	2.0	3.7	2.8	2.8	2.9	3.0	3.1
Contribution											
Domestic demand	3.7	3.9	2.8	1.5	2.6	4.6	3.8	3.2	3.3	3.5	3.4
Private consumption	2.5	2.9	2.2	3.1	1.2	3.7	3.1	2.1	2.2	2.4	2.3
Government consumption	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Gross fixed capital formation	1.6	0.7	0.0	-0.8	-0.1	0.3	0.4	0.7	0.8	0.8	0.8
Inventories	-0.8	0.1	0.4	-1.2	1.1	0.1	0.0	0.0	0.0	0.0	0.0
Net exports	-1.9	-0.8	-0.1	0.8	-0.5	-0.9	-0.9	-0.4	-0.4	-0.5	-0.4
Potential GDP growth	2.9	2.8	2.7	2.7	2.8	2.8	2.9	2.9	2.9	3.0	3.0
Output gap (in percent of potential)	0.1	0.4	0.4	0.1	-0.6	0.2	0.1	0.0	0.0	0.0	0.0
Saving and investment (percent of GDP)											
Gross national saving	26.8	25.5	25.2	24.9	26.4	24.4	24.1	24.4	24.5	24.6	24.7
Gross domestic investment	25.2	24.0	23.8	21.5	21.7	21.4	21.1	21.1	21.2	21.2	21.2
Saving-investment balance	1.6	1.5	1.4	3.3	4.6	3.0	3.1	3.2	3.3	3.4	3.5
LABOR MARKET											
Employment (percent change)	2.1	1.9	0.4	0.9	0.2	0.5	0.3	0.2	0.2	0.2	0.1
Unemployment rate (percent, period average)	3.3	3.4	3.3	3.3	3.4	3.2	3.2	3.2	3.2	3.2	3.2
Real wages (percent change)	1.6	0.2	-2.4	0.5	1.2	0.6	0.8	0.9	1.2	1.3	1.4
PRICES											
Inflation (percent change)											
Consumer prices	4.1	4.3	4.4	3.0	2.4	1.6	1.8	2.0	2.2	2.4	2.6
GDP deflator	3.5	1.8	2.9	3.6	1.8	3.0	1.0	1.1	1.1	1.3	1.5
GENERAL GOVERNMENT (percent of GDP)											
Consolidated budget balance	3.2	1.0	3.6	0.6	4.5	2.6	1.6	1.4	1.3	1.2	1.2
Revenue	21.7	21.3	21.2	18.8	23.0	21.0	20.4	20.4	20.5	20.6	20.6
Expenditure	18.5	20.3	17.5	18.2	18.6	18.4	18.9	19.0	19.2	19.4	19.4
Fiscal reserves as of March 31	36.0	35.3	36.7	35.1	38.3	38.5	38.7	38.5	38.3	37.9	37.4
FINANCIAL											
Interest rates (percent, period-average)											
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	0.6	0.9	...	...	...	...	...
10-year Treasury bond yield 1/	1.0	1.7	2.0	1.6	1.2	1.5	...	...	...	...	...
MACRO-FINANCIAL											
Loans for use in Hong Kong SAR (not including trade financing)	7.0	10.6	13.5	6.3	8.0	13.3	4.8	1.0	3.0	4.5	5.1
House prices (end of period, percent change)	25.7	7.7	13.5	2.4	7.9	16.1	1.6	1.9	5.7	5.6	5.3
Mortgage payment to income ratio 2/	43.6	45.7	44.7	49.1	45.1	50.3	52.1	53.2	53.6	51.1	48.5
Household debt (in percent of GDP)	61.3	62.7	65.5	67.1	67.7	73.6	72.0	70.6	71.7	72.6	73.1
Non-financial corporate debt (in percent of GDP)	173.1	195.2	213.4	227.7	233.9	224.9	219.4	219.5	219.4	218.8	218.2
Hang Seng stock index (percent change)	22.9	2.9	1.3	-7.2	0.4	28.0	...	...	...	...	...
EXTERNAL SECTOR											
Merchandise trade (percent change)											
Export volume	-0.1	2.7	1.5	-1.7	1.4	5.5	3.0	2.8	3.1	3.4	3.5
Domestic exports	-12.4	-9.3	2.8	-12.8	-7.1	5.5	3.0	2.8	3.1	3.4	3.5
Reexports	0.1	2.9	1.5	-1.6	1.5	5.5	3.0	2.8	3.1	3.4	3.5
Export value	2.9	3.6	3.2	-1.8	-0.5	7.0	4.8	3.9	3.9	4.4	3.8
Import value	3.9	3.8	4.0	-4.1	-0.9	7.9	5.1	4.3	4.4	5.0	4.5
Terms of trade	0.1	0.4	0.1	0.5	0.0	-0.2	0.5	-0.1	-0.2	-0.2	-0.4
Current account balance (percent of GDP) 3/	1.6	1.5	1.4	3.3	4.6	3.0	3.1	3.2	3.3	3.4	3.5
Foreign exchange reserves 3/											
In billions of U.S. dollars, end-of-period	317.4	311.2	328.5	358.8	386.1	392.3	405.2	421.4	433.7	445.1	456.9
In percent of GDP	120.9	112.9	112.7	116.0	120.3	115.0	114.2	113.2	112.0	110.5	108.8
Net international investment position (percent of GDP)	274.5	274.8	298.6	324.2	367.5	347.3	337.4	327.8	318.3	308.4	298.3
Linked rate (fixed)											
Market rate (HK\$/US\$, period average)	7.757	7.757	7.755	7.752	7.762	7.790	...	...	...	...	...
Real effective rate (period average, 2010=100) 1/	98.7	102.2	105.6	113.9	117.8	118.3	...	...	...	...	...

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

1/ For 2017, average for first 11 months

2/ CentaData, HIBOR-based for all households

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