



INTERNATIONAL MONETARY FUND

**People's Republic of China—Hong Kong Special Administrative Region:
Staff Concluding Statement of the 2018 Article IV Consultation Discussions**

November 9, 2018

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or ‘mission’). Missions are undertaken as part of regular (usually annual) consultations under [Article IV](#) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Hong Kong SAR's economy benefited from a strong cyclical upswing through the first half of 2018, supported by the continued global recovery and buoyant domestic sentiment. However, near-term risks have increased – including those from trade tensions, tighter global financial conditions, and capital outflows from emerging markets. Also, long-term challenges, including from aging, elevated inequality, and housing shortage, need to be tackled. Prudent macroeconomic policies and ample buffers are in place to help smoothen the transition and ensure continued stability.

WHILE THE NEAR-TERM GROWTH OUTLOOK IS STRONG, DOWNSIDE RISKS HAVE INCREASED.

1. Context. The Hong Kong SAR economy benefited from a strong cyclical upswing and momentum continued through the first half of 2018, as a result of the global recovery, continued solid growth in Mainland China, and increased consumer confidence. Inflation remained subdued and the unemployment rate fell to a 20-year low. The booming economy and the buoyant property market boosted fiscal revenues, resulting in a large surplus. Although there are signs of moderation in the property boom, housing affordability remains stretched and inequality remains high.

2. Outlook. Growth is projected to remain robust at 3.8 percent in 2018 and 2.9 percent in 2019. Consumption is projected to continue to be supported by a tight labor market and investment is expected to remain strong with planned infrastructure projects in the pipeline. These projections assume that a 25 percent tariff on US \$250 billion of U.S. imports from China comes into effect by January, but that trade tensions do not escalate further. Inflation is projected to remain contained at around 2 ½ percent in 2018-19. Over the medium-term, Hong Kong SAR is expected to grow close to its potential growth of around 3 percent on the back of sustainable (though gradually slowing) growth in Mainland China as rebalancing and financial sector reforms progress.

3. Risks. Risks to global growth have shifted to the downside. Hong Kong SAR, as a highly open economy and an international financial center, is vulnerable to further escalating U.S.-China trade tensions, possible disorderly tightening of global financial conditions, slower-than-expected

growth in Mainland China, and a sharp housing market correction. These shocks are likely correlated and could materialize together, which would amplify their effects. The development of the Guangdong-Hong Kong SAR-Macao SAR Bay Area creates opportunities for Hong Kong SAR over the medium term, given its unique position as the gateway to Mainland China and as a global financial center with renowned professional services. It is also noteworthy that the normalization of global financial conditions better aligns Hong Kong SAR's monetary conditions with its domestic economic and financial needs. Even so, as with the global outlook, risks have shifted to the downside, from both external and domestic sources. These include:

- **Escalation in trade tensions.** Further rising trade tensions would have a significant impact on the global economy, including Hong Kong SAR. While tariff actions thus far have not weighed on trade through Hong Kong SAR, further escalation would impact the economy through real economy channels—chiefly trade, logistics and tourism—and financial channels, through re-pricing of risk in equity markets, higher corporate spreads and possible deterioration of loan quality, particularly of the large Mainland-related loan portfolios.
- **Sharper-than-expected tightening of global financial conditions.** Financial conditions could tighten more than expected as a result of monetary policy surprises in major economies or if global sentiment sours further, resulting in capital outflows from emerging markets and sizable losses in asset markets. Unanticipated tightening in financial conditions would weigh on consumption and investment via increasing debt servicing burdens of households and firms.
- **Sharp slowdown in the property market.** Despite tight macroprudential settings and demand-side measures, housing prices grew by 45 percent from trough-to-peak (March 2016 to July 2018). More recently, prices retreated from their July peak by 2 percent to September, indicating that the housing market may be starting to cool. Gradual interest rate increases would cool the market in an orderly way, but a significant deterioration in sentiment remains a key risk. If a sharp correction in housing prices materializes, the direct impact on the banking sector would likely be limited given low loan-to-value ratios and healthy levels of bank capital. Instead, banks would be affected through second-round effects of lower consumption and investment.
- **Sharper-than-expected slowdown in Mainland China.** Hong Kong SAR benefits from close ties to Mainland China through trade, tourism, and financial sector linkages. Thus, a significant slowdown in Mainland China either due to insufficient/not-well-managed domestic reforms or further trade tensions could impact Hong Kong SAR.

4. **Buffers.** Many years of prudent macroeconomic policies have endowed Hong Kong SAR with significant buffers to weather these shocks. FX reserves stood at around 127 percent of GDP at the end of 2017 or twice the monetary base. The current account is in surplus and the net international investment position was equivalent to 409 percent of GDP at the end of 2017, one of the largest in the world, and a strong buffer against external shocks. Prudent fiscal management and the strong real estate market have led to the accumulation of fiscal reserves of 41 percent of GDP, or 28 months of government spending. Banks' capital buffers and liquidity positions remain strong, due to stringent regulatory standards.

POLICY RECOMMENDATIONS

A. ENSURING CONTINUED FINANCIAL STABILITY

5. **Robust financial regulation and supervision should help weather domestic and external shocks.** The implementation of Basel III requirements remains on track. Given the large credit gap and the overvalued housing market, the countercyclical capital buffer has been appropriately set at 1.875 percent and is set to increase to 2.5 percent in 2019. To ensure stability of banks' liquidity positions, the authorities have introduced the net stable funding ratio. Rules on loss-absorbing capacity requirements for authorized institutions will be operationalized by year-end, ensuring that institutions have sufficient financial resources to absorb losses and can be re-capitalized in case of failure. Supervision of bank loans to property developers has been appropriately strengthened through higher capital charges. Mainland China-related exposures are also closely monitored. Plans by the Securities and Futures Commission to impose quantitative limits on margin lending by brokers are welcome. The development of a risk-based capital regime for insurance companies is in the Phase-2, with a focus on detailed rules for quantitative requirements.

6. **Continued efforts are necessary to counter potential risks.** Personal bank loans have risen rapidly despite prudent underwriting standards and credit limits, and merit intensified scrutiny. Stock-collateralized lending is also on the rise warranting continued close cooperation between the HKMA and the Securities and Futures Commission. Mortgage lending by nonbanks, particularly property developers, continues to grow fast from a low base and should continue to be monitored closely. Consideration should be given to extending the regulatory perimeter to reduce regulatory arbitrage.

B. MANAGING THE HOUSING CYCLE

7. **The combination of macroprudential measures and demand side measures in the form of stamp duties currently in place remains appropriate, but more needs to be done to raise housing supply.** While macroprudential measures have allowed for building buffers in the financial system against a correction, housing prices remain overvalued, and affordability has deteriorated. A significant increase in housing supply remains the most needed course of action.

- **Tight macroprudential regulations have helped contain systemic risks and should remain in place.** These measures, together with stringent regulation and supervision, allowed banks to build significant buffers that should help cushion the impact of house price declines. While the mix should be reassessed on a regular basis, the authorities should cautiously await more signs of a sustained decline before considering loosening macroprudential and demand-side measures. At the same time, if prices rebound, further tightening would likely result in leakages to unregulated non-bank financial institutions as borrowers secure mortgage financing outside regular bank channels (e.g., property developers).
- **Demand side measures in the form of stamp duties have helped contain systemic risks and should be retained for now but phased out if these risks dissipate.** The DSD/NRSD is levied at a higher rate on non-Hong Kong permanent residents (as well as Hong Kong permanent residents who owned another residential property in Hong Kong SAR at the time of purchase), and is assessed to be a capital flow management measure and macroprudential

measure under the IMF's Institutional View of Capital Flows. It continues to be assessed as appropriate but should be phased out once systemic risks dissipate.

- **Efforts to further increase supply continue to be key to resolving the demand-supply imbalance and moderating house price overvaluation.** While housing production has increased in recent years, it has fallen short of housing demand. Recent efforts to boost housing supply are welcome and should be stepped up. The authorities should also review and -- where possible -- expedite the procedures for identifying land and building sites, zoning/rezoning, and conducting the necessary environmental, design, transportation, and other assessments.
- **More frequent reviews of eligibility for public housing could potentially help alleviate affordability concerns.** Around half of households currently live in public rental and subsidized housing, with eligibility based on income and asset limits. Private housing remains unaffordable for segments of the population and the wait time for public housing has grown. Plans to allocate a larger share of new housing for public purposes are welcome. Also, the authorities could consider increasing spending on public housing. To ensure proper allocation of benefits, more frequent reviews of eligibility could be conducted: in 2016, around 5½ percent of households in the highest income quantile lived in public rental housing.

C. PRESERVING AN ANCHOR OF STABILITY

8. **The Linked Exchange Rate System (LERS) remains the appropriate exchange rate arrangement for Hong Kong SAR.** Since its introduction in 1983, the LERS has served as an anchor of stability, helping to ensure sustained growth, competitiveness, and the smooth functioning of the extensive financial services industry. The functioning of LERS is aided by Hong Kong SAR's flexible economy, ample fiscal buffers, and strong financial regulation and supervision. The credibility of the arrangement is further underscored by ample FX reserves. Hong Kong SAR's external position and the HK dollar remain broadly in line with medium-term fundamentals and desirable policy settings.

D. ENSURING FISCAL SUSTAINABILITY

9. **The FY2018/19 budget is expected to deliver a fiscal stimulus through a combination of modest revenue cuts and significant spending increases.** According to the budget, revenues are expected to fall next year, as a result of lower personal income tax rates, increased child and parent allowances, a new personal disability allowance, a one-off rates concession in the recurrent property tax, and property-related revenues coming down from a historically-high level. At the same time, the authorities plan to significantly increase spending, and staff projects the primary fiscal balance to fall by 1.3 percentage points of GDP.

10. **While increased expenditure in certain areas is welcome, fiscal stimulus is not necessary given the economy's strong cyclical position.** Higher expenditure on social welfare and healthcare is welcome, though higher allowances to help the vulnerable could have been better targeted. The Old Age Allowance for those aged 70 or above is not means-tested and its benefits are relatively low. Merging it with the means-tested Old Age Living Allowance and increasing its level would be more beneficial to the elderly poor. Spending on public housing is expected to remain constant as a share of GDP, amid significant unmet demand for public housing, and should be

raised. On other expenditure, the authorities should carefully consider spending plans on innovation and technology and other industries to ensure that there is adequate demand for planned facilities and the focus is on services that could not be met by private sector initiatives. More generally, other increases in recurrent spending should also be carefully analyzed as they may be difficult to reverse in the future, thus complicating long-term fiscal management when aging pressures arise. Furthermore, the authorities should strive for greater countercyclicality in the face of both positive and negative shocks.

11. **On the revenue side, tax relief measures could have been more progressive, and the authorities should consider reversing the tax cuts.** Resources spent through tax relief measures could have been better targeted to the most vulnerable as taxes are already mostly paid by the wealthy. Personal and corporate income tax cuts will further reduce non-property revenues and increase reliance on a narrow and volatile tax base. Hong Kong SAR's tax revenue as a share of GDP is relatively low, even when compared to other financial centers.

12. **In the long term, measures will be needed to ensure fiscal sustainability.** Aging will lead to higher pension and healthcare spending and the housing market will likely normalize, which may lead to structural fiscal deficits. Therefore, measures will be needed to ensure fiscal sustainability, unless the social safety net is scaled back (which would have undesirable social and economic costs). Amid these pressures, options to raise revenues while maintaining competitiveness should be considered. The Tax Policy Unit should study possible tax-broadening measures and their impact on long-term fiscal sustainability, competitiveness and growth. Options identified through international benchmarking include introducing/raising indirect taxes like sales tax or VAT and raising excise taxes to avoid overreliance on direct taxes. On the expenditure side, periodic expenditure reviews should continue to ensure adequate quality of fiscal spending. Hong Kong SAR's strong fiscal buffers afford it time to plan for meeting future needs.

E. BOLSTERING LONG-TERM GROWTH

13. **Preserving growth in the medium- to long-term will require addressing the expected shrinkage in labor force, high income inequality, as well as maintaining competitiveness.** Long-term challenges are three-fold. First, aging is expected to lower potential annual GDP growth by $\frac{3}{4}$ percent between 2020-2050 on average. Second, despite significant redistributive policies, inequality remains high and is projected to rise. Finally, while one of the most competitive economies in the world, Hong Kong SAR faces increased competition from other financial centers in Asia, and is rightly focusing on boosting competitiveness further.

14. **Raising labor force participation (LFP) of women and older workers could help alleviate labor supply declines.**

- While the average female participation rate in Hong Kong SAR, at 65 percent for age 15-64, is about the same as the OECD average, it is over 15 percentage points lower than the male LFP rate in Hong Kong SAR; this gap compares to an average of 8 percentage points in the OECD countries. It is also noteworthy that a number of OECD countries have significantly higher female labor participation rates. Additional expenditure in the FY2018/19 budget aimed at increasing child care is a step in the right direction. Other options include more affordable child care, with extended hours to accommodate working parents, as well as after-school care. Promoting flexible work arrangements and part-time employment would also help, as well as improving care for the elderly.

- Retaining older workers —whose LFP rate of 11 percent remains below the OECD average despite relatively-long life expectancy—could be another avenue to stop labor force depletion. Enhancement to the Employment Programme for the Middle Aged in September 2018, by providing higher incentives to employers for hiring unemployed people or retirees aged 60 or above, is welcome. The Research Office of the Legislative Council identified policies currently in place in Japan and Singapore that could be usefully considered in Hong Kong SAR. These include legislating re-employment of older workers up to a certain age, employer subsidies, support for short-term and flexible job creation, and statutory protection against age discrimination. The authorities' plan to abolish the arrangement for "offsetting" severance payment and long service payment with Mandatory Provident Fund benefits is welcome, and should proceed as planned.

15. **The authorities have taken steps to tackle inequality and efforts should continue.** The authorities' policies aimed at increasing inclusion are welcome and include introducing and raising the Statutory Minimum Wage, the Working Family Allowance, the Old Age Living Allowance, and the Personal Disability Allowance, transport subsidies, and public housing. Introduction of the Annuity Scheme could also help ensure adequate retirement income. Going forward, additional steps would be welcome including: increasing progressivity of personal income taxation, ensuring adequate levels of spending on housing, health, education and social welfare, and better targeting existing benefits.

16. **For many years Hong Kong SAR has been considered one of the most competitive economies in the world, and is rightly taking steps to maintain competitiveness.** It continues to be recognized for the high-quality regulatory framework based on the common law tradition that reflects international standards. This, combined with transparent and efficient institutions, high-quality infrastructure, a stable macro-economic environment, and highly efficient and flexible markets for goods, labor, and finance, have rendered Hong Kong SAR one of the most business-friendly economies globally. Taking advantage of rising demand for bond financing in Asia, the authorities have taken steps to develop the bond market. These steps include the launch of a Pilot Bond Grant Scheme that will cover half of the issuance expenses of first-time bond issuers, enhancement of tax incentives, and the introduction of various green finance initiatives. Increasing usage of the Bond Connect, boosted by recent enhancements such as establishing a real-time delivery-versus-payment settlement system, clarification of tax liability, and launch of block trade functionality, is helping Hong Kong SAR to further develop its fixed income market. Innovation and technology is also increasingly playing a role, as attested by the launch of eTradeConnect, a distributed ledger technology-based trade financing platform, and the Faster Payment System, which supports instant, multi-currency payments on a 24/7 basis.

17. **The authorities remain committed to further expanding Hong Kong SAR's role as a leading financial center and as the gateway to the Mainland.** The development of the Guangdong-Hong Kong SAR-Macao SAR Bay Area could help increase the flow of people, capital, goods and services between Guangdong province and Hong Kong SAR and Macao SAR. Recently-completed infrastructure projects, including the high-speed rail and the bridge-tunnel system, as well as Mainland's granting of resident permits to Hong Kong SAR residents living on the Mainland and the pilot program allowing e-wallets issued in Hong Kong SAR to be used in Mainland China, will foster further integration of the Greater Bay Area.

In closing, the mission would like to thank the Hong Kong SAR authorities and the Shenzhen Central Sub-Branch of the People's Bank of China for their kind hospitality and for open and productive discussions.