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IMF Executive Board Concludes 2018 Article IV Consultation with People's Republic of China—Hong Kong Special Administrative Region

On January 10, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with People's Republic of China—Hong Kong Special Administrative Region and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

The Hong Kong SAR's economy is expected to grow 3.5 percent in 2018 resulting from a strong cyclical upswing in the first half of the year, continued global recovery, and buoyant domestic sentiment. In 2019, growth is expected to slow to 2.9 percent. Private consumption (aided by tight labor market) and investment (benefitting from projects currently in the pipeline) are expected to continue to support growth, with headwinds coming from the increased trade tensions, tighter global financial conditions, and slower growth in Mainland China. Over the medium-term, the economy is expected to grow at around 3 percent, close to its potential.

The authorities continued their track record of prudent macroeconomic policies. Financial regulation and supervision continued to be strengthened, including through the implementation of the Basel III requirements on capital, liquidity, and loss absorbing capacity of banks. Supervision of bank loans to property developers has been appropriately tightened, and Mainland China-related exposures have been closely monitored. Despite the fiscal stimulus in 2018/19, the budget is expected to deliver a surplus. While the property market showed initial tentative signs of softening in the recent months, the authorities thus far appropriately maintained their three-pronged approach of increasing housing supply and retaining tight macroprudential measures and demand side measures to guard financial stability.

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[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.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Nevertheless, risks to Hong Kong SAR's outlook have increased. These include the further escalation of global trade tensions, possible disorderly tightening of global financial conditions, slower-than-expected growth in Mainland China, and a sharp housing market correction. In the long-term, population aging may weaken weigh on Hong Kong SAR's growth and fiscal position. Sizable buffers build over the years should help navigate this less favorable environment: at the end of 2017, fiscal reserves stood at 41 percent of GDP at the end of 2017, or 28 months of government spending, while the FX reserves stood at around 127 percent of GDP at the end of 2017 or twice the monetary base. Banks have built strong capital and liquidity buffers, significantly above the international standards, and asset quality remains strong. The Linked Exchange Rate System continued to be the appropriate exchange arrangement for Hong Kong SAR.

Executive Board Assessment

In concluding the 2018 Article IV consultation with Hong Kong Special Administrative Region (SAR), Executive directors endorsed staff appraisal as follows:

Outlook. Growth is projected to remain robust in 2018 a result of the global recovery, continued solid growth in Mainland China, and increased consumer confidence, while a modest slowdown is expected in 2019 including as a result of ongoing trade tensions. Over the medium-term, Hong Kong SAR is expected to grow close to its potential growth of around 3 percent supported by sustainable (though gradually slowing) growth in Mainland China as rebalancing and financial sector reforms progress.

Risks. The balance of risks for Hong Kong SAR has shifted to the downside. Risks arise from 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. At the same time, the development of the Greater 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.

Buffers. Many years of sound macroeconomic and prudential policies have endowed Hong Kong SAR with significant buffers to weather these shocks. These include ample FX reserves, one of the strongest net International Investment Positions in the world, and fiscal reserves covering more than two years of government spending. Banks' capital buffers and liquidity positions remain strong, due to stringent regulatory standards.

Financial sector policies. Robust financial regulation and supervision should help weather domestic and external shocks. The implementation of Basel III requirements remains on track, and the countercyclical capital buffer has appropriately been increased further. The authorities have also introduced the net stable funding ratio, and 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 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. The authorities should also consider measures to extend the regulatory perimeter to reduce regulatory arbitrage from lending by property developers. The Securities and Futures Commission intends to impose quantitative limits on margin lending by brokers. 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.

Housing policy. The combination of macroprudential measures and 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. The DSD/NRSD is assessed to be a capital flow management measure and macroprudential measure under the IMF's Institutional View of Capital Flows and should be phased out once systemic risks dissipate.

Exchange rate regime and external position. The LERS remains the appropriate exchange rate arrangement for Hong Kong SAR. Since its introduction, 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.

Fiscal policy. The FY2018/19 budget is expected to deliver a fiscal stimulus that is not needed given the economy's strong cyclical position. At the same time, increased expenditure on social welfare, health, and education is welcome, though some allowances could be better targeted, and spending on public housing should be raised. Other expenditure increases should be carefully analyzed as they may be difficult to reverse in the future, thus complicating long-term fiscal management when aging pressures arise. The authorities should also consider reversing the recent tax cuts. Furthermore, the authorities should strive for greater countercyclicality in the face of both positive and negative shocks.

Long-term fiscal challenges. Aging will lead to higher pension and healthcare spending and the housing market will likely normalize, which may lead to structural fiscal deficits. Therefore, the authorities will need to consider measures to ensure fiscal sustainability, unless the social safety net is scaled back. 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.

Inequality. The authorities’ efforts to reduce inequality and poverty through a combination of subsidies, allowances, social welfare payments, and public housing should continue. Introduction of the Annuity Scheme and the reverse mortgage can 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.

Competitiveness and long-term growth. Efforts to raise labor force participation of women and older workers should continue. 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. Plans to develop the bond market and further promote innovation and technology are steps in the right direction. Further expansion of the Hong Kong SAR’s role as a leading financial center and as the gateway to Mainland China should also help.

Hong Kong SAR: Selected Economic and Financial Indicators, 2015-23

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Proj.					
NATIONAL ACCOUNTS									
Real GDP (percent change)	2.4	2.2	3.8	3.5	2.9	3.0	3.1	3.1	3.1
Contribution									
Domestic demand	1.4	2.5	5.2	5.4	3.3	3.5	3.5	3.6	3.5
Private consumption	3.1	1.3	3.7	4.0	2.2	2.3	2.3	2.5	2.5
Government consumption	0.3	0.3	0.3	0.4	0.3	0.3	0.3	0.3	0.3
Gross fixed capital formation	-0.7	0.0	0.7	0.9	0.8	0.9	0.8	0.7	0.8
Inventories	-1.2	0.9	0.5	0.1	0.0	0.0	0.0	0.0	0.0
Net exports	0.8	-0.3	-1.4	-1.9	-0.4	-0.5	-0.3	-0.5	-0.4
Output gap (in percent of potential)	-0.2	-0.8	0.0	0.5	0.3	0.2	0.2	0.1	0.1
Saving and investment (percent of GDP)									
Gross national saving	24.9	25.5	26.6	25.6	25.7	25.7	25.7	25.5	25.5
Gross domestic investment	21.5	21.5	22.3	22.3	22.2	22.3	22.3	22.2	22.1
Saving-investment balance	3.3	4.0	4.3	3.4	3.5	3.4	3.4	3.4	3.5
LABOR MARKET									
Employment (percent change)	0.9	0.2	0.9	1.0	0.4	0.4	0.3	0.3	0.3
Unemployment rate (percent, period average)	3.3	3.4	3.1	2.6	2.6	2.6	2.6	2.6	2.6
Real wages (percent change)	0.5	1.2	2.3	1.6	1.0	1.2	1.3	1.3	1.3
PRICES									
Inflation (percent change)									
Consumer prices	3.0	2.4	1.5	2.4	2.1	2.2	2.4	2.5	2.5
GDP deflator	3.6	1.7	2.9	3.1	2.0	2.0	1.7	1.9	1.9
GENERAL GOVERNMENT (percent of GDP)									
Consolidated budget balance	0.6	4.5	5.6	3.3	2.0	1.8	1.7	1.7	1.7
Revenue	18.8	23.0	23.3	22.2	21.0	20.9	21.2	21.2	21.2
Expenditure	18.2	18.6	17.7	18.9	19.0	19.1	19.5	19.5	19.5
Fiscal reserves as of March 31	35.1	38.3	41.4	42.2	42.1	41.9	41.6	41.3	41.0
FINANCIAL									
Interest rates (percent, period-average)									
Best lending rate	5.0	5.0	5.0	...	...	...	...	...	...
Three-month HIBOR	0.4	0.6	0.9	...	...	...	...	...	...
10-year Treasury bond yield	1.6	1.2	1.6	...	...	...	...	...	...
MACRO-FINANCIAL									
Loans for use in Hong Kong SAR (ex. trade financing	6.3	8.0	16.1	14.6	8.4	7.4	9.1	8.1	9.3
House prices (end of period, percent change)	2.4	7.9	14.7	14.8	3.3	3.1	4.5	5.9	6.6
Credit Gap 1/	11.0	10.9	19.6	19.3	10.2	7.2	5.6	2.6	2.0
Hang Seng stock index (percent change)	-7.2	0.4	36.0	...	...	...	...	...	...
EXTERNAL SECTOR									
Merchandise trade (percent change)									
Export value	-1.8	-0.5	8.0	8.0	5.3	3.6	4.0	3.6	3.5
Import value	-4.1	-1.0	8.7	8.6	5.3	3.9	4.3	4.1	3.8
Terms of trade	0.5	0.0	-0.1	0.8	0.0	-0.1	-0.2	-0.2	-0.1
Current account balance (percent of GDP) 2/	3.3	4.0	4.3	3.4	3.5	3.4	3.4	3.4	3.5
Foreign exchange reserves 2/									
In billions of U.S. dollars, end-of-period	358.8	386.2	431.6	447.7	470.0	492.8	510.7	528.1	540.9
In percent of GDP	116.0	120.3	126.4	123.6	122.2	119.9	117.2	113.9	109.4
Net international investment position (percent of GD	324.2	359.2	409.4	387.0	372.1	357.6	344.4	331.3	318.7
Linked rate (fixed)									
Market rate (HK$/US$1, period average)	7.752	7.762	7.793	...	...	...	...	...	...
Real effective rate (period average, 2010=100)	113.9	118.3	118.2	...	...	...	...	...	...

Sources: BIS,CEIC; HKSAR Census and Statistics Department; and IMF staff estimates.
1/ Based on loans for use in Hong Kong SAR
2/ Data published using the Balance of Payments Statistics Manual 6 (BPM6) format