CONCLUDING STATEMENT

People's Republic of China—Hong Kong Special Administrative Region: Staff Concluding Statement of the 2023 Article IV Consultation Discussions

FOR IMMEDIATE RELEASE

Washington, DC – March 31, 2023: *Economic activity in Hong Kong SAR is normalizing with the reopening of the border. Strong fiscal policy support has helped the economy navigate through multiple shocks over the last few years, while strong institutional frameworks and financial buffers have allowed the financial system to remain resilient and continue to operate smoothly, including the Linked Exchange Rate System (LERS). The economy is facing macro-financial challenges amid rising interest rates, ongoing stress in the real estate sector of Mainland China, possible adjustment in the local housing market, and the global economic slowdown. Securing a sustainable recovery and fortifying the status as an international financial center while safeguarding financial stability require a policy strategy aimed at promoting balanced recovery, maintaining financial system resilience, ensuring orderly adjustment in the housing market, and bolstering long-term growth prospects.*

Navigating through Global Headwinds

1. **Despite a challenging global macro-financial environment, the Hong Kong SAR economy is recovering strongly with post-COVID normalization of economic activity.** The economic recovery stalled in 2022 following a major COVID outbreak and U.S. monetary policy tightening, but the government effectively ramped up its fiscal policy support to about 8 percent of GDP to help mitigate the impact of the adverse shocks, while extending various financial relief measures. Economic challenges have broadened to labor markets with a large decline in the labor force over the last few years reflecting the combined impacts of structural factors such as population aging, and short-term factors related to the pandemic such as limited inflows of foreign workers. While slowing global growth and tighter financing conditions loom as headwinds for the economy, high frequency indicators suggest robust domestic recovery in the first quarter of 2023.

2. **The financial system remains resilient and continues to serve as an international financial center.** Amid challenging macro-financial conditions, the financial

system has remained stable, supported by strong institutional frameworks, in particular high-quality financial sector oversight and substantial capital and liquidity buffers. The LERS continues to function smoothly, providing a solid anchor to the economy and the financial system, allowing the latter to perform its role as an international financial center. Financial linkages with Mainland China continue to deepen, including through the expansion of various Connect schemes, reinforcing Hong Kong SAR's status as a key financial gateway vis-à-vis Mainland China.

3. **Real GDP is projected to grow by 3.5 and 3.1 percent in 2023 and 2024, respectively.** Despite slowing growth and tightening financial conditions around the world, and projected return to fiscal balance in about two years, exports of tourism services and domestic economic activity, in particular private consumption, are expected to normalize as border control and other COVID-related restrictions have been lifted in both Hong Kong SAR and Mainland China, easing policy uncertainty. As large slack in the economy will keep overall wage pressures moderate while housing rentals are likely to remain soft, inflation pressure is expected to remain muted with CPI inflation gradually rising to about 2¼ percent by end-2023. In the medium term, against a backdrop of an aging population, elevated private debt, and Mainland China's secular growth slowdown, GDP growth is forecast to slow below 3 percent, but the ongoing economic integration with Mainland China (especially the Greater Bay Area) and the active promotion of innovation and technological development locally may avert the deceleration in potential growth.

4. Near-term risks to the growth outlook are balanced, with systemic risk in the financial sector manageable given significant buffers.

- *Downside.* A sharper-than-expected global growth slowdown as well as escalation of regional conflicts and resulting disruptions in trade could derail the recovery. A sharp rise in global risk premia amid renewed stress in the global banking system and further tightening of monetary policy in major advanced economies could have adverse spillovers through financial channels.

- *Upside.* Transition to the post-pandemic new normal in both Hong Kong SAR and Mainland China could be smoother and more rapid than anticipated with strong pent-up demand, leading to a faster-than-expected economic recovery including inbound tourism.

5. Deepening geoeconomic fragmentation may pose downside risks in the medium to long term. While this will adversely affect all economies around the world, as Hong Kong SAR is one of the most open economies as a regional trading hub, an international financial center, and a financial gateway vis-à-vis Mainland China, geoeconomic fragmentation may affect the economy through various channels, such as trade, labor and capital flows.

Fostering a Resilient Recovery

6. **Gradual fiscal consolidation would help secure a sustained and inclusive recovery.** Despite the ongoing strong recovery, there remains large slack in the economy, with real GDP in 2022 remaining 6 percent below its level in 2018, while fiscal space remains ample with fiscal reserves of 27.4 percent of GDP as of end-2022. A gradual pace of fiscal consolidation to return to a balanced budget in the medium term, rather than in about two years, would help ensure a solid and balanced recovery. Pandemic-era measures to support vulnerable households and affected SMEs could be unwound gradually to help promote an

inclusive growth. Additional household support should be more targeted to low-income households to increase the effectiveness of fiscal policy in stimulating growth, especially private consumption.

7. **Expanding social safety nets would help enhance the automatic stabilizer role of fiscal policy.** The adequacy and coverage of social assistance benefits could be further increased, and the introduction of a dedicated unemployment benefit system would help better protect the labor force and vulnerable households against idiosyncratic and systemic shocks. A comprehensive tax reform over the medium term to broaden the tax base is imperative to provide a stable source of revenue to meet long-term spending needs while ensuring fiscal sustainability.

8. **As economic activity normalizes in the post-pandemic period, exceptional financial support should be phased out to facilitate necessary post-crisis debt restructuring.** Financial relief measures such as the moratorium on principal payments and full credit guarantee schemes should be unwound as they expire. The mission welcomes the Hong Kong Monetary Authority's (HKMA's) intention to introduce a positive countercyclical capital buffer (CCyB) in a risk-neutral environment. The CCyB should be kept at the current level of 1 percent to help maintain the banking system's resilience against impending macro-financial headwinds as soft credit growth is largely driven by weak credit demand despite ample banks' capital.

Safeguarding Financial Stability

A. Maintaining the Financial System's Resilience

9. **Banks should maintain adequate capital buffers to absorb potential credit losses arising in the challenging macro-financial environment.** Staff welcomes the HKMA's conservative approach of having not relaxed prudential norms during the pandemic. As credit risk will likely continue to materialize after years of domestic economic contractions, rising interest rates, and the ongoing stress in Mainland China's real estate sector, the supervisory focus should continue to be on ensuring banks' proper credit loss recognition and provisioning. The intensive banking supervision proportional to major macro-financial risks is welcome and should continue to be complemented with the use of Pillar 2 capital requirements as needed.

10. **Proactive management of risks arising from the stress in Mainland China's real estate sector and the impact of weak economic activity during the pandemic is warranted.** As financial stability risks could span beyond bank lending, a more comprehensive cross-sectoral approach to monitoring Mainland China exposures would be important to ensure that risks, particularly related to nonbank and market-based financial intermediation, can be detected and managed. The HKMA should continue devoting supervisory resources to ensure banks' appropriate risk management related to Mainland China-related exposures.

11. **Close monitoring of liquidity risks of banks and investment funds is warranted amid more volatile global risk sentiment.** While banks' unrealized losses from rising interest rates appear low, the HKMA should remain vigilant against liquidity risks following recent strains in global banking markets, particularly with respect to less stable deposits, and continue to ensure that banks have appropriate risk management. Building on recent efforts by the Securities and Futures Commission (SFC) to strengthen the data collection framework, the monitoring and stress testing of investment funds' liquidity should be integrated into the supervisory framework as recommended by the FSAP.

12. **Rising risks from geoeconomic fragmentation require comprehensive efforts to step up risk monitoring and enhance resilience.** As Hong Kong SAR is at a forefront of rising geoeconomic fragmentation as a financial gateway vis-à-vis Mainland China, it is important that associated financial stability risks are well understood, monitored, and managed. Analysis covering a wide range of scenarios could be useful to help formulate actionable supervisory guidelines and contingency plans.

13. **The LERS remains the appropriate arrangement for Hong Kong SAR as an anchor for macroeconomic and financial stability.** Several factors, including the mechanism's transparency, ample foreign reserves, a prudent fiscal policy framework, robust financial regulation and supervision, and the economy's flexibility, ensure the credibility of LERS.

B. Facilitating Orderly Adjustment of Housing Market

14. **While the housing market corrected in 2022, a further adjustment in the property market could still pose risks to the economy.** On the back of weak economic activity and rising interest rates, residential property prices declined by about 16 percent by end-2022 from the peak in September 2021, before recovering in early 2023. Financial stability risks have been mitigated by existing macroprudential measures, which help limit potential nonperforming loans as well as banks' potential credit losses once defaults materialize. However, a further market adjustment in the face of rising mortgage rates could suppress private consumption through higher debt servicing burden and negative wealth effects.

15. **Increasing housing supply is critical to resolving the structural supply-demand imbalance.** Staff welcomes the new administration's more coordinated approach to boost housing and residential land supply by identifying more land and streamlining statutory and administrative procedures. Fiscal measures could be employed to incentivize a more efficient use of the housing stock.

16. **Housing-related macroprudential measures should be maintained and can be recalibrated in the event housing-related stress materializes.** As the principal objective of these macroprudential measures is to safeguard financial stability, any relaxation of loan-to-value (LTV) and debt service-to-income (DSTI) requirements should be commensurate with the extent that housing-related downside risks (e.g. house price declines and rising interest rates) have materialized.

17. **Stamp duties need to be adjusted if the systemic risks arising from speculative demand dissipates.** Amid the economic normalization and the reopening of the border, the authorities should carefully monitor the systemic risk arising from speculative demand by both residents and non-residents and stand ready to adjust relevant stamp duties. In particular, the Buyer's Stamp Duty and New Residential Stamp Duty, which are assessed to be capital flow management and macroprudential measures (CFM/MPMs) under the IMF's Institutional View on capital flows, could be phased out once systemic risk from non-resident and speculative demands dissipate.

C. Further Enhancing Financial Sector Oversight

18. The mission welcomes the authorities' ongoing efforts to further enhance financial sector oversight and safety net.

- *Systemic risk oversight.* Building on recent efforts to utilize trade repository data and granular bank lending data, which help monitor the leverage of certain non-bank financial institutions (such as securities intermediaries and brokers/dealers) and their connection with banks, the authorities should continue to collect more comprehensive data on cross-sectoral and cross-border exposures to improve systemic risk surveillance.

- *Oversight of the banking sector.* The HKMA's thematic examination of banking groups with both subsidiaries and branches should continue to ensure their proper risk management of concentrated exposures and limit potential opportunities for regulatory arbitrage.

- *Oversight of the insurance sector.* The Insurance Authority should ensure sufficient supervisory resources to implement the group-wide supervision framework and advance work on recovery and resolution planning of systemically important insurers. In addition to the risk-based capital regime, more efforts to enhance systemic risk monitoring are also warranted to ensure insurers' financial soundness, especially in light of rapid increases in interest rates and heightened credit risk.

19. **A comprehensive and risk-based regulatory framework related to virtual assets is critical to safeguard financial stability and ensure investor protection.** The mission welcomes the authorities' efforts to supervise regulated financial institutions' exposures to virtual asset-related activities. Strong and agile regulatory and supervisory frameworks should be put in place to mitigate financial stability risks while allowing market development and fintech innovation.

- As the virtual asset ecosystem continues to evolve, the authorities should stand ready to refine and expand the regulatory regime, guided by the applicable international standards. Adopting a risk-based approach to develop a regulatory regime for stablecoins could help address risks related to macro-financial stability, consumer protection, financial integrity, and fair competition.

- A cross-sectoral approach is important to limit regulatory arbitrage as virtual asset-related activities tend to cut across the sectoral boundaries of traditional financial services. Enhanced monitoring of virtual asset-related activities could help guide the regulatory design and support systemic risk surveillance. Supervisors should continue ensuring that financial institutions adequately manage credit, liquidity and operational risks related to virtual assets.

20. **Climate-related financial risks should continue to be carefully monitored and proactively managed.** The HKMA has incorporated climate related risks into its prudential policy and supervisory framework, while the SFC has set supervisory expectations for asset managers and investment funds. Similar efforts should also be applied to the insurance sector given that the investment of long-term insurance business could be exposed to stranded assets, while physical effects of climate change could significantly affect general insurance business.

Bolstering Long-Term Growth Prospects

21. **The free flow of capital should continue to underpin Hong Kong SAR's competitiveness as an international financial center.** The authorities should continue to preserve the rule of law and the common law system, enhance high-quality financial regulation and supervision, and attract talents to provide world-class financial and other related professional services. Fostering the development of climate finance by further strengthening

the climate information architecture and continuing to strengthen capital market connectivity between Mainland China and the rest of the world (for instance, the planned Swap Connect scheme and Mainland government bond futures) could also help maintain Hong Kong SAR's competitive position.

22. **Deepening Hong Kong SAR's links with regional and global economies will boost its growth potential.** Continued pursuit of deeper trade, investment, and human capital ties with member countries of the Regional Comprehensive Economic Partnership (RCEP) will help solidify the competitiveness as a regional trade hub. The further strengthening of infrastructure and commercial linkages within the Greater Bay Area should remain a priority for authorities.

23. **Promoting innovation and technological development can provide additional growth engines and boost economic resilience amid geoeconomic fragmentation.** A newly launched investment fund set up by the Government can play a constructive role in boosting innovation and should operate with a clear mandate and strict standards for governance, accounting, and public reporting. Along with trading partner diversification, such measures can also help mitigate the risks of geoeconomic fragmentation. Policy efforts to support commercialization of technological development could improve Hong Kong SAR's status as an innovation hub.

24. **Hong Kong SAR should continue to strengthen its competitiveness in attracting human capital.** Supporting the development of innovative new industries and fostering business dynamism, together with additional education and job training focusing on digital-related technologies, would help support the supply of labor needed for the transition to a digitalized and technology-driven economy. Recent enhancements to overseas talent attraction programs are welcome and could be expanded further as needed.

In closing, the mission would like to thank the Hong Kong SAR authorities for their kind hospitality and for the