People's Republic of China—Hong Kong Special Administrative Region: Staff Concluding Statement of the 2024 Article IV Mission

Hong Kong SAR – November 22, 2024

Hong Kong SAR's economy is on a path of gradual but uneven recovery after a protracted period of shocks. With continued economic slack and external and domestic headwinds, policies should be geared toward supporting domestic demand and mitigating risks. The authorities' plan for a more gradual fiscal consolidation path is appropriate as it would help sustain the recovery. At the same time, additional efforts are needed to increase and broaden government revenues in the medium term to counter aging-related spending pressures and finance growth-enhancing investment. Financial sector risks appear manageable given significant buffers and robust regulatory framework, although financial strains in some areas call for enhanced monitoring and oversight. Rapid population aging and increased regional competition in logistics and trade services underscore the need to boost labor supply and productivity and identify new growth drivers to support high quality and sustainable growth. Enhancing resilience against climate change-related risks and advancing the green transition are also critical.

Emerging Challenges Amid a Changing Environment

1. **Hong Kong SAR economy is recovering gradually after a protracted period of setbacks.** The territory's economy endured three years of recession since 2019 due to several shocks. The removal of COVID-related restrictions in early 2023 resulted in a strong rebound in domestic demand and inbound tourism in 2023H1, but the recovery has since faced multiple headwinds, including a high interest rate environment, prolonged adjustment in the property sector, and a challenging environment for small and medium-sized enterprises (SMEs). Notwithstanding these developments, the financial system has remained resilient, supported

by robust institutional frameworks, ample policy buffers, and smooth functioning of the Linked Exchange Rate System (LERS).

2. Emerging near- and longer-term challenges also require close attention. As Hong Kong SAR's economic and financial integration with Mainland China increased further, it has become more exposed to Mainland-specific risks, including from the housing market downturn and rising geoeconomic fragmentation. Traditional growth drivers like logistics and trade are under pressure from competition in the region while the city's rapid aging and slowing labor force growth also pose challenges. Recognizing these challenges, the authorities are developing new sources of growth, including by promoting the Greater Bay Area (GBA) initiative, increasing investment, and attracting foreign talent and businesses in high-value industries.

3. Real GDP growth is projected to gradually moderate over the forecast horizon. In 2024, growth is projected to decelerate to 2.7 from 3.3 percent in 2023, as post-reopening momentum has further waned, and the high interest rate environment and strong Hong Kong dollar continue to weigh on domestic activity. In 2025, growth is projected to remain unchanged at 2.7 percent as the pickup of domestic demand, supported by the gradual monetary policy easing in the U.S., is expected to be offset by weakening external demand, including from Mainland China. Over the medium-term, growth is expected to slow modestly and converge to a potential rate of about 2½ percent in 2029, reflecting rapid population aging and slower capital accumulation. Inflation is projected to gradually increase and stabilize at 2.5 percent as economic slack narrows and the drag from lower import prices, particularly from Mainland China, dissipates.

4. The outlook is subject to high uncertainty with risks to growth tilted to the downside.

- *Downside risks*. A sharper-than expected slowdown in Mainland China, due to escalation of trade tensions or a deeper and more protracted adjustment in the property market, would further weaken confidence and adversely affect domestic activity through financial and trade channels. Slowing growth in major economies would weaken external demand for Hong Kong SAR's services and goods, while a longer-than-expected period of tight monetary policy in the U.S. would result in more prolonged tight domestic financial conditions, constraining domestic demand and exerting further downward pressure on the local property market. Increasing geopolitical fragmentation pressures and competition among regional hubs could weigh on the economy. Systemic global financial instability could trigger market dislocations, with cross-border spillovers and adverse macro-financial feedback loops affecting banks and nonbank financial institutions (NBFIs).

- *Upside risks*. A meaningful improvement of consumer and business confidence in Mainland China would support external demand and increase foreign investment. Further improvement in market access to Mainland China, deeper integration with GBA, and increased investment in high value industries could support stronger growth. Sustained inflows of skilled workers would support productivity and innovation and help offset demographic headwinds, thereby raising potential growth.

Fostering a Resilient Recovery and Addressing Aging-Related Spending Pressures

5. **With continued weak domestic demand, the authorities' gradual medium term fiscal consolidation path is appropriate.** IMF staff project the fiscal deficit before debt issuance and repayment to stand at 5.2 percent of GDP in FY2024/25, narrowing by less than initial budget estimates mainly due to continued weakness in property-related revenues. Fiscal space is expected to remain sizable, with fiscal reserves—although declining—standing at an ample level of about 21 percent of GDP at end FY2024/25. Going forward, the fiscal deficit is projected to narrow further, albeit at a slower pace than previously anticipated, supported by new revenue measures, efforts to contain expenditure, and the winding down of pandemic-related support. This path, which delays the return to a balanced budget (before bond issuance and repayment) by two years to FY2027/2028, is appropriate given the economic slack and the need to further strengthen the adequacy of the social safety nets.

6. **Increased revenue mobilization is needed to tackle the mounting aging-related spending pressures and support important spending priorities.**

- As spending on social welfare and healthcare is expected to further increase in the coming years, attaining the authorities' plan of closing the deficit (before bond issuance and repayment) by 2027 without introducing additional fiscal measures will likely require scaling back planned infrastructure spending. Over the longer term, these spending pressures are expected to bring the budget back into deficit under the current fiscal settings, implying that the attainment of the authorities' balanced budget target will likely be challenging.
- A larger and more stable revenue base would help to address aging related pressures, fund the needed improvements to social safety nets, and serve as a sustainable foundation for spending on critical structural initiatives needed to lift potential growth. In this regard, steps are needed to boost tax revenue while protecting the most vulnerable. Such steps could include increasing the progressivity of personal income taxes with higher rates for top earners . Increases in excise taxes and introduction of VAT and taxes on capital gains and dividends could provide additional revenues.

Safeguarding Financial Stability and Strengthening Oversight

7. **Risks to banking sector stability appear manageable despite the ongoing property market adjustments.** Locally incorporated banks are well capitalized and liquid, and their profitability is strong, albeit with increases in non-performing loans and impaired credit and loss provisions from low levels. Domestic mortgage delinquencies remain low despite the decline in real estate prices and rising share of residential mortgage borrowers with negative equity. Impairments on commercial property exposures have risen but risks are mitigated by their relatively low leverage and low loan-to-value ratios. Household credit quality is supported by low unemployment and the sector's high net worth.

8. Continued proactive efforts are warranted to ensure effective monitoring and management of deteriorating debt repayment capacity in the nonfinancial corporate sector. As local firms, particularly real estate developers and small businesses, have seen weakening debt servicing capacity and rising liquidity risk, the authorities should remain vigilant and continue to use the full range of supervisory tools to ensure that banks apply prudent risk management, including in expected credit loss recognition and provisioning. Policy support to SMEs, which have faced more challenges in access to finance, should be well-calibrated to strike a proper balance between providing necessary support and facilitating an orderly exit of non-viable firms. For Mainland exposures, continued strengthening of the risk surveillance framework with a focus on Mainland's counterparties' vulnerabilities to interconnectedness and macro-financial risks would be important.

9. The HKMA's decision to introduce a positive-neutral Counter-Cyclical Capital Buffers (CCyB) rate is welcome. A positive-neutral CCyB rate will increase the banking sector's capacity to support lending to the real economy when system-wide risks materialize. More recently, recognizing the challenging business environment for SMEs, the HKMA reduced the CCyB rate from 1 percent to 0.5 percent as part of a multi prong support package for this sector. Going forward, further releases of capital buffers should be reserved for periods of broad-based financial stress.

10. Risks in NBFIs merit continued close monitoring. Private credit funds and other types of risky nonbank financial intermediation have grown in Hong Kong SAR, although their activity appears relatively small compared to other jurisdictions. The authorities should continue to prioritize systemic risk assessments for NBFIs and high-risk activities, augmented with enhanced data collection and NBFIs stress testing, both at system-wide and sector specific levels.

11. The LERS remains the appropriate arrangement for Hong Kong SAR given its highly open economy and large and globally integrated financial services industry. The territory's robust policy and institutional setup, including a transparent mechanism, ample fiscal and foreign reserves, strong regulatory and supervisory frameworks, and a healthy financial system have supported a smooth functioning of the currency board and ensured macroeconomic and financial stability amid bouts of global financial volatility.

Ensuring an Orderly Adjustment in the Property Market

12. The relaxation of housing measures is warranted amid declining risks, but a cautious approach is needed for further policy easing. Staff's analysis suggests that the decline in house prices has been largely driven by increased supply, and to a lesser extent by high interest rates. As the risks of a sharp and disorderly house price correction and speculative demand have eased, the recent abolition of demand-side management measures and relaxation of macroprudential policies were warranted. Further macroprudential policy easing should be carefully designed to maintain prudent underwriting standards and avoid encouraging excessive risk-taking.

13. For public housing, where demand remains high, boosting production and strictly enforcing eligibility criteria can help address affordability pressures. Despite the recent decline in house prices, Hong Kong SAR's housing market continues to rank among the world's most unaffordable, contributing to socio-economic inequality and undermining the economy's competitiveness. Additional streamlining of statutory and administrative procedures for freeing up land and reducing development costs will help to further expedite public housing production and thus mitigate housing affordability pressures. Continued reviews of eligibility for social housing, coupled with strict enforcement and measures to combat tenancy abuse, could further alleviate social pressures.

Reinforcing Hong Kong's Role as an International Financial Center

14. Continued efforts to create a vibrant but well-regulated digital finance ecosystem would safeguard the territory's status as an international financial hub. The authorities have continued to stay in the forefront of experimenting with different forms of digital money. They have stepped up regulation for the fast-evolving intermediation of crypto assets, and are preparing legislation for the regulation of stablecoin issuers and over-the counter trading of virtual assets. Going forward, these efforts should be part of a comprehensive regulatory strategy for crypto assets that includes a risk-based approach for stablecoin issuers to address risks related to macro-financial stability, financial integrity, and regulatory arbitrage; close cross-sectoral monitoring to enhance oversight and systemic risk surveillance; and continued supervisory efforts to ensure financial institutions appropriately manage risks related to crypto assets. As the digital finance ecosystem grows in complexity and scale, these initiatives should be paired with continued efforts to enhance resilience against digital and cyber threats.

15. Advancing the development of a sustainable finance hub could enhance Hong Kong SAR's competitive position. The authorities have made significant strides in developing a dynamic green and sustainable finance landscape, including the recent publication of the Sustainable Finance Taxonomy, which provides a standardized framework for classifying and labeling financial products and investments, alongside the launch of the Sustainable Finance Action Agenda that encourages banks to enhance transparency on climate-related risks and reach net-zero financed emissions by 2050. Further strengthening the climate information infrastructure in line with international frameworks and standards—as the authorities plan to do by adopting the IFRS Sustainability Disclosure Standards—would enhance market transparency and support Hong Kong SAR's efforts to position itself as a leading global hub for mobilizing private sector capital for green and sustainable investments.

16. Ensuring that climate risks are thoroughly integrated into financial institutions' risk management practices will help to support systemic risk surveillance efforts. In recent years, HKMA has put in efforts to enhance banks' capabilities for managing climate risks and incorporated climate risk management into its supervisory framework while the Securities and Futures Commission has set out supervisory expectations for asset managers to incorporate climate risk considerations into their investment strategies and decision-making processes. Going forward, continued efforts to monitor climate-related physical and transition risks, integrate them into systemic risk analysis, and track financial institutions' progress in managing these risks and in transitioning towards carbon neutrality should be a priority.

Ensuring high-quality and sustainable growth

17. Boosting the supply and quality of labor will help to ease aging-related pressures and lift medium-term growth prospects. Efforts to attract skilled labor are helpful and should be continuously monitored to ensure the talent attraction programs meet their objectives. At the same time, steps are needed to raise labor force participation, particularly among older adults and women. These could include measures to encourage retention of older workers, increase the flexibility of work arrangements, expand programs to reskill and upskill workers, and provide more affordable childcare.

18. The GBA initiative has the potential to lift growth prospects and address challenges from increased regional competition. Greater integration could bring significant economic opportunities, including by creating a new global technology cluster that will benefit from economies of scale, and attracting young migrants to new activities in the area. A critical policy priority is to mobilize private sector-led R&D, which will leverage on the territory's key strengths in finance, its well-regarded and established academic institutions, and pro-market legal framework. Ensuring that business environment remains conducive to private investment would support Hong Kong SAR's competitiveness and limit potential adverse side effects that could accompany the integration, including displacement of some activities.

19. While authorities have been proactive in addressing climate risks, more can be done to address climate change's long-term challenge to Hong Kong's economy. To mitigate the risk of falling short of the authorities' emissions reduction targets, more proactive measures are needed, including by prioritizing regional collaboration with Mainland China to develop renewable energy, and improving energy efficiency in many aging and poorly maintained buildings. Incentivizing energy saving and green transportation with additional forms of carbon pricing mechanisms, such as a mileage-based vehicle taxation scheme, can also be considered. Finally, continued efforts to bolster infrastructure and enhance resilience against climate-related risks are also important.

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