INTERNATIONAL MONETARY FUND

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PEOPLE'S REPUBLIC OF CHINA—HONG KONG SPECIAL ADMINISTRATIVE REGION

January 2018

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; STATEMENT BY THE EXECUTIVE DIRECTOR FOR PEOPLE'S REPUBLIC OF CHINA–HONG KONG SPECIAL ADMINISTRATIVE REGION

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with the People's Republic of China—Hong Kong Special Administrative Region, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its January 10, 2018 consideration of the staff report that concluded the Article IV consultation with People's Republic of China–Hong Kong Special Administrative Region.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 10, 2018. It is based on information available at the time it was completed on November 3, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for the People's Republic of China–Hong Kong Special Administrative Region.

The document listed below has been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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January 22, 2018

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700 19th Street, NW
Washington, D. C. 20431 USA

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 discussions[1] 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 opportunities as a global financial center, including supporting fintech business development through various initiatives.

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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.

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 Assessment[2]

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.

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

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[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.

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	2017	2018	2019	2020	2021	2022
						Proj.					
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$1, 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

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA—HONG KONG SPECIAL ADMINISTRATIVE REGION

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION DISCUSSIONS

December 19, 2017

KEY ISSUES

- **Outlook and Risks.** Growth bottomed out and economic activity has gathered momentum since the second half of 2016 and over the course of 2017, in line with the global economic recovery. The macroeconomic outlook has improved and a robust recovery is expected to continue. Nevertheless, the outlook faces multiple challenges, both external and domestic, including from tighter global financial conditions, possible bumps in Mainland China's ongoing transition, a retreat from cross-border integration, a potential adjustment following the current housing boom, as well as long-term challenges from rapid population aging.

- **Policies.** The economy should be able to navigate through these challenges with policies to further build buffers and use them effectively, if needed, to secure sustainable growth over the medium term. The recommended policy strategy includes:

  - **Fiscal.** In the near term, greater countercyclicality would help cushion the economy against shocks. Over the medium to long term, in view of demographic pressures and the need to increase aging-related spending, tax reform should be considered to boost revenues while maintaining competitiveness and flexibility.

  - **Property market**. The three-pronged approach—boosting housing supply, macroprudential measures and stamp duties on transactions to maintain financial stability—should continue, with further adjustments in response to evolving financial stability risks;

  - **Exchange rate regime**. The Linked Exchange Rate System should be maintained, together with flexible markets and ample buffers, as an anchor of expectations and the cornerstone of economic and financial stability;

  - **Financial sector**. The robust regulatory and supervisory framework should be further strengthened to limit the build-up of systemic vulnerabilities, while carefully balancing between efficiency and stability in the face of rapid advances in digital technology which are transforming the financial services landscape; and

  - **Inclusive growth.** Continued attention is needed to address high inequality and prepare for aging to ensure sustainable and inclusive growth.

Approved By
Markus Rodlauer and Petya Koeva Brooks

Discussions took place in Hong Kong SAR during October 23 – November 3, 2017. The team comprised Sonali Jain-Chandra (head), Joong Shik Kang, Rui Mano (all APD), Pau Rabanal (RES), and Sally Chen (Resident Representative). The mission met Financial Secretary Paul Chan, HKMA Chief Executive Norman Chan, and other senior officials. Zhongxia Jin, Sun Ping, and Raymond Yuen (OED) joined the official meetings. Ananya Shukla, Gabriel Alvim (all APD), Daisy Wong (COM), Atis Lee, and Daniel Law (Resident Representative Office) provided support to the mission.

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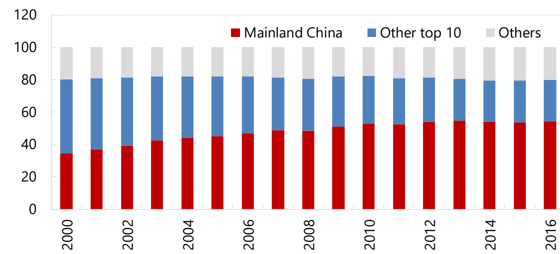
APPENDICES

CONTEXT: OPPORTUNITIES AND CHALLENGES

1. **Hong Kong SAR—a highly open economy with a globally integrated financial services sector—has successfully navigated challenging global tides over the last decade.** Economic growth remained robust after the global financial crisis, benefitting from ultra-low global interest rates and strong growth in Mainland China. Growth has been supported by Hong Kong SAR's role as a trading and financial gateway between Mainland China and the rest of the world. However, amid low interest rates, housing prices more than tripled over the past decade as rising demand outpaced supply despite a series of government measures, leading to deteriorating housing affordability and contributing to rising social tensions. Also, while income inequality has narrowed slightly, it remains high. The new government assumed office in July 2017, on the 20th anniversary of the handover, amid public concerns regarding income inequality and high and rising housing costs, both of which are at the center of the new administration's agenda.

Merchandise Exports
(In percent of total)



Sources: Haver analytics; and IMF staff estimates

2. **Going forward, the economy faces both opportunities and challenges**. The global economic recovery is on track, Mainland China's growth is projected to remain robust and its Belt and Road Initiative (BRI), which aims to foster global and regional cooperation in infrastructure, trade and finance, and plans for the development of the Guangdong-Hong Kong SAR-Macao SAR Bay Area create opportunities for Hong Kong SAR given its unique position as a gateway to Mainland China and a global financial center. At the same time, challenges could stem from tightening global financial conditions amid rising U.S. rates, bumps in Mainland China's transition to a more sustainable growth, retreat from cross-border integration, and the risk of a disorderly domestic property market adjustment. In a longer-term perspective, high income inequality, rising social discontent and an aging population could weigh on Hong Kong SAR's prospects. Strong policy frameworks and ample buffers are in place, but they need to be further strengthened to maximize benefits from tailwinds while managing risks from those headwinds.

RECENT DEVELOPMENTS AND OUTLOOK: SOLID RECOVERY ON TRACK

3. **The economy bottomed out in mid-2016 and momentum accelerated in 2017 amid the global recovery, robust Mainland China growth, booming housing prices, and rebounding credit growth.**

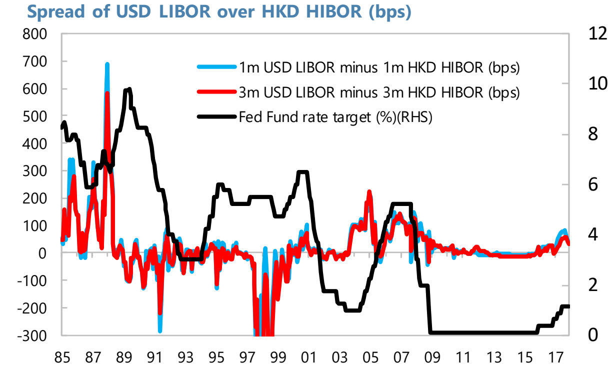
- **Activity**. Economic activity has gained momentum after bottoming out in the second half of 2016, with GDP growth rising to 0.9 percent (q/q sa) on average for 2016Q3-2017Q3 from 0.5 percent (q/q sa) for 2015Q1-2016Q2. Private consumption remained robust and contributed 1.0 percentage point to growth in 2016Q3-2017Q3; the labor market remained tight, with the 3-

month average unemployment rate edging further down to 3.0 percent in November. Strong construction activity on the resumption of planned public investment projects and ongoing housing supply projects contributed to a strong recovery of investment. External demand picked up in line with the global trade recovery, and tourist arrivals have rebounded since late 2016 driven by Mainland Chinese visitors. The composite PMI for November remained in expansionary territory, suggesting continued momentum in 2017Q4.

- **Inflation and output gap.** Inflation remained contained at below 2 percent. The output gap turned modestly positive in 2017Q3 (0.2 percent) with the rebound in economic activity.

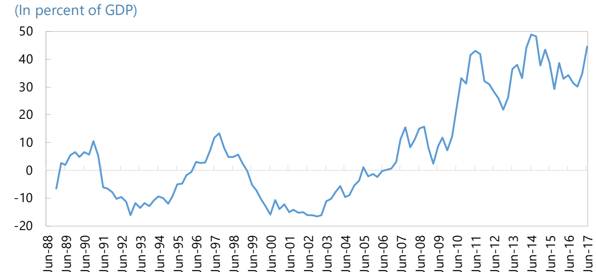
- **Financial conditions.** Overall financial conditions remain accommodative. Despite increasing policy rates amid rising US rates, average funding costs have remained low and stable. Notwithstanding modest increases in interest rates, asset prices witnessed robust gains, while liquidity remained abundant. As ample liquidity kept HKD Hibor rates low, its spread against USD Libor widened and the HK dollar depreciated vis-à-vis the US dollar in 2017H1. Since then, the HKD-USD interest rate spread has narrowed and the HK dollar remains around the mid-point of the Convertibility Undertaking range. The Hang Seng Index rose 53 percent from February 2016 through November 2017. Credit growth also picked up to around 21 percent (y/y) in October 2017, after slowing to near zero in mid-2016, as domestic loans rose in line with the growth recovery; loans for use outside Hong Kong SAR also rebounded reflecting a rise in funding demand by multinational corporations. Accordingly, the credit-to-GDP gap—a measure of the deviation of actual credit-to-GDP ratio from its historical trend, developed by the Bank for International Settlements—widened and remained high at 45 percent of GDP in 2017Q2.

Spread of USD LIBOR over HKD HIBOR (bps)



Note: The spreads are calculated as the USD LIBOR minus HKD HIBOR. The data of USD LIBOR is not available before 1986 and is proxied by Eurodollar deposit rate at London.
Source: CEIC.

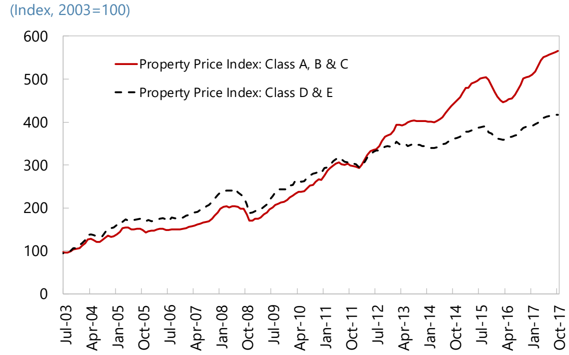
Credit-to-GDP gap
(In percent of GDP)



Source: Bank for International Settlements.

- **Property sector**. After a fall of 9.2 percent in late 2015 and early 2016 (in seasonally adjusted terms), housing prices resumed rising since 2016Q2 amid expectations of a slower pace of U.S. rate hikes. Notwithstanding the tightening of macroprudential measures, residential property prices rose by 24 percent between March 2016 and June 2017. Early signs of stabilization in housing prices are emerging as growth moderated to 12.8 percent (y/y) in October, from 21.6 percent in June. Residential property transactions volume declined by about 24.7 percent (y/y) in the period from

Property Prices
(Index, 2003=100)



Source: CEIC Data Co. Ltd.

July to October. The household debt-to-GDP ratio increased driven by ample liquidity, low interest rates, and the rise in house prices.

- **External position.** There has been an overall improvement in external conditions in 2017. Trade remained strong, after rebounding in mid-2016, in line with global trade. The current account surplus stood at 2.7 percent of GDP in 2017H1, similar to the same period in 2016. Capital inflows resumed in 2017H1 after the largest net outflows since the GFC in 2016, reflecting an improved Mainland China outlook and expectations of slower monetary tightening in the U.S. The REER, following the U.S. dollar, depreciated by 1.4 percent through November after appreciating by 5 percent in 2016.
- **Fiscal.** The overall fiscal surplus rose to 4.5 percent of GDP in FY2016/17, much larger than the post-GFC average of 2.5 percent and the budgeted surplus of 0.5 percent. Buoyant property markets contributed to the large fiscal surplus, with stamp duties and the land premium accounting for two-thirds of the overperformance, while the remaining was due to delayed infrastructure projects.

4. **Strong growth momentum is expected to continue in the near term.** Growth picked up strongly in 2017, amid robust domestic demand and recovering external demand. It is expected to moderate somewhat in 2017Q4 and over the course of 2018, though remain robust (with average growth rate of ¾ percent (q/q)). Annual growth is projected to rise to 3.7 percent in 2017 and remain strong at 2.8 percent in 2018, up from 2 percent in 2016. Underlying assumptions for the baseline projections are:

- Global economic recovery continues and Mainland China's growth remains robust at about 6½ percent in the near term.
- Global trade picks up with global growth, but the pace is still below pre-GFC rates.
- Interest rates rise in line with a gradual U.S. rate tightening cycle.
- A supportive fiscal stance, excluding one-off revenue gains from higher-than-projected property prices.
- Credit growth remains strong in 2017, and then moderates in 2018 due to tighter macroprudential measures and higher borrowing costs.
- Private consumption continues to be supported by a tight labor market, while investment remains strong, with major infrastructure and housing projects in the pipeline.

5. **The gradual recovery will keep output close to potential over the medium term.** Hong Kong SAR's overall business cycle is still more in sync with the U.S. business cycle but Mainland China's influence has increased. Under the baseline scenario with a gradual recovery of the global economy and orderly monetary tightening in the U.S., Hong Kong SAR is projected to continue to grow over the medium term at about 3 percent, its medium-term potential growth, as the drag from aging is partly offset by a smooth transition of Mainland China to a sustainable growth path.

Authorities' View

6. Outlook. The authorities generally agreed with the mission's assessment that Hong Kong SAR's economy should maintain solid growth in the near term, considering the improvement in the balance of risks. The authorities also noted that growth in the Mainland Chinese economy should continue to remain on its medium-high growth track going forward, with continued supply-side structural reforms and policies to contain systemic financial risks. With Mainland China continuing to be a growth engine of the world, they expected that Hong Kong SAR would benefit from increasing ties with the Mainland, given its gateway position. They expected that the BRI and the Bay Area development would also bring large opportunities.

RISKS: CLOUDS ON THE HORIZON

7. The balance of risks has improved since last year. The implementation of fiscal stimulus in the U.S. as well as a stronger recovery in the euro area could drive stronger global growth. Faster-than-anticipated implementation of reforms in Mainland China could further improve Hong Kong SAR's medium-term growth outlook. The BRI could also boost prospects for regional economies, including Hong Kong SAR, as associated projects aim to facilitate greater integration and generate positive spillovers.

8. However, overall risks are still tilted to the downside and arise from both external and domestic sources (Appendix I). Risks from external sources include tighter-than-expected global financial conditions, bumps in Mainland China's transition including a sharp growth slowdown, and policy uncertainty in and increased inward-looking policies by major economies (retreat from cross-border integration). A potential disorderly adjustment following the ongoing housing boom in Hong Kong SAR is the main domestic downside risk.

A. Sharp Property Price Correction

9. Despite a series of government measures, property prices continue to rise amid the demand-supply imbalance. Staff analysis, based on various models, suggests that property prices were overvalued by about 25-35 percent as of 2017Q3.[1] Affordability has deteriorated as the housing price-to-income ratio has doubled since the GFC. Tighter financial conditions could lead to a slowdown in property price growth, as demand softens in response to higher borrowing costs, or even to a large correction if market sentiment deteriorates due to increased uncertainty.

10. A housing market correction could have a significant impact on private consumption and financial stability through a higher debt servicing burden and negative wealth effects. The sensitivity of households' debt service burden to interest rate changes remains high as a significant

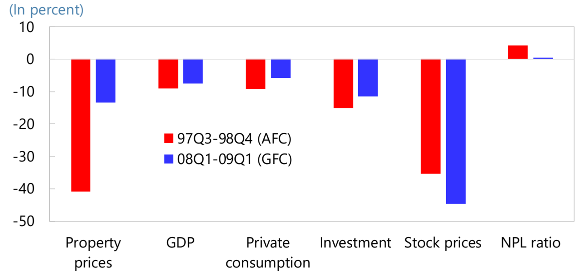
[1] Staff used four different models to assess the degree of overvaluation: (i) deviations from the historical price/income ratio, (ii) deviations from the historical price/rent ratio, (iii) deviations from the Hodrick-Prescott filter trend with a large smoothing parameter (lambda=400,000), and (iv) deviations from an error-correction model that includes house prices, credit, GDP and interest rates.

portion of new mortgages are at floating rates and indexed to the Hibor. Analysis by the Hong Kong Monetary Authority (HKMA) indicates that households' debt-servicing burden will increase significantly if interest rates were to rise by 3 percentage points.[2] Staff analysis suggests a potential asset price correction (housing and equities) by cumulative 35 percent could reduce private consumption, with overall growth falling by more than 2 percentage points. Experiences during previous episodes of housing price adjustment indicate that a sharp adjustment in the property market could lead to a significant slowdown in economic activity. Furthermore, amid increasing household debt, a disorderly housing price correction could trigger an adverse feedback loop between house prices, debt service ability, and lower consumption, with weakening growth leading to second-round effects on banks' balance sheets. A large and disorderly housing market correction (such as the one experienced during the Asian Financial Crisis) would erode collateral values in banks' balance sheets and pose systemic risks in the banking sector. Further, the presence of global systemically important financial institutions in Hong Kong SAR which are actively engaged in real estate lending poses additional risks to the financial system. These risks become more pressing the larger the deviation of house prices from fundamentals.

Indicators of Housing Affordability
(In percent of household income, LHS; In number of years, RHS)

Sources: R&VD; HKSAR Census and Statistics Department; and HKMA staff estimates.

Cumulative Impact of Housing Market Adjustment
(In percent)



Sources: Haver analytics; and IMF staff estimates.

B. Global Financial Conditions

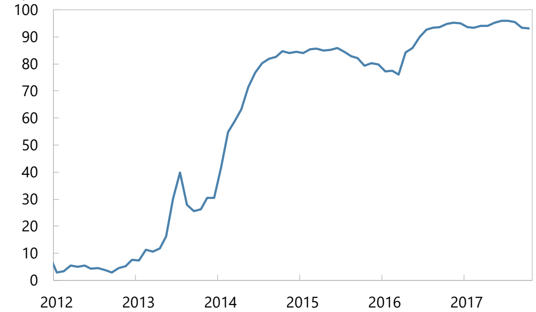
11. Financial conditions could tighten more than expected if volatility jumps as a result of monetary policy surprises in the U.S. or the Euro Area. A disorderly response to Fed normalization and tapering of the ECB balance sheet expansion could lead to higher global rates and term premia, stronger U.S. dollar and euro vis-à-vis other currencies, and a correction in market valuations. Given its highly globally-integrated financial sector, these developments could spillover rapidly to Hong Kong SAR, weighing on growth and creating financial stress.

12. Unanticipated tightening in financial conditions would weigh on domestic demand. Private sector credit increased by more than 100 percentage points of GDP since the GFC, exceeding 300 percent of GDP in 2016, leading to increased vulnerability to higher rates.

[2] The debt-service index of new mortgages (1998Q2=100), which rose to about 50 in 2017Q2, would further rise to close to 70 in a four-quarter period (beyond the level last seen in 2007).

- **Households**. Amid the decade-long property market boom, household debt has increased steadily from about 50 percent of GDP in 2007 to 67 percent in 2016. The share of new mortgages on floating rates with reference to Hibor increased sharply, from 3 percent in September 2012 to 93 percent in October 2017, reflecting a protracted period of low interest rates. Sharply rising interest rates are estimated to increase households' debt service payments (by an estimated 5 percent of their income for a 1 percent increase in interest rates), and dampen private consumption. Staff analysis suggests that household consumption would slow by about 7-8 percent if mortgage rates rise by 300 basis points. In addition, elevated household debt could pose a macro-financial risk if interest rates increase or income growth slows down, which could trigger an adverse feedback loop between house prices, mortgage debt service ability, and banking sector balance sheets.

Proportion of New Mortgage Loans Priced with Reference to HIBOR
(In percent)

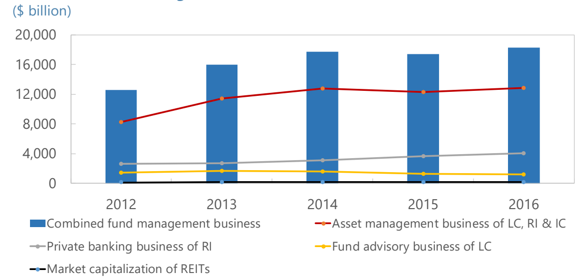


Source: Haver Analytics.

- **Corporates**. Leverage of nonfinancial corporates has also been rising, with corporate debt increasing to about 235 percent of GDP in 2016, from about 130 percent in 2007. Hence, rising refinancing costs, as well as U.S. dollar appreciation, could weigh on private investment. Staff analysis suggests that the direct effect of a 300 basis points increase in interest rates would reduce corporate investment by ½-1 percent. The overall slowdown in domestic demand could be larger as it would impair asset quality and hurt banking sector profitability.

- **Capital flows**. Risks from increased financial volatility and resulting capital outflows are particularly high in Hong Kong SAR due to the presence of globally active banks, the prominence of foreign currency loans (about 41 percent of total credit in October 2017), and the rapid expansion of the asset management industry. Funding strains at the bank group level could restrain the ability of local branches or locally-incorporated banks to expand domestic credit. As multinational firms have increased leverage during the period of low interest rates and used Hong Kong SAR as a financing platform, about a third of total credit is for external use, rendering banks vulnerable to currency mismatches (i.e., U.S. dollar loans to emerging market economies). Also, the asset management industry has grown rapidly, with total asset under management reaching HK$18.3 trillion in 2016 (about 90 percent of bank assets) with overseas investors accounting for two-thirds of funding, increasing the sensitivity to capital flow reversals.

Combined Fund Management Business
($ billion)



Sources: Hong Kong SAR Securities and Futures Commission

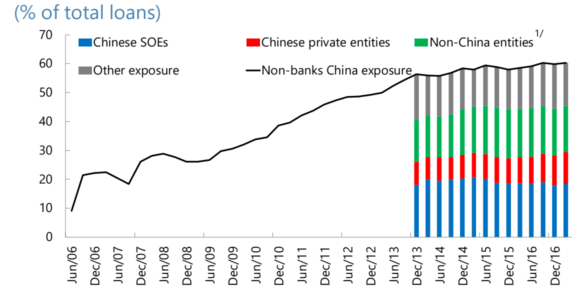
C. Mainland China's Transition

13. The impact of a possible disorderly adjustment in Mainland China would be significant due to increasing integration through various channels. Hong Kong SAR has benefited from robust growth in Mainland China through strong real sector linkages (trade and tourism) as well as deepening financial linkages (cross-border bank lending, investment flows, RMB internationalization). However, a disorderly adjustment in Mainland China's financial markets could unexpectedly expose underlying financial vulnerabilities, leading to a knock-on effect on growth. Over the medium term, high growth targets based on unsustainable policies in Mainland China could lead to increasing risks of a disorderly adjustment. Hong Kong SAR is vulnerable to a bumpy transition of Mainland China's economy through the following channels:

- **Trade and tourism**. Hong Kong SAR is a key trading gateway between Mainland China and the rest of the world. Mainland China is the destination for more than a half of its merchandise exports and more than three-quarters of its merchandise exports to other countries are originally from the Mainland. Similarly, three-quarters of tourists are from Mainland China, estimated to account for about 39 percent of retail sales. A sharp slowdown in Mainland China would hit the tourism, trading and logistics industries, which account for more than a quarter of GDP and employment in Hong Kong SAR.

- **Banking system exposure.** With slowing growth in Mainland China and expectations for RMB depreciation, the Hong Kong SAR banking system's exposure to Mainland China fell between 2015H1 and 2016Q1. Since mid-2016, this exposure has increased, amid strengthening growth and abating RMB depreciation pressures. As of 2017Q2, gross claims on onshore Chinese banks amounted to HK$2.1 trillion (about 80 percent of GDP) and total exposure to Mainland non-banks was HK$5.3 trillion (about 206 percent of GDP). Asset quality of exposures to nonbank Mainland corporates (NPL ratio of 0.8 percent as of 2017Q2) has remained broadly in line with overall asset quality in the Hong Kong SAR banking system (0.8 percent), and better than that of onshore Chinese banks (1.7 percent). Compared to all non-financial A share firms, staff analysis also suggests that Hong Kong SAR-based banks have a lower exposure to riskier Mainland corporates. The overall debt-at-risk ratio fell to 4.8 percent of their Mainland China corporate loan book in 2017Q2, from 8 percent in 2016Q1 amid rebounding Mainland Chinese firms' profits. While risks are manageable, high and rising concentration in real estate and construction loans, which amounts to about 30 percent of total loans for use in Mainland China, remains a concern (Box 1).

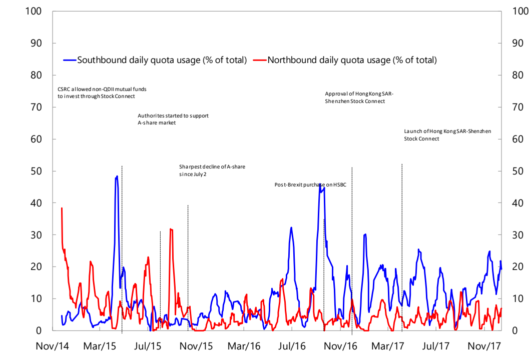
Hong Kong SAR banks: Non-bank China exposure by borrower type
(% of total loans)



Note: The breakdown is only available from 2013Q4. 1/ Loans used onshore, thus exposed to Mainland China's economic cycle.
Source: HKMA, CEIC; staff calculations.

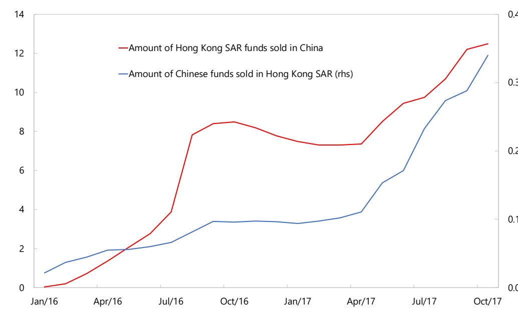
- **Capital flows.** In addition to existing channels for two-way investment flows between Hong Kong SAR and Mainland China,[3] new channels have been opened in recent years: Hong Kong SAR-Shanghai Stock Connect Scheme (November 2014), Mutual Recognition of Funds (July 2015), Hong Kong SAR-Shenzhen Stock Connect Scheme (December 2016), and Bond Connect (July 2017). Stock Connect Schemes allow individuals and institutions to trade stocks in the other market while Mutual Recognition of Funds permits mutual funds in either location to mobilize investments from the other jurisdiction. The recently-launched Bond Connect allows international investors to access Mainland China's bond market from Hong Kong SAR. Aggregate flows through these channels are still limited and small compared to the market sizes in Hong Kong SAR and Mainland China. Daily flows through the Stock Connects are less than 20 percent of the daily quota on most days, and the cumulative sales of mutual fund recognition in both Hong Kong SAR and Mainland markets amounted to around RMB 12 billion in September 2017 compared to the quota of RMB 300 billion each way. While these programs facilitate greater trading volumes and enhance market liquidity in both markets, they create new spillover channels for volatility and financial stress. Staff analysis shows that financial spillovers from Mainland China to Hong Kong SAR have increased in recent years with higher correlation of returns and volatilities for various assets, particularly equities.

Stock Connect daily quota usage (7 day moving average) 1/



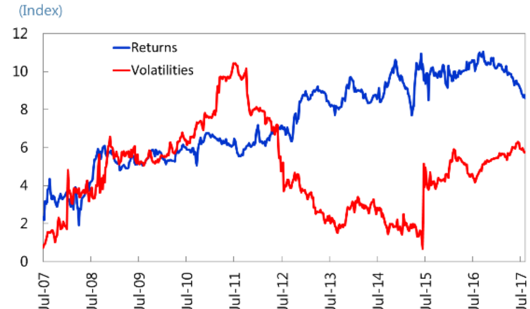
1/ The usage is the average for Shanghai and Shenzhen trading links. The quota of Southbound and Northbound of each link is RMB10.5 bn and RMB13bn respectively.
The aggregate quota was abolished in August 2016.
Source: Shanghai stock exchange, Shenzhen stock exchange; CEIC.

Sales amount of mutual recognition of funds
(RMB bn)



The investment quota is set at RMB300 billion for fund flows between Mainland China and Hong Kong SAR each way.
Source: SAFE, CEIC.

Gross Equity Spillovers: Mainland China to Hong Kong SAR
(Index)



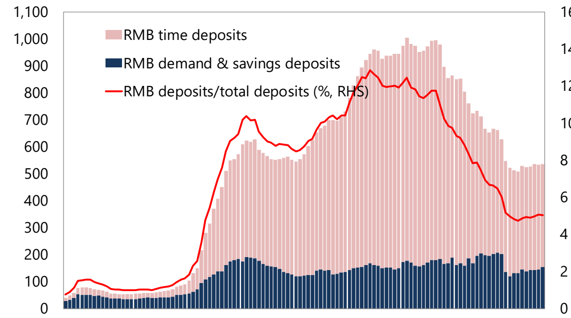
Sources: Haver Analytics and IMF staff calculations

- **Offshore RMB business.** The international appeal and use of the RMB has grown since 2010 and Hong Kong SAR became the largest offshore RMB center and a net provider of liquidity to other markets. However, offshore RMB activity contracted since 2015 amid expectations for RMB

[3] These include the following schemes: China Interbank Bond Market direct access, Qualified Foreign Institutional Investor, Renminbi Qualified Foreign Institutional Investor, Qualified Domestic Institutional Investor and the Renminbi Qualified Domestic Institutional Investor schemes.

depreciation and volatile funding conditions in the offshore CNH market. RMB deposits had declined by 48 percent from their peak in December 2014 through May 2017 and RMB bond issuance also declined sharply. Occasional spikes in the CNH-Hibor rates, combined with reduced liquidity, had discouraged active participation in the offshore market. Since 2017Q2, RMB deposits have stabilized with strengthening growth in Mainland China and much-reduced RMB depreciation expectations. Over the medium to long term, this market is expected to continue to grow with ongoing RMB internationalization and opening-up of Mainland China's capital account.

Renminbi Deposits in Hong Kong SAR
(In billions of RMB)

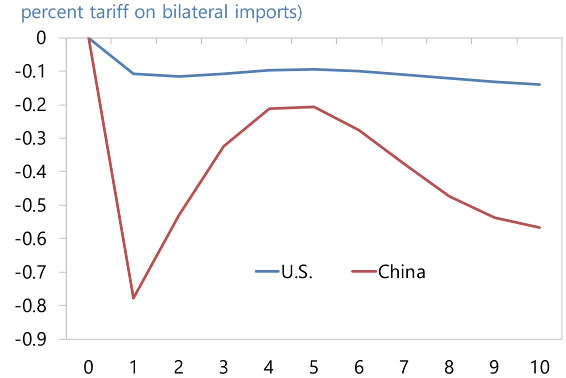


Sources: Haver analytics; and IMF staff estimates.

D. Retreat from Cross-Border Integration

14. Hong Kong SAR is particularly vulnerable to a retreat from cross-border integration given its very high trade openness. The risk of a shift toward inward-looking policies, including protectionism, is rising in many advanced economies. Such policy shifts would reduce cross-border flows of trade, investment, and labor, which could dampen productivity and global growth. The near-term economic impact could vary substantially depending on the exact nature of the measures. An illustrative simulation in the IMF's Global Integrated Monetary and Fiscal Model suggests that if the U.S. were to impose a 10-percent tariff on Mainland Chinese exports and Mainland China retaliated with similar tariffs, real GDP in Mainland China and U.S. would fall by about 0.8 and 0.1 percentage points in the first year, respectively. Hong Kong SAR would be negatively affected due to strong bilateral trade dependence on Mainland China and still-high degree of synchronicity with the U.S. business cycle.

Tariff Retaliation between U.S. and Mainland China
(In percent difference from baseline: impact on real GDP of 10 percent tariff on bilateral imports)



Sources: IMF staff estimates.

15. Uncertainty associated with negotiating post-Brexit arrangements could also weigh on the business environment. Hong Kong SAR is closely connected with the U.K. financial sector due to the presence of large U.K. banks, with Hong Kong SAR's financial sector liabilities to the U.K. at 116 percent of GDP as of 2016 (14 percent of total bank assets). Hence, shocks impinging on the U.K. financial system, for example due to protracted policy and economic uncertainty arising from Brexit negotiations, could have large spillovers to Hong Kong SAR. U.K-based banks and businesses could see a decline in profits and hold off on investments in Hong Kong SAR, triggering a knock-on effect on credit, investment and growth.

Authorities' View

16. Risks. The authorities considered that various downside risks facing the economy remained beyond the short term, despite the improved balance of risks. These included an increasingly complicated global monetary environment as the US proceeded further with normalization and some other central banks in the advanced economies reduced their monetary stimuli, possibly resulting in sharp movements in asset markets and capital flows. Other risks included rising protectionist sentiment as well as heightened geopolitical tensions. While risks and uncertainties remained for the outlook beyond the near term, the authorities noted that Hong Kong SAR's strong buffers and robust policy frameworks, including ample fiscal reserves, strong regulatory and supervisory frameworks as well as a well-capitalized banking system, would enable them to navigate through the challenges. The authorities' views on specific risk factors were as follows.

- **Housing market correction.** While a disorderly housing market adjustment could have a significant impact on aggregate demand through negative wealth effects, the authorities did not expect that it would lead to systemic risks as the banking system had large capital and liquidity buffers and banks' mortgage borrowers were not overstretched, thanks to prudent banking supervision and the eight rounds of macroprudential measures. Also, they noted that a decline in transactions in the past few years meant that fewer people were entering the market during the boom period, and they were less leveraged as a result of the tighter LTV ratio requirement. Moreover, more than 60 percent of homeowners had no mortgages.

- **Liquidity risks**. The authorities noted that, as the financial system had experienced a significant increase in liquidity since the GFC, a disorderly reversal, e.g. a tail-risk scenario of abrupt capital outflows, or financial market dislocations, could potentially pose a significant risk to the economy and the financial system. The authorities were stepping up preparedness for such adverse scenarios by various measures, including very conservative capital and liquidity stress tests. The authorities believed that Brexit would have a limited impact on Hong Kong SAR's economy unless it triggered a global confidence shock.

- **Credit risks**. The authorities noted that Mainland China-related risks were prudently monitored by banks and risks were manageable, with more than three quarters of exposures to large Mainland China SOEs and multinational corporations. They also noted that they were not complacent about the currently low NPL ratio, as the current credit cycle had not yet turned.

- **On upside risks**, they concurred that various developments in the Mainland (e.g. the BRI and the Bay Area development) would be positive for Hong Kong SAR's medium to long term growth prospects.

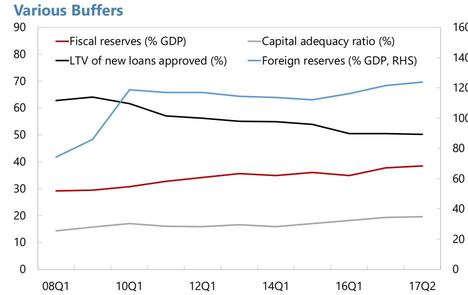
STRONG BUFFERS IN PLACE

17. Strong policy frameworks and ample buffers have been built and strengthened further over the last decade, which will help to weather challenges.

- **External**. Cross-border capital flows are large and volatile reflecting the nature of a major global financial center, but vulnerabilities in the international investment position are low with net foreign assets of 368 percent of GDP and foreign exchange reserves of US$386 billion (or 120 percent of GDP) as of end-2016.

- **Fiscal**. Conservative fiscal management over the past decades and strong real estate-related revenues have helped build buffers against the expected structural weakening of the fiscal position arising from aging. Fiscal reserves amounted to 38 percent of GDP in 2017Q1 (or about 25 months of total government expenditure) and gross government debt is less than 0.1 percent of GDP (Appendix II).

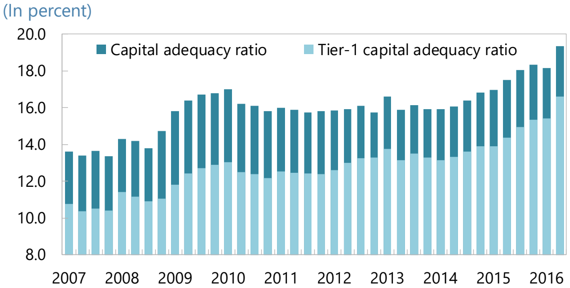
Various Buffers



Sources: Haver analytics; and IMF staff estimates

- **Banks**. Banks have built up strong capital buffers and ample liquidity thanks to enhanced regulatory and supervisory frameworks. The capitalization of the banking sector remains strong and well above international standards.[4] In light of the HKMA's assessment of the credit-to-GDP and property price-to-rent gaps, a countercyclical capital buffer (CCyB) was introduced (currently at 1.25 percent) and will be further raised to 1.875 percent in 2018. Banks have ample liquidity with liquidity coverage ratio of category 1 institutions at 144.2 percent and liquidity maintenance ratio of category 2 institutions at around 50 percent in 2017Q2, both well above their respective international minimum standards. Policy efforts have enhanced resilience of the banking system to property price shocks with progressive tightening of macroprudential measures since 2009.[5] Thus, asset quality remains very strong, with the NPL ratio at only 0.8 percent as of 2017Q2. However, amid tight prudential regulations on banks, property market developers, which receive financing from banks, have been rapidly increasing lending to households, though their share relative to banks' mortgage lending remains low. Banks are thus exposed to substantial systemic financial risk given the high and increasing exposure to

Capital Adequacy Ratio of Authorized Institutions 1/ 2/
(In percent)



1/ Consolidated positions.
2/ With effect from January 1, 2013, a revised capital adequacy framework (Basel III) was introduced for locally incorporated authorized institutions. The capital adequacy ratios from March 2013 onwards are therefore not directly comparable with those up to December 2012.

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[4] The total capital adequacy ratio (CAR), Tier-1 CAR, and the common equity Tier 1 (CET-1) ratios were 18.7, 16.1, and 15.1 percent in 2017Q2, respectively.

[5] Loan-to-value (LTV) and debt-servicing ratios (DSR) for new mortgages declined since their introduction (LTV from 64 to 48 percent and DSR from 41 to 34 percent).

Mainland China and to the overvalued property market, stemming from rising household leverage. In addition, these risks are likely to be highly correlated, making the aggregate risk exposure of the system larger than the sum of individual risks would suggest.

POLICIES: NAVIGATING CHALLENGES AND SECURING SUSTAINED AND INCLUSIVE GROWTH

18. Policy frameworks need to be further strengthened to address near-term challenges and secure sustained growth over the medium term. The currently strong buffers need to be further built up and be used effectively if needed.

A. Fiscal Policy: Ensuring Long-Term Sustainability and Short-Term Flexibility

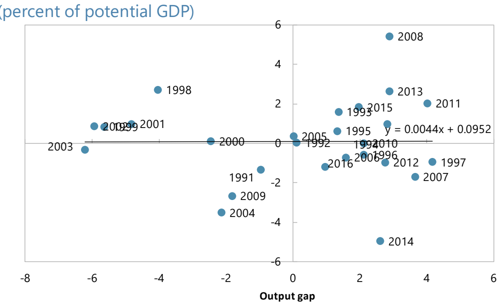
19. Fiscal policy continued to be conservative in FY2016/17, but the contractionary impulse of about 1¼ percentage points of GDP is projected to be more than reversed in FY17/18. The current fiscal stance is assessed to be appropriate and additional fiscal stimulus is not needed due to the economy's cyclical position**.**

- **FY2016/17.** In FY2016/17, the larger-than-expected fiscal surplus, of about 4½ percent of GDP, was driven by slower non-recurrent spending due to delayed implementation of infrastructure projects and the strong rebound in property markets, with stamp duties and land premium accounting for two-thirds of the overperformance relative to the budget. Consequently, fiscal reserves increased further and were around 38 percent of GDP in 2017Q1.

  FY2017/18. Staff projects the overall fiscal surplus in FY2017/18 to narrow to 2½ percent of GDP, larger than budgeted by about 2 percent of GDP, due to stronger-than-expected revenues from rising property prices and overall economic strength. The structural fiscal balance is expected to decline by around 1½ percent of GDP, implying an expansionary fiscal stance, which is appropriate despite the near-zero output gap, because its composition mostly reflects carry over of delayed implementation of infrastructure and land supply projects from the previous year and strengthening of social safety nets, in line with past staff advice. As a robust recovery is expected to continue in the near term with a close-to-zero output gap, there is little need for additional fiscal stimulus in FY2018/19 and beyond, and several temporary tax relief measures could be phased out. The focus should be on implementing planned projects, particularly boosting housing and land supply, as well as infrastructure projects. Over the medium term, there is little need for additional fiscal support.

20. In the past, fiscal policy could have been more cyclically supportive. As the main demand management tool under the currency board arrangement, fiscal policy should support aggregate demand to a greater extent when cyclical conditions worsen, and *vice versa*. In the past, fiscal policy has been mostly acyclical in part due to weak expenditure-side automatic stabilizers, and often asymmetric reflecting a bias towards fiscal savings.

Adjusted Impulse compared to univariate output gap
(percent of potential GDP)



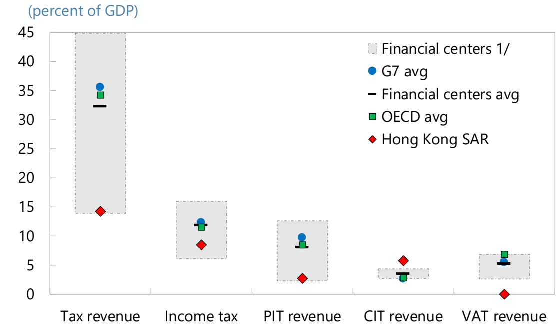
Sources: Staff estimates.

21. There would be benefits from greater countercyclicality in the face of negative shocks. The current fiscal rule of adherence to at least budget balance should be implemented flexibly and symmetrically over the cycle, rather than strictly every year. In particular, if downside risks materialize, the government should actively use fiscal policy to support domestic demand with the size of stimulus depending on the severity of the shock. Short-term countercyclical measures should be aligned with long-term goals to ensure that they do not exacerbate unfavorable long-term fiscal trends, and could include: (i) expediting the implementation of capital projects that are already identified and seeking final approval (i.e. already appraised through a rigorous economic, financial and technical analysis and selected through a transparent process); (ii) supporting small businesses including with targeted and temporary subsidized access to funding through credit guarantee schemes as done in past downturns; (iii) bringing forward spending on healthcare and retirement protection schemes which are earmarked for the medium term; and (iv) expanding relief measures for vulnerable households, including extra allowances for the elderly and physically challenged, and higher thresholds for providing rental relief to families in public housing. Automatic stabilizers of appropriate sizes should work smoothly when needed, also through actively strengthening means-tested social safety nets.

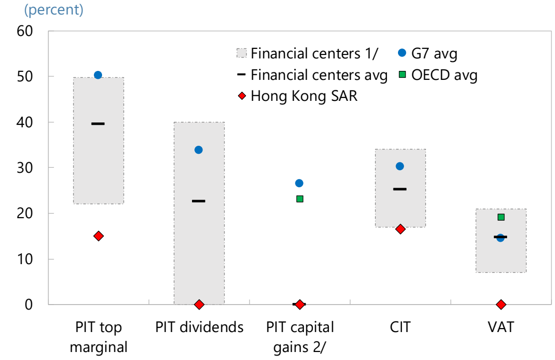
22. The authorities should consider possible adjustments to the fiscal framework in the face of medium- to long-term challenges to ensure fiscal sustainability. Aging will lead to higher pension and healthcare spending (estimated to rise by 2½ percentage points of GDP by 2030), as well as social spending. Also, education and capital spending should be preserved as investment in both physical and "soft" infrastructure is essential to maintain and boost competitiveness. Against that, in the event of house price moderation, it would be difficult to maintain the current level of revenues. Hence, it is important to further strengthen the current fiscal framework to ensure long-term sustainability (See Selected Issues Paper 1):

- **A structural deficit will emerge by 2030 unless additional revenues are mobilized or social safety nets are scaled back significantly, with associated social and economic costs.** Aging will result in higher public spending. Efforts to rein in non-essential expenditure growth through expenditure reviews and reprioritizing overall spending should continue but are likely insufficient to offset the additional long-term spending needs. Thus, the authorities will face the choice of compressing current expenditures, which could strain social stability and undermine inclusive growth, or allow the expenditure-to-GDP ratio to rise over the medium to long term. In addition, revenues could decline by at least 3 percentage points of GDP as the real estate market stabilizes.

- **Preserving Hong Kong SAR's sound fiscal position over the longer term thus would require revenue mobilization.** The current taxation regime, predicated on a narrow tax base and low tax rates, while supporting Hong Kong SAR's competitiveness in the financial and services industries, has resulted in a low tax revenue-to-GDP ratio of 13.8 percent in FY2016/17, lower than other financial centers. But the emergence of structural deficits over the long term requires early analysis and consideration of options to raise revenues while maintaining competitiveness. Options identified through international benchmarking, relative to other global financial centers, include introducing/raising indirect taxes (such as VAT and excises) to avoid overreliance on direct taxation and increasing top marginal income tax rates modestly. In this context, the establishment of a new tax policy unit to review possible broadening of the tax base is welcome. This unit should study the relative distributional, efficiency and growth impacts of these and other revenue measures for the medium to long term.



1/ Range for Belgium, Luxembourg, Netherlands, Singapore (2014) and Switzerland.
Sources: OECD revenue statistics, WEO, CEIC, staff estimates.



1/ Range for Belgium, Luxembourg, Netherlands, Singapore and Switzerland. 2/ 2015.

Sources: CEIC; OECD; E&Y; and Deloitte Tax Foundation; IRAS; Government of Hong Kong SAR; and IMF staff estimates.

Authorities' View

23. The authorities viewed that an important aspect of enhancing fiscal sustainability in the long term was to raise Hong Kong SAR's economic growth capacity so as to meet increasing expenditure due to population aging in the future. They noted that significant efforts had been put on this front through, for instance, investment in infrastructure and education, increase in land supply and the promotion of research and development. The authorities also highlighted the efforts recently announced in the Chief Executive's Policy Address to boost growth through the introduction of a two-tiered profits tax rates regime and enhanced tax deduction for R&D expenditure. Boosting the growth potential and improving preventive health care for the elderly were seen as key to solving the fiscal long-term challenges outlined by the staff.

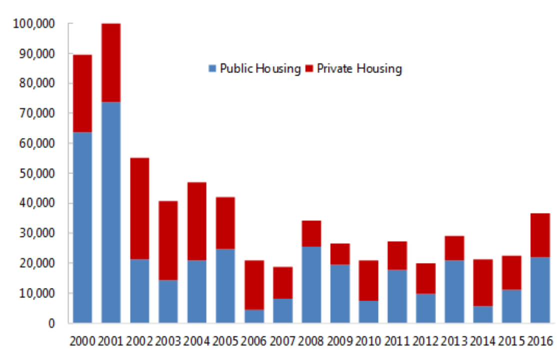
24. Regarding revenue mobilization, the authorities noted that Hong Kong SAR's simple and low tax regime was one of the core attributes of being an international financial center. They considered it necessary to maintain and plan to further enhance Hong Kong SAR's competitiveness and economic development, by the strategic use of tax measures. The authorities agreed that supportive fiscal policy would help tide the economy over short-term difficulties amid the challenging global economic environment, and that public resources had been effectively and actively deployed in the past to render support to domestic demand at a time of weak external demand.

B. Deflating the Housing Boom Safely

25. Amid the booming and overvalued property market, the three-pronged approach to limiting risks should continue. Since 2009, the HKMA has introduced a series of macroprudential measures to limit the financial system's exposure to the asset price boom, which have been complemented by various stamp duties introduced by the government to stem excessive price increases and safeguard financial stability (Appendix III). Further tightening of macroprudential policies could exacerbate leakages to non-bank institutions outside the regulatory perimeter (such as property developers offering financing schemes to potential buyers). In this context, and amid surging housing prices, the government increased the ad valorem stamp duty for residential properties from the Doubled Ad Valorem Stamp Duty (DSD) rates to a flat rate of 15 percent in November 2016 (also known as New Residential Stamp Duty (NRSD)), and removed the stamp duty exemption for "acquisition of multiple residential properties under 1 instrument" in April 2017. Measures have also been taken to boost housing supply but were insufficient to meet rising demand. Indeed, housing prices and household indebtedness continue to rise, increasing the risk of a disorderly adjustment as well as exacerbating unaffordability.

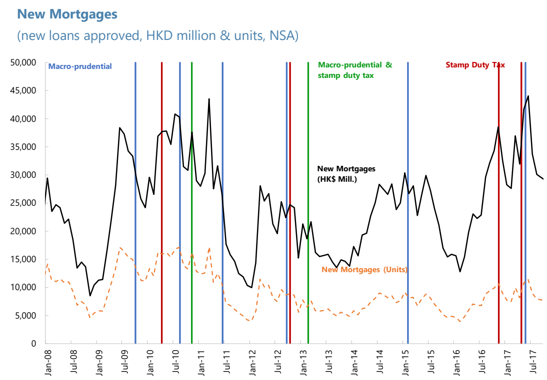
26. Sustained increases in housing supply are critical to resolving the structural supply-demand imbalance. Housing supply increases declined to an annual average of 25,000 units between 2006 and 2015, compared to more than 50,000 units in the previous decade, contributing to strong house price growth. Housing supply has been rising with the implementation of the government's Long-Term Housing Strategy which was adopted in 2014 and targets providing 460,000 units of housing over the next decade. To complement this, the government is finalizing Hong Kong 2030+, which is a longer-term development strategy to provide land and housing on a more sustainable basis. It is important to meet the housing supply target set by the Strategy to cement public expectations about sustained increases in supply. However, given various obstacles to further increasing supply in the near term, including the lack of ready sites and relevant development restrictions, it will be difficult to meet the ten-year housing supply target under the Strategy. Thus, there is benefit to expediting the process for identifying land and building sites, together with conducting the relevant environmental, transport, and community facility assessments.

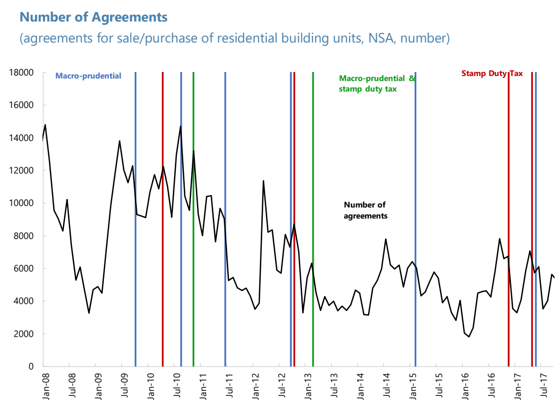
Housing Production
(Units)



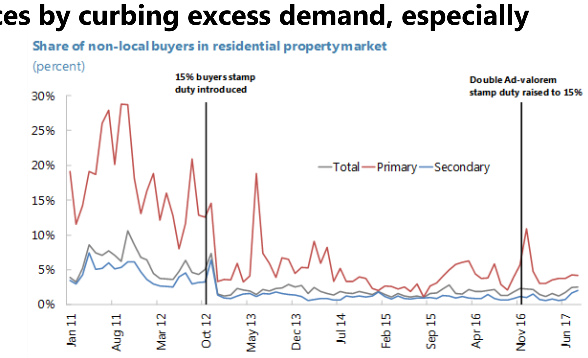
Note: 1) Public Housing includes both rental and subsidized sale flats; Rental flats include those completed under Hong Kong Housing Authority (HKHA); Subsidised sale flats include those completed under HKHA and Hong Kong Housing Society, and does not include the 322 subsidised sale flats provided by the Urban Renewal Authority on a one-off basis in 2015/16. 2) Private flats from 2003 onwards exclude village houses; 2004 figures include subsidized flats converted to private during the year; 2015 figures include flats completed and designated as subsidised sale flats in the year but sold to the public in the open market at prevailing market prices in 2017.
Source: Housing Department, Hong Kong.

27. Macroprudential measures have been effective in building buffers in the financial system against possible housing market adjustments. Since 2009, the authorities have introduced a series of macroprudential measures, including tighter ceilings on loan-to-value (LTV) and debt service-to-income (DSR) ratios, stress testing the DSR, and imposing a floor on risk weights on property loans. On continued increases in housing prices, in May 2017, the HKMA lowered the LTV ratio for second property mortgages and lowered the DSR limit for borrowers whose income is mainly derived from outside Hong Kong SAR. These policies have helped limit financial system exposure to the housing boom and strengthened banks' mortgage loan origination standards. Staff analysis finds that macroprudential policies were effective in building buffers, but played only a minor role in containing house price appreciation (see Selected Issues Paper 2). As housing prices continue to rise and a disorderly adjustment could pose significant macro-financial risks, these measures should remain in place to protect the financial system. However, amid tight prudential regulations on banks, lending to households by property developers (which are partly financed by banks) has been rising rapidly, though their share relative to banks' mortgage lending remains low. In response, the HKMA also further tightened the capital requirement for banks on their lending to property developers, to rein in these practices. Adjustment of the macroprudential measures should be considered based on evolving financial stability risks, with due attention to the emerging risk of regulatory leakages to the non-bank sector.





28. Stamp duties have helped contain house prices by curbing excess demand, especially by cash buyers. Three stamp duties are currently in place: Special Stamp Duty (SSD) on resale of residential properties within 36 months of purchase; Buyer's Stamp Duty (BSD) on purchases by nonresidents; and DSD/NRSD on all residential property purchases except primary residences of permanent residents.[6] Staff analysis shows that stamp duties have been effective in stemming price increases, and that house prices would have been higher by about 9 percent without them. By



Source: Hong Kong SAR authorities

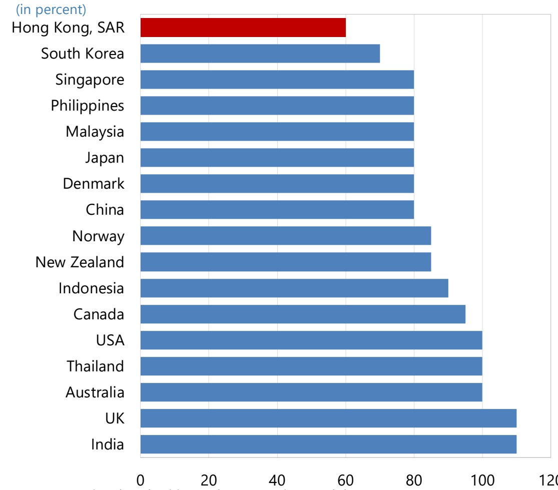
[6] The BSD was put in place in October 2012 at 15 percent for all residential property transactions except for Hong Kong SAR permanent residents. It was designed to limit inflows into the real estate market. It was put in place in

(continued)

stemming house price increases, these measures have also helped contain household leverage and systemic risk. However, the higher the rates the greater the possible distortions as high stamp duty rates may render the housing market less liquid and exacerbate any future correction.

29. While stamp duties have helped contain systemic risks, they should be phased out when these risks dissipate. The BSD was introduced in 2012 in response to a capital inflow surge into the housing market, to address demand pressures from non-resident buyers. The BSD complements macro-prudential policies and helps contain house prices and excessive household leverage. Similarly, a second surge in 2016 led to an increase in the ad valorem stamp duty from the DSD rates to a flat rate of 15 percent in November 2016 (also known as the NRSD). The BSD and the DSD/NRSD are assessed to be capital flow management measures and macro-prudential measures under the IMF's Institutional View on the Liberalization and Management of Capital Flows. While they are intended to contain housing price overvaluation and systemic financial risk, they discriminate between residents and non-residents. The discriminatory feature is designed to contain excess demand from non-resident buyers. Both stamp duties are assessed to be appropriate because: (i) they were put in place amid a surge of capital flows into the property market; (ii) they were not used to substitute for necessary macroeconomic adjustment as monetary and exchange rate policies are constrained under the currency board arrangement, and fiscal policy has been conservative; and (iii) additional tightening of macro-prudential policies, which are very tight by international standards and do not apply to cash buyers, could exacerbate leakages to non-bank financial institutions outside the regulatory perimeter. Going forward, once systemic risks from the housing market dissipate, staff recommends phasing out and replacing the stamp duties with alternative non-discriminatory measures. In addition, the authorities could phase out mortgage interest deductibility as it boosts demand for housing and encourages higher leverage.

Maximum loan-to-value ratios
(in percent)



Sources: National Authorities and RES Housing Module.

Authorities' View

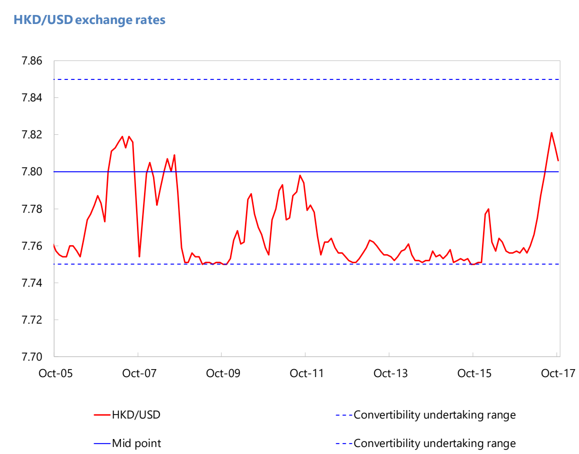
30. The authorities agreed that increasing housing supply would help alleviate affordability concerns in the long run. They also stated that in the short run macro-prudential measures and various demand-side management measures in the form of stamp duties would remain in place. The authorities explained that while they envisaged considerable challenges in

response to a significant surge of inflows into the real estate market, amid sharply rising housing prices. Its introduction was preceded by progressive and significant tightening of macroprudential measures and the implementation of a non-discriminatory SSD on resale of properties between 6-24 months. The ad valorem stamp duty for residential properties was increased from the DSD rate to a 15 percent flat rate in November 2016 (also known as the NRSD). Permanent residents without existing properties are subject to lower rates (up to 4.25 percent, depending on the transaction value).

meeting the ten-year housing supply target under the Long-Term Housing Strategy, they would continue to spare no efforts in increasing housing production. The authorities agreed that the macroprudential stance was very tight, but indicated that they stood ready to modify the measures appropriately when necessary. They also shared staff concerns that some borrowers obtained credit through property developers, and were monitoring the situation closely. They explained that the demand-side management measures were meant to be stop-gap measures while the Government strived to increase housing supply, and that they had been effective in containing systemic financial risk. The authorities underscored that when the market normalizes, there might be room to review the need for these measures, but at this point they could not remove them. On the recommendation on phasing out mortgage interest deductibility, the authorities noted that this served a social policy purpose of helping people own their homes and hence they had no plan to remove this tax deduction.

C. Preserving an Anchor of Stability

31. The Linked Exchange Rate System (LERS) remains the best arrangement for Hong Kong SAR. The US dollar is still the most commonly used international currency in trade and financial transactions and Hong Kong SAR's economic cycles and financial conditions are, to a large extent, influenced by the U.S. and the global economic/financial environment. The currency board arrangement has been supported by the flexible economy, ample fiscal and reserve buffers, and strong financial regulation and supervision. LERS anchors the stability of Hong Kong SAR's highly-open economy with its large and globally integrated financial services industry. Even during the recent global financial stress episodes (U.S. taper tantrum, China stock market correction, RMB depreciation), the HK dollar continued to trade close to the strong side of convertibility undertaking range while other regional currencies depreciated sharply. Recently, it depreciated to the mid-point of the range on widening spreads between HKD Hibor and USD Libor rates. Over the medium term, as U.S. monetary policy normalizes, the HK dollar could resume appreciation in line with the U.S. dollar, raising concerns of diminishing competitiveness. Hong Kong SAR's flexible product and labor markets should allow rapid adjustment and help ensure that departures from the equilibrium REER do not persist.



Sources: Haver analytics

32. Staff assesses that the external position in 2016 was broadly consistent with medium-term fundamentals and desirable policy settings. As noted in the July 2017 External Sector Report, the cyclically-adjusted current account surplus narrowed to 2½ percent of GDP in 2016 while the current account norm is estimated to range between 1 and 4 percent of GDP. The real effective exchange rate was also assessed to be at a level consistent with medium-term fundamentals and desirable policy (within a range of -5 to +5 percent). Since then, the REER has depreciated by 1.4 percent, and analysis through November 2017 delivers the same results (Appendix IV).

Authorities' View

33. The authorities welcomed staff's positive assessment of the LERS' role in anchoring Hong Kong SAR's economy and financial system. In response to anticipated increases of the Federal Funds rate, the authorities expected local interbank interest rates to increase further in the long run under the LERS. Although some market participants interpreted the increase in HKMA bill issuance in recent months as efforts by the HKMA to narrow the gap between the Hibor and Libor, the authorities explained that such increases were conducted in response to strong demand from banks for high-quality assets and they had had little impact on abundant market liquidity.

D. Maintaining Financial Stability

34. The financial system is well placed to cope with challenges thanks to the robust regulatory and supervisory framework.

- Potential systemic vulnerabilities and regulatory arbitrage are closely monitored and addressed through coordination among the government and the regulators in the Financial Stability Committee, close dialogue with Mainland China regulators, and active participation in global fora.
- Banks have ample loss absorption buffers and limited vulnerabilities to short-term funding. Mainland China-related exposures are being closely monitored with quarterly updates and staff assesses the risks as manageable.
- Considering the large credit-to-GDP gap and overvalued housing prices, the introduction and progressive increase of the CCyB is appropriate.
- Substantial progress has also been made on implementing the 2014 FSAP recommendations (Appendix V). A comprehensive framework for recovery and resolution, which was established under the Financial Institutions (Resolution) Ordinance, commenced operation in July 2017. The HKMA, the Securities and Futures Commission, and the Insurance Authority will take actions to orderly resolve non-viable systemically important financial institutions to mitigate systematic risks and minimize losses of public funds by imposing losses on shareholders and creditors.

35. Hong Kong SAR is rightly working continuously to tap new opportunities as a global financial center. Leveraging its position as a well-established international financial center with comparative advantages such as skilled labor, high legal standards and common languages with its main trading partners, the authorities are further developing the asset management industry as well as encouraging corporate treasury centers to domicile in Hong Kong SAR. It is well positioned to contribute to, and benefit from, increasing regional connectivity and cooperation in investment, trade, and finance (including under the BRI and the Bay Area), as it can provide a platform for developing multiple channels for funding. To do so, the HKMA's establishment of the Infrastructure Financing Facilitation Office is welcome.

36. The authorities' continued strengthening of the regulatory and supervisory framework is welcome and crucial for maintaining financial stability. Further strengthening the oversight regime for non-bank institutions (including securities markets, broker dealers and asset managers) would prevent risks, including those arising from new channels connecting Hong Kong SAR and Mainland China. Recent efforts to enhance coordination among different regulators, including coordination platforms for new fintech businesses, is a welcome development. High standards for securities listing should be maintained for financial stability. The development of the new risk-based capital regime for insurance companies is in "Phase 2," focusing on detailed rules for quantitative requirements. Continued close and regular monitoring of risks arising from Mainland China exposures will allow Hong Kong SAR to reap the benefits of closer integration while mitigating potential risks. Enhanced oversight of cybersecurity risks by the authorities is welcome. Continued efforts to enhance transparency related to legal persons and trusts, including enacting the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) (Amendment) Bill and Companies (Amendment) Bill and ensuring their effective implementation in line with the international standards, underpin Hong Kong SAR's reputation as a key global financial center.

37. The authorities need to balance carefully the tradeoff between greater efficiency and maintaining stability in the face of rapid developments in fintech. The authorities' support for fintech business developments through various channels, including establishing the Fintech Facilitation Office, the Fintech Innovation Hub, a central bank digital currency project, closer cross-border collaboration with Singapore and Shenzhen on fintech development (including the recently announced initiative with Singapore on Distributed Ledger Technology-based trade finance platform), is welcome and will help preserve its role as a key global financial center. Technological progress can promote the development and adoption of new financial services as well as affect the existing market structure by reducing the need for some traditional financial intermediaries, while encouraging innovation and potential new market entrants. Keeping up with such progress, financial regulation must adapt to remain effective and ensure that risks to stability and integrity—including from cyberattacks, money-laundering and terrorism financing—can be effectively managed while not unduly stifling innovation. The authorities are using "regulatory sandboxes," which allow firms to test new technologies and business models in a controlled environment and enable regulators to address the potential risks from new technologies without curbing innovation. Going forward, the authorities should continue to review and enhance the regulatory framework for fintech to ensure that it remains effective (see Selected Issues Paper 3).

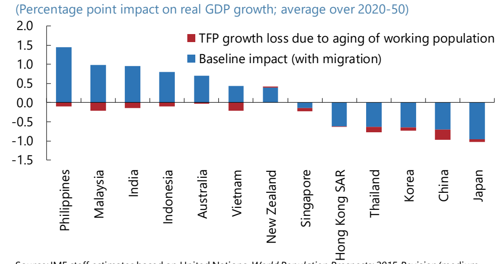
Authorities' View

38. The authorities welcomed the staff's positive assessment of Hong Kong SAR's regulatory and supervisory framework and ample buffers. They noted that ongoing efforts to implement a risk-based capital regime for insurance companies are in place, as they were undertaking quantitative assessments and moving forward with legislative proposals. Meanwhile, the newly-independent Insurance Authority is preparing to directly oversee licensing of intermediaries by mid-2019, in line with FSAP recommendations. On the regulation and supervision of fintech, the authorities noted that regulation would be technology neutral. Further, they noted that they would continue to keep abreast of the dynamic fintech landscape, and ensure an appropriate balance between market innovation and investor protection.

E. Ensuring Sustained and Inclusive Growth

39. Population aging is the key medium- to long-term challenge and will weigh on growth. According to the latest UN population projections, the population will start shrinking from 2045 but the labor force (ages 20-64) will start to contract very soon. Thus, the old age dependency ratio, which has already risen from 17.2 in 2010 to 20.6 in 2015, will rise sharply to 26.5 in 2020 and 50.1 in 2035. The government working group on long-term fiscal planning assessed, in 2014, that under current policies, fiscal reserves would be depleted by 2035-40, with the start of structural deficits around 2025-30. Aging will strain public finances due to rising spending pressures on pensions and healthcare. Also, staff analysis confirms the negative impact of population aging on growth: the shrinking labor force will lower annual real GDP growth by about ¾ percentage points during 2020-50, and lower average total factor productivity growth could pose a further modest drag on growth.

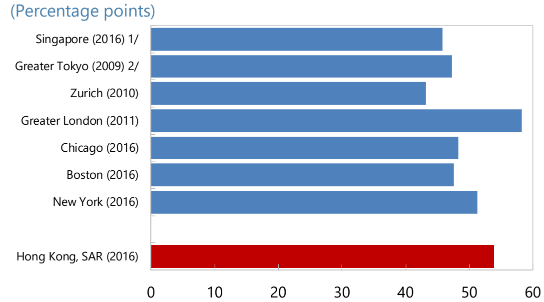
Baseline Growth Impact of Demographic Trends and Impact of Aging on TFP
(Percentage point impact on real GDP growth; average over 2020-50)



Source: IMF staff estimates based on United Nations, *World Population Prospects: 2015 Revision* (medium-fertility scenario; and Penn World Tables 9.0
Note: Estimated impact of workforce aging on total factor productivity (TFP) growth follows Aiyar and others (2016) based on a sample of Asian and European countries.

40. Despite recent improvement, Hong Kong SAR's income inequality remains high compared to peers. The latest study on household income distribution revealed that government policies, including various social benefits, helped improve income distribution over the past five years. The net Gini index, based on post-tax post-social transfers monthly household income, fell to 47.3 in 2016 (from 47.5 in 2011). Despite this improvement, Hong Kong SAR's inequality remains high compared to peers. In addition, on continued increase in housing prices, housing affordability is deteriorating further, with the housing price-to-income ratio doubling over the last decade (to more than 16 years) and exceeding the previous peak. Together, these factors could limit consumption and impair growth prospects over the medium term.

Cities with a Sizable Financial Industry Have High Market Gini Indices
(Percentage points)



Sources: U.S. Census, Statistics Singapore, HKSAR Census and Statistics Department, OECD.
1/ Not entirely comparable due to methodological differences.
2/ Southern Kanto region.

41. The authorities have taken steps to address high inequality and prepare for the needs of an aging population. They have introduced several policies, and spending on social welfare, housing and health has increased to around 33 percent of public spending. Provision of public housing, amid deteriorating housing affordability, has long been a policy priority as almost half of all households live in subsidized housing. The statutory minimum wage, introduced in 2011 and increased three times, has helped boost labor supply without damaging wage flexibility. The plans to enhance the Low-Income Working Family Allowance (LIFA) Scheme, including by boosting monthly payments and relaxing the income and working hour requirements, are welcome. The authorities are moving forward to enhance the existing multi-pillar retirement protection system, including strengthening social security for the elderly with more financial needs and developing financial products to convert assets into stable post-retirement income.

42. The authorities should continue to promote sharing the benefits of economic growth. As high and persistent inequality can undermine the sustainability of growth, policies should continue to foster inclusive growth and further build social safety nets, such as by maintaining housing support for the most vulnerable. Changes to the Mandatory Provident Fund (MPF) system, including the abolition of the arrangement for "offsetting" severance payment and long service payment, should be implemented. Working hours policy should strike a balance between equality and inducing labor force participation, while not compromising competitiveness and, especially, the flexible labor market. In the context of reviewing the existing social safety net, consideration should be given to consolidating and strengthening means-testing of the programs geared to serve the elderly. In view of the projected decline in the labor force over the medium term, consideration should be given to providing childcare for young children, which will boost female labor force participation, as well as increase fertility.

Authorities' View

43. The authorities agreed that achieving inclusive growth was of paramount importance and a key challenge in the years to come. Aiming to contain inequality, the authorities continued to prioritize boosting labor force participation and supporting the aged and working families. They noted that the introduction and subsequent increases in the statutory minimum wage helped attract more older female workers to enter or re-enter the labor market. Child care policies were under review to further boost female labor force participation. After the introduction of the poverty line, the authorities indicated that they wanted to better target working families with children and increase the level of support through the introduction of the LIFA Scheme. They had recently announced a series of improvements to the Scheme. Old age support would also be strengthened so as to meet the challenges arising from the aging population. The authorities agreed that changes to the MPF system were necessary, while balancing needs of employees and employers.

STAFF APPRAISAL

44. Outlook. Growth momentum accelerated since mid-2016 and over the course of 2017 amid the global recovery, robust Mainland China growth, booming housing prices, and rebounding credit growth. The strong growth momentum is expected to continue in the near term. Under the baseline, with the continued gradual global recovery, orderly monetary tightening in the U.S., and a smooth transition of Mainland China to a sustainable growth path, Hong Kong SAR should grow close to its medium-term potential.

45. Risks. The balance of risks has improved since last year. Going forward, stronger-than-expected global growth and faster-than-anticipated implementation of reforms in Mainland China could further improve Hong Kong SAR's growth outlook. Also, Mainland China's BRI and plans for the development of the Bay Area create opportunities for Hong Kong SAR over the medium term. Even so, overall risks are still tilted to the downside, from both external and domestic sources, and include a correction in property prices, tighter-than-expected global financial conditions, disorderly adjustment in Mainland China, and a global retreat from cross-border integration.

46. Fiscal policy. The current fiscal stance is assessed to be appropriate and additional fiscal stimulus is not needed due to the economy's cyclical position. In the event of negative shocks, there would be benefits from greater countercyclicality, as fiscal policy is the main demand management tool under the currency board arrangement. The current fiscal rule of adherence to at least budget balance should be implemented flexibly and symmetrically over the cycle, rather than every year. In particular, if downside risks materialize, the government should actively use fiscal policy to support domestic demand. Short-term countercyclical measures should be aligned with long-term goals to ensure they do not exacerbate unfavorable long-term fiscal trends.

47. Long-term fiscal challenges. The authorities should consider possible adjustments to the fiscal framework to ensure fiscal sustainability in the face of medium- to long-term challenges. Efforts to rein in non-essential expenditure growth through expenditure reviews and reprioritizing overall spending should continue, though additional efforts are likely needed to offset the additional long-term spending needs. The emergence of structural deficits over the long term requires early analysis and consideration of options to raise revenues while maintaining competitiveness. Options identified through international benchmarking, relative to other global financial centers, include introducing/raising indirect taxes (such as VAT and excises) and increasing top marginal income tax rates modestly. The newly established tax policy unit should study the relative distributional, efficiency and growth impacts of these and other revenue measures for the medium to long term.

48. Housing policy. Amid the booming and overvalued property market, the three-pronged approach to limiting risks should continue. Sustained increases in housing supply are critical to resolving the structural supply-demand imbalance. Macroprudential measures have been effective in building buffers in the financial system against possible housing market adjustments. Adjusting macroprudential measures should be considered based on evolving financial stability risks, with due attention to the emerging risk of regulatory leakages to the non-bank sector. Stamp duties have helped contain house prices and associated systemic financial risks by curbing excess demand, especially by cash buyers. The Buyer's Stamp Duty and the Double Ad-Valorem/New Residential Stamp Duty are assessed to be capital flow management measures and macro-prudential measures under the IMF's Institutional View on the Liberalization and Management of Capital Flows. Going forward, once systemic risks from the housing market dissipate, both stamp duties should be phased out and replaced with alternative, non-discriminatory measures.

49. Exchange rate regime and external position. The LERS remains the best arrangement for Hong Kong SAR. The currency board arrangement has been supported by the flexible economy, ample fiscal and reserve buffers, and strong financial regulation and supervision. The LERS anchors the stability of Hong Kong SAR's highly-open economy with its large and globally integrated financial sector. The external position in 2016 is assessed to be broadly consistent with medium-term fundamentals and desirable policy settings, and developments through November 2017 do not change this assessment.

50. Financial sector policies. The authorities' continued strengthening of the regulatory and supervisory framework is welcome and crucial for maintaining financial stability. Potential systemic vulnerabilities and regulatory arbitrage are closely monitored and addressed through coordination among the government and the regulators in the Financial Stability Committee, close dialogue with the Mainland China regulators, and active participation in global fora. Substantial progress has also been made in implementing the 2014 FSAP recommendations, including a comprehensive framework for recovery and resolution. Hong Kong SAR is right to work continuously to tap new opportunities as a global financial center. The authorities need to balance carefully the tradeoff between greater efficiency and maintaining stability in the face of rapid developments in fintech.

51. Inclusive growth. The authorities should continue to promote sharing of the benefits of economic growth. Changes to the MPF system, including the abolition of the arrangement for "offsetting" severance payment and long service payment, should be implemented. Working hours policy should strike a balance between equity and inducing labor force participation while not compromising competitiveness, especially the flexible labor market. In the context of reviewing the existing social safety net, consideration should be given to consolidating and strengthening means-testing of the programs geared to serve the elderly.

52. It is recommended that the next Article IV consultation discussions take place on the standard 12-month cycle.

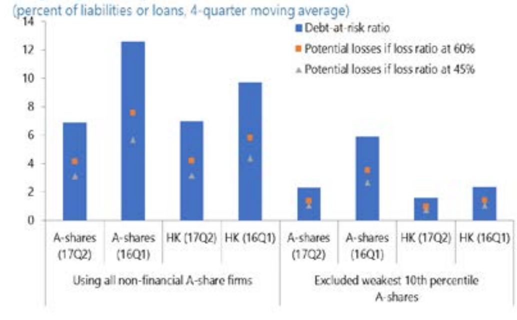
Box 1. Hong Kong SAR Banks' Mainland China Exposure[1]

Over the past year, Hong Kong SAR banks' non-bank China exposures continued to rise on Chinese corporates' higher investment demand amid better growth prospects and overseas expansion. However, vulnerabilities, as measured by debt-at-risk ratio, fell amid improved profitability. Strong prudential measures remain a crucial bulwark safeguarding Hong Kong SAR banks.

Hong Kong SAR banks' mainland China exposures have risen to a record level, driven by strengthening growth in China and the global recovery. Non-bank Mainland China exposure[2] recovered from HK$4.4 trillion in 2016Q1 to HK$5.3 trillion in 2017Q2, representing 206 percent of GDP and 24 percent of banking assets. The growth is not only driven by funding needs in Mainland China, on improving growth prospects, but also investment demand of Mainland Chinese corporates fueled by the global recovery and Mainland Chinese firms' overseas expansion.

Mainland Chinese corporates' improved profitability has reduced risks to Hong Kong SAR banks' balance sheets, though banks' exposures remained concentrated in real estate. The debt-at-risk ratio fell from 8 percent of total loan exposure in 2016Q1,[3] to about 4.8 percent (or 0.9 percent of banking assets) in 2017Q2. The fall in debt-at-risk is primarily a result of improved corporate profits, which grew 13 percent yoy. Also, the ratio of bad loans to total loans fell to 0.8 percent in 2017Q3 (from 0.9 percent in 2016Q1). The composition of lending remains largely unchanged: lending to property developers and construction remained high, while that to "old" industries, such as mining, was low.

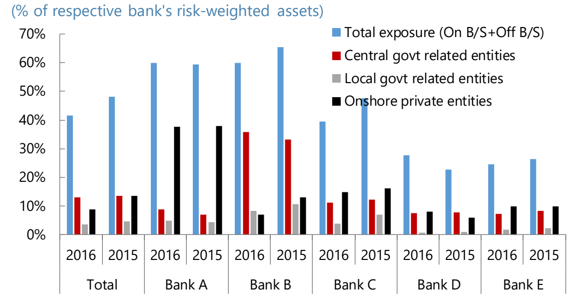
Comparison of Debt-at-risk ratio and Potential losses between A-shares and Hong Kong SAR's exposure
(percent of liabilities or loans, 4-quarter moving average)



Source: HKMA; WIND; staff estimates.

While individual bank exposures remained varied, exposure to higher-risk Chinese local state-owned enterprises (SOEs) appeared low. Of the banks analyzed[4], the debt-at-risk ratio ranged between 4 to 6 percent in 2016, falling from 7 to 11 percent in 2015. Individual banks with higher debt-at-risk ratios are usually more exposed to private Mainland Chinese firms. However, the financials of A-share firms showed the highest risk for local SOEs, followed by private firms and central SOEs. Exposure to local SOEs was low while some banks were either concentrated in lending to central SOEs or private firms.

Distribution of Non-bank Mainland exposure of major banks
(% of respective bank's risk-weighted assets)



Source: Company reports and staff calculations.

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[1] Prepared by Daniel Law.

[2] Non-bank Mainland China exposure is a broad indicator that includes loans for use in Mainland China by Mainland Chinese and foreign firms and loans for use outside Mainland China by Mainland Chinese firms, which account for about three-quarters of total nonbank exposure.

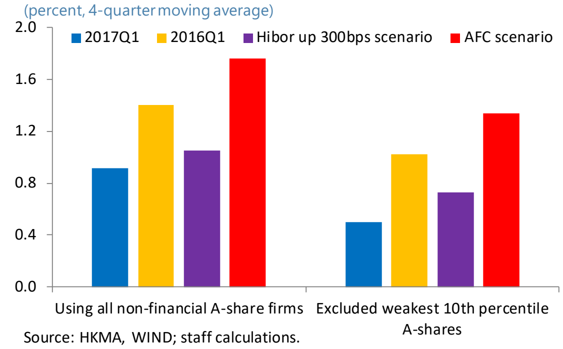
[3] Debt-at-risk is estimated using the interest coverage ratio, which is considered "at risk" when income is insufficient to cover interest associated with outstanding debt. The debt-at-risk ratio in each sector in A shares traded onshore, which is the share of debt-at-risk in each sector's liabilities, is used to calculate the entire system's weighted average according to the composition of the loan exposure.

[4] These banks include global banks, Mainland Chinese banks' subsidiaries in Hong Kong SAR and large local banks.

Box 1. Hong Kong SAR Banks' Mainland China Exposure[1] (Concluded)

In stressed scenarios, Hong Kong SAR banks remain sensitive to a sharp downturn in Mainland China, but vulnerabilities appear manageable. In a stress scenario in line with losses suffered during the Asian Financial Crisis, we assume corporate profits fall by 26 percent and interest expenses rise by 14 percent. In such a scenario, debt-at-risk rises to 1.8 percent of banking assets. Under a separate scenario in which the Hibor rises by 300 basis points following Fed rate hikes (like in 2005H2), debt-at-risk accounts for 1.1 percent of banking assets, still less than 1.40 percent in 2016Q1 when Mainland China suffered its slowest growth since 2009Q1.

Debt-at-risk of Mainland related lending as % of total assets
(percent, 4-quarter moving average)



Source: HKMA, WIND; staff calculations.

The authorities remain prudent and vigilant. The HKMA has maintained strong guidance and close monitoring of lending activities, including stable funding requirements to curb rapid loan growth since October 2013 and guidance to tighten corporate loan approval in 2014. Under such guidance, banks have focused lending to large SOEs and multinationals operating in Mainland China to mitigate risks

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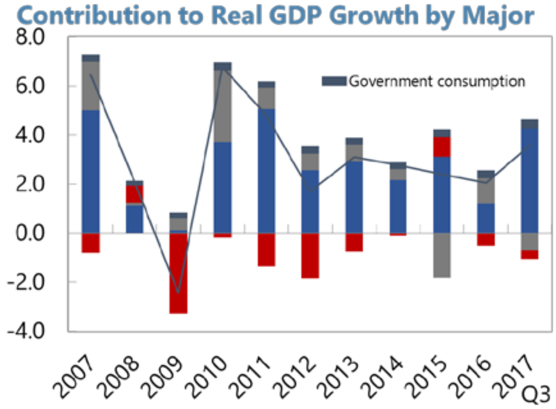
Figure 1. Hong Kong SAR: Strong Rebound in the Real Economy

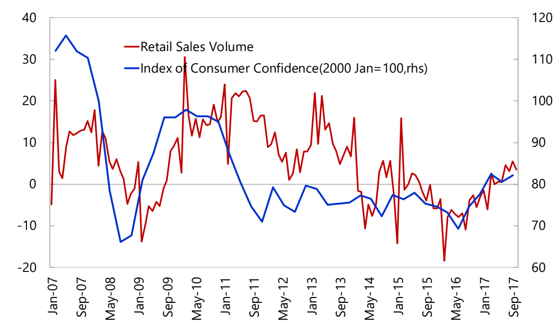
Growth bottomed out and economic activity has gained momentum since 2016H2 ...

Contribution to Real GDP Growth by Major



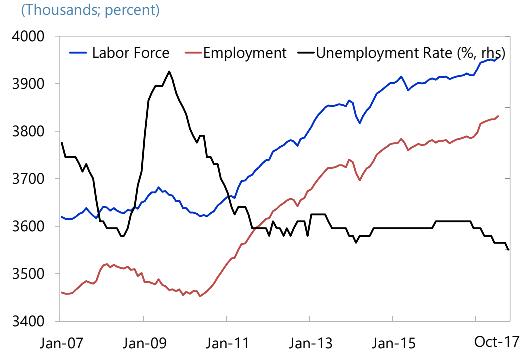
... driven by strong private consumption ...

Consumer Confidence and Retail Sales
(In percent (yoy))



... amid very tight labor market conditions.

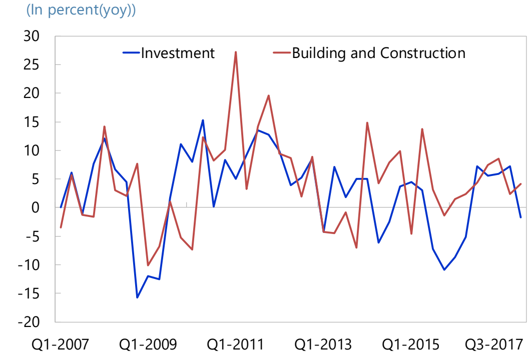
Employment 1/
(Thousands; percent)



1/ These three series are seasonally adjusted, 3 month averages.

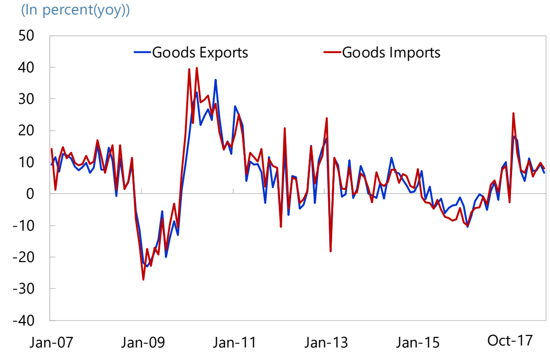
Investment also recovered on the resumption of planned infrastructure projects and continued housing projects.

Investment
(In percent(yoy))



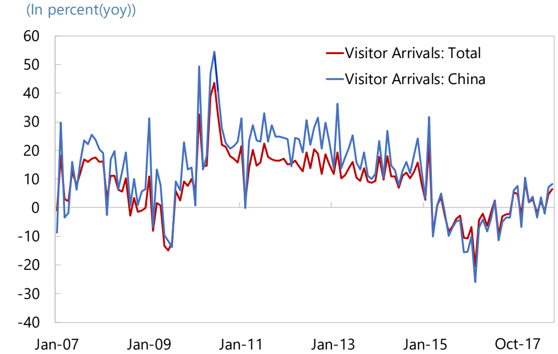
Trade activity is picking up as well in line with global trade recovery ...

Exports and Imports of Goods
(In percent(yoy))



... and growth of tourist arrivals turned positive since late 2016 driven by Mainland Chinese visitors.

Visitor Arrivals
(In percent(yoy))

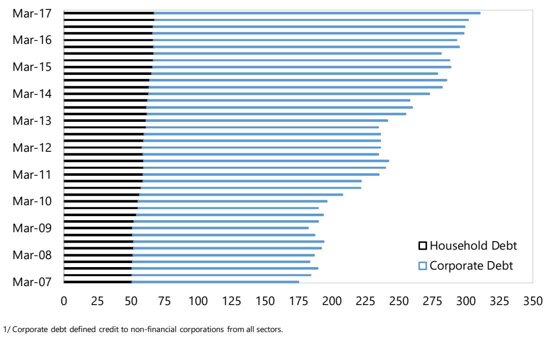


Sources: CEIC Data Company Ltd., Haver Analytics, WEO.

Figure 2. Hong Kong SAR: Snapshot of Credit and Asset Price Developments

Both household and corporate debt have increased further

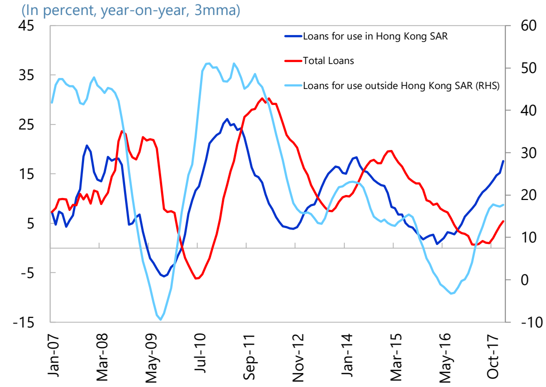
Household and Corporate Debt
(In percent of GDP)



1/ Corporate debt defined credit to non-financial corporations from all sectors.

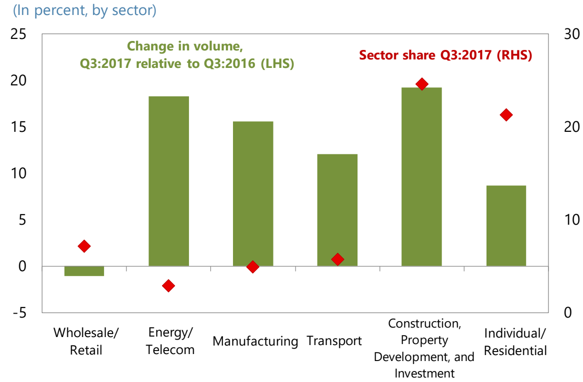
... boosted by accelerating credit growth

Credit Growth
(In percent, year-on-year, 3mma)



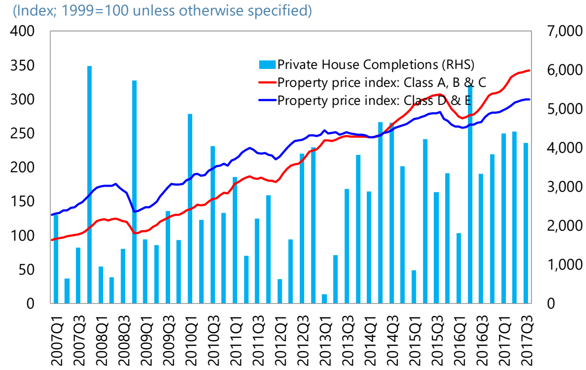
Property-related and household mortgages evidenced the biggest increases

Loans Outstanding for Use in Hong Kong SAR
(In percent, by sector)



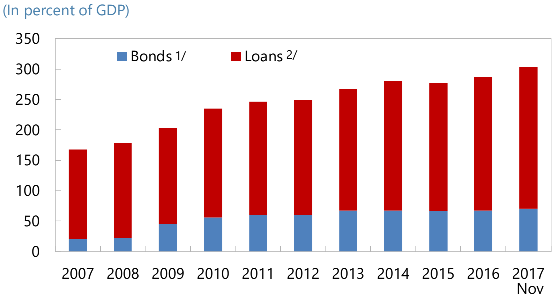
... boosted in large part by ongoing property price appreciation while completions lagged

Property Price
(Index; 1999=100 unless otherwise specified)



Loan and bonds whose domicile of risk is in Hong Kong SAR remain high

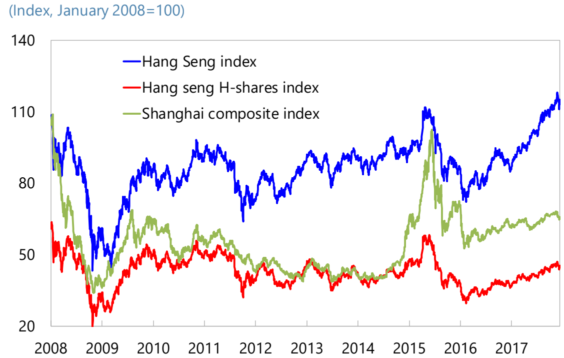
Loans and Bonds Outstanding, Domicile of Risk in Hong Kong SAR
(In percent of GDP)



1/ Bonds issued by entities incorporated in Hong Kong SAR with domicile of risk in Hong Kong SAR (2017 data as of November).
2/ Loans for use in Hong Kong SAR (2017 data as of September).

Equity prices have also gained, approaching the highest level in 10 years

Stock Price Index
(Index, January 2008=100)

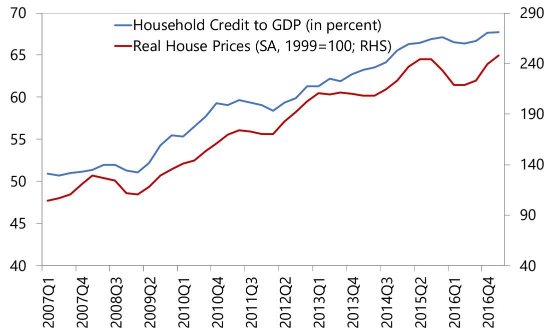


Sources: CEIC Data Company Ltd., HKMA, Haver Analytics, and IMF staff estimates.

Figure 3. Hong Kong SAR: The Booming Property Market

House prices and credit accelerated in the first half of 2017…

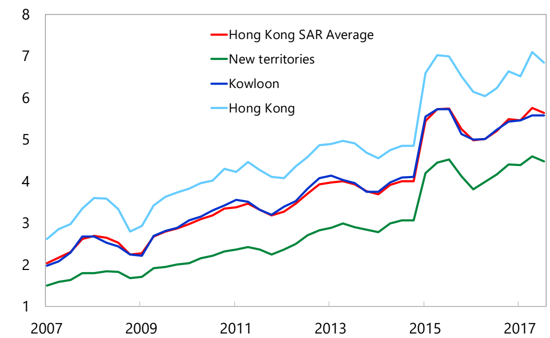
House Prices and Credit



… while affordability indicators continued to deteriorate

Minimum Down Payment-to-Income

(In multiple of median annual household disposable income, by area)

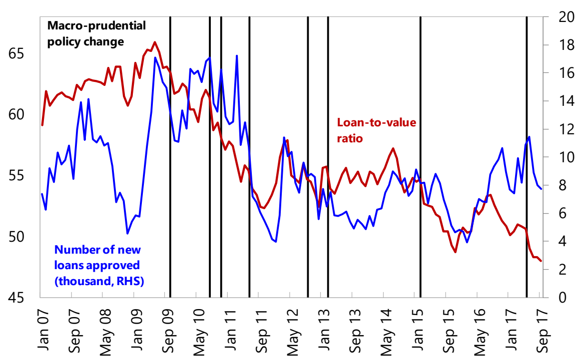


Note: For 45 sq.m. flat, assuming 70 percent LTV and 5 percent income tax rate.

Macroprudential measures helped lower average LTVs…

Loan-to-Value Ratio and New Loans Approved

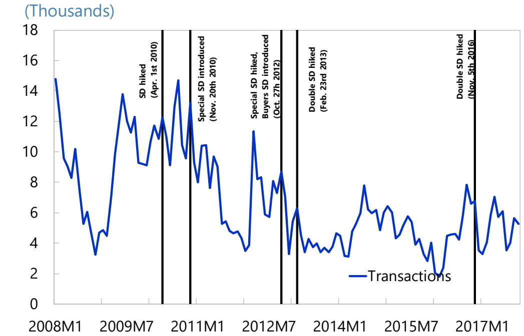
(In percent)



… while fiscal policy measures reduced transaction volumes

Residential Property Transactions

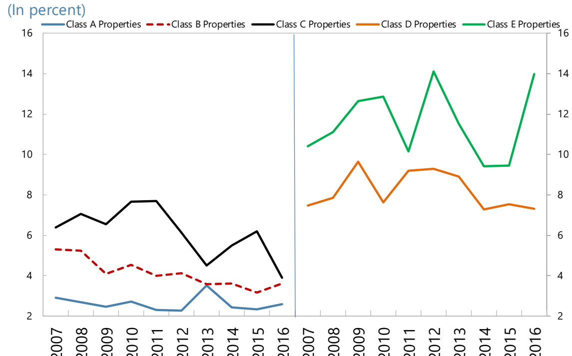
(Thousands)



Vacancy rates remain low, especially in the mass market…

Vacancy Rate

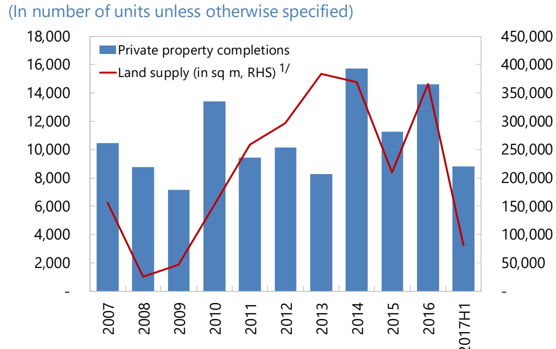
(In percent)



… while increasing housing supply remains a key priority

Private Property Completions

(In number of units unless otherwise specified)



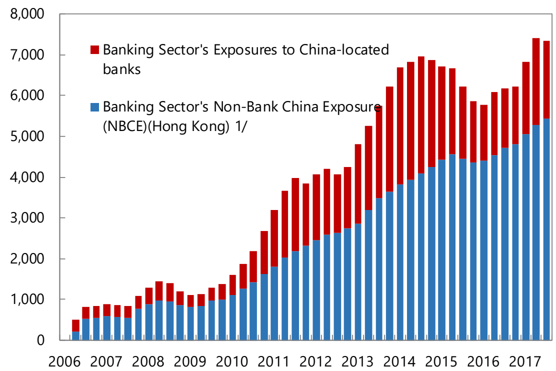
Note: 1/ Land supply refers to government land sale by auction/tender.

Sources: CEIC Data Company Ltd., HKMA, Haver Analytics, Transport and Housing Bureau, Government of Hong Kong SAR and IMF staff estimates.

Figure 4. Hong Kong SAR: Exposure to Mainland: Financial Channels

Hong Kong SAR banks' exposure to mainland banks and corporates rebounded.

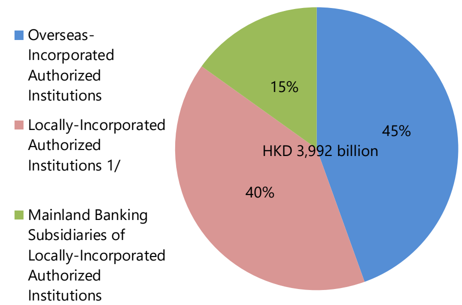
Exposure to China
(In billions of HKD)



Note: 1/ Non-Bank China exposure (NBCE) refers to the sum of Mainland-related lending and other non-bank exposure.

Local incorporated authorized institutions and their Mainland banking subsidiaries account for around 55 percent of the total Mainland-related lending.

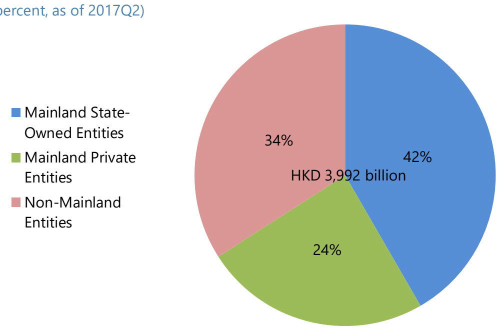
Mainland-related Lending
(In percent as of 2017Q2)



1/ Including loans booked in their Mainland branches

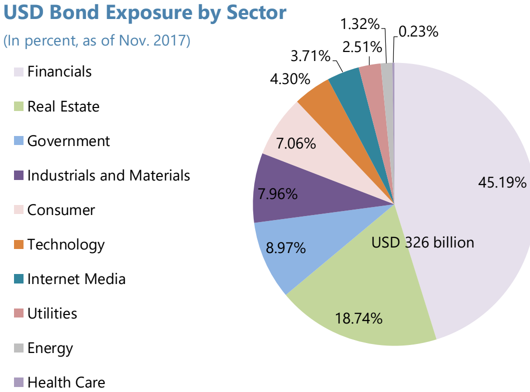
Lending is focused primarily on SOEs and non-Mainland entities with loans for use in Mainland China or subject to Mainland credit risk.

Mainland-related Lending
(In percent, as of 2017Q2)



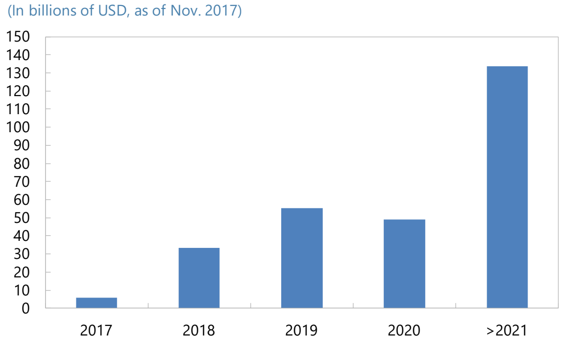
U.S. dollar securities issuance in Hong Kong SAR with ultimate risk domiciled in mainland China spans a range of sectors.

USD Bond Exposure by Sector
(In percent, as of Nov. 2017)



One half of these bonds mature in the next three years and may face rollover risk in a higher interest rate environment.

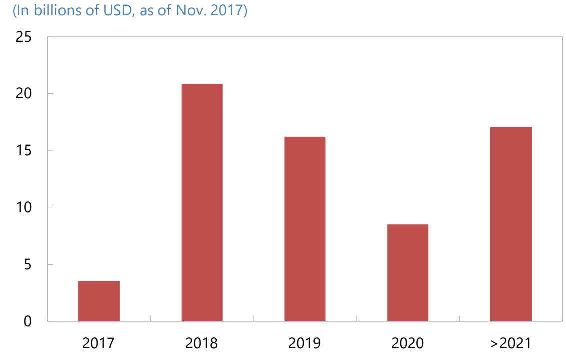
Maturity Profile of Offshore USD Bond 1/
(In billions of USD, as of Nov. 2017)



1/ All bonds issued by entities incorporated in Hong Kong SAR, Mainland China, and Cayman Islands with domicile of risk in Mainland China, excluding CDs.

The bulk of RMB bonds issued in Hong Kong SAR are also maturing in the next two years.

Maturity Profile of Dim Sum Bond 1/
(In billions of USD, as of Nov. 2017)



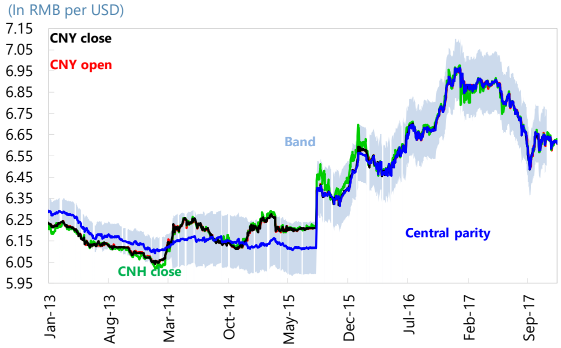
1/ All RMB bonds issued in Hong Kong SAR, excluding CDs.

Sources: Bloomberg, CEIC Data Company Ltd., HKMA, and IMF staff estimates.

Figure 5. Hong Kong SAR: Developments in the Offshore RMB Market

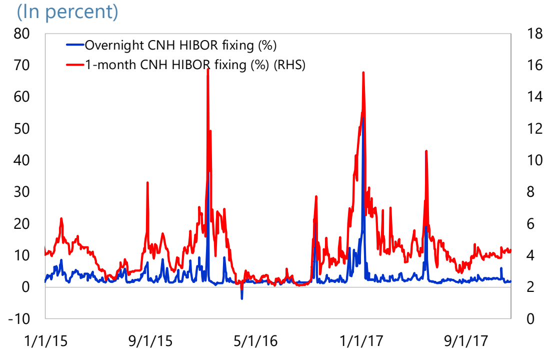
Expectations of RMB depreciation have abated, and ...

Exchange Rate
(In RMB per USD)



CNH interbank rates remained stable in recent months after spikes in June 2017.

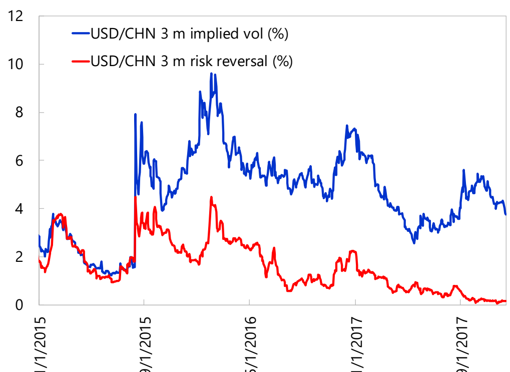
CNH Interbank Interest Rates
(In percent)



Sources: TMA; and Bloomberg.

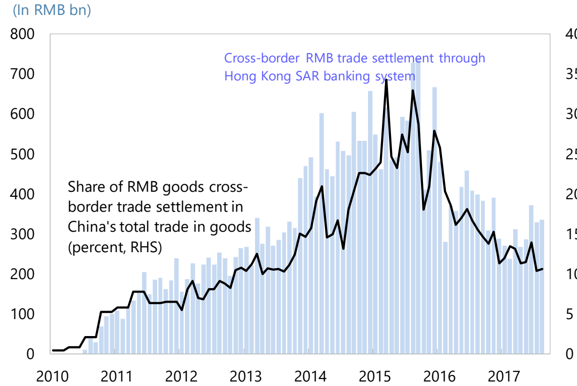
The implied volatility rose recently on the strengthening of the RMB while USD/CNH risk reversals remained low.

USD/CNH 3-month Implied Vol and Risk Reversal



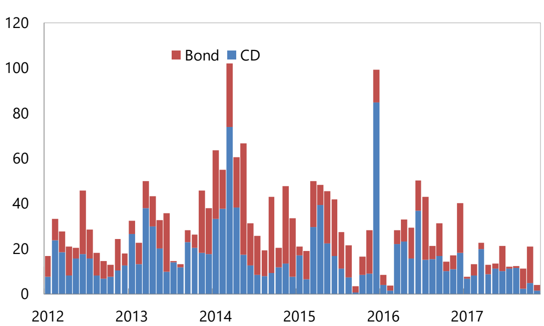
More balanced RMB exchange rate expectations contributed to the stabilization of trade settlement volumes..

Cross-Border RMB Trade Settlement
(In RMB bn)



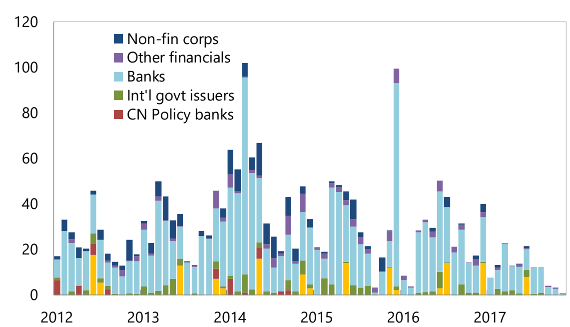
But, dim sum bond issuance has not recovered yet

Dim Sum Bonds: Gross Issuance
(In billions of RMB)



... with banks remaining dominated in the Dim Sum issuance in the form of certificates of deposits.

Dim Sum Bonds: Gross Issuance by Sector
(In billions of RMB)

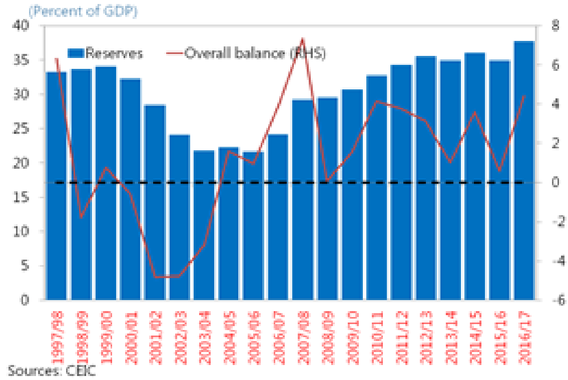


Sources: Bloomberg, CEIC Data Company Ltd., HKMA, and IMF staff estimates.

Figure 6. Hong Kong SAR: Fiscal Developments

Prudent fiscal policy has helped build large fiscal buffers…

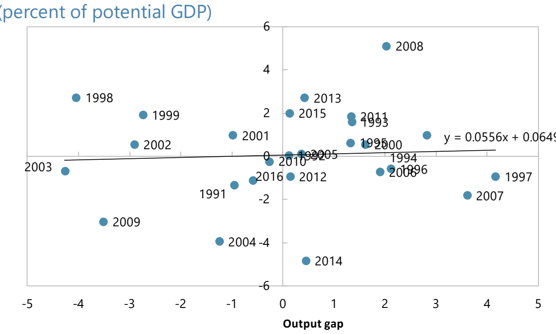
Fiscal reserves and overall balance
(Percent of GDP)



Sources: CEIC

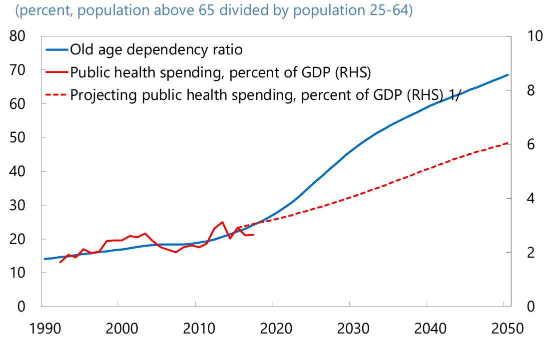
…But fiscal stance could have been more supportive.

Adjusted Impulse compared to univariate output gap
(percent of potential GDP)



In the longer-term, aging will create expenditure pressures…

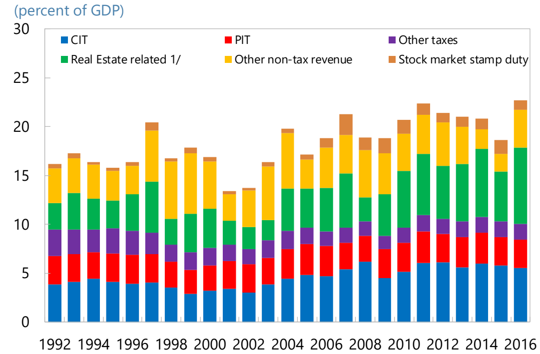
Old age dependency ratio and public health spending
(percent, population above 65 divided by population 25-64)



1/ Using IMF's Fiscal Affairs Department template for assessing the fiscal implications of demographic shifts.

…While revenues are volatile and dependent on the property market.

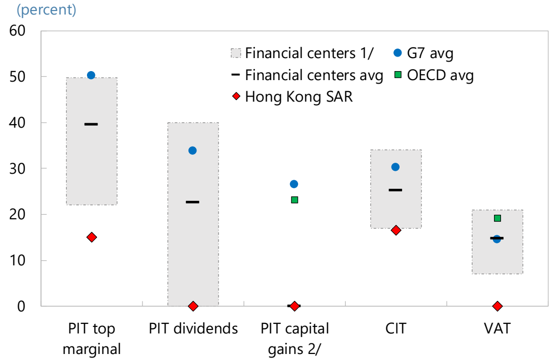
Revenue breakdown by main sources
(percent of GDP)



1/ Government rent revenues added since FY2001/2.

There is ample room to mobilize resources without hampering competitiveness.

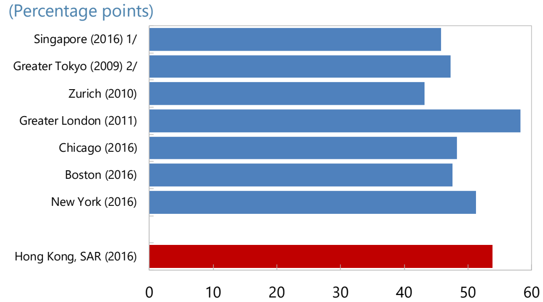
Comparing tax rates in 2016
(percent)



1/ Range for Belgium, Luxembourg, Netherlands, Singapore and Switzerland. 2/ 2015.

…And supporting a more inclusive society.

Cities with a Sizable Financial Industry Have High Market Gini Indices
(Percentage points)



Sources: U.S. Census, Statistics Singapore, HKSAR Census and Statistics Department, OECD.
1/ Not entirely comparable due to methodological differences.
2/ Southern Kanto region.

Sources: CEIC Data Company Ltd., UN, OECD, E&Y and Deloitte Tax Foundation, IRAS, Government of Hong Kong SAR and IMF staff estimates.

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 2012-22

						Proj.					
	2012	2013	2014	2015	2016	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$1, 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

Table 2. Hong Kong SAR: Balance of Payments, 2012-18 1/

	2012	2013	2014	2015	2016	Proj. 2017	Proj. 2018
	(In billions of U.S. dollars)						
Current account	4.1	4.2	4.1	10.3	14.9	10.2	10.8
Goods balance	-18.9	-27.9	-32.4	-22.9	-17.6	-23.5	-26.6
Services balance	21.9	29.6	33.0	30.3	24.4	29.5	33.2
Income balance	1.2	2.5	3.5	2.9	8.0	4.1	4.2
Primary income balance	3.8	5.2	6.0	5.7	10.8	7.0	7.3
Secondary income balance	-2.6	-2.7	-2.6	-2.9	-2.8	-2.9	-3.1
Capital and financial account	-8.7	-11.1	-9.5	-16.6	-15.8	-10.2	-10.8
Capital account	-0.2	-0.2	-0.1	0.0	0.0	0.0	0.0
Financial account	-8.5	-10.9	-9.4	-16.6	-15.8	-10.1	-10.8
Net direct investment	-13.2	-6.5	-11.1	102.5	45.7	61.3	67.6
Assets	-88.1	-83.3	-140.9	-78.5	-71.4	-63.2	-61.9
Liabilities	74.9	76.8	129.8	181.0	117.1	124.5	129.5
Portfolio investment	-4.1	-49.8	-8.3	-125.2	-41.9	-44.6	-46.4
Assets	-40.1	-66.3	-35.6	-85.3	-46.5	-49.5	-51.5
Liabilities	36.0	16.6	27.3	-39.9	4.6	3.5	2.4
Financial derivatives	2.0	7.0	15.3	12.8	3.7	4.1	4.4
Assets	39.7	54.8	57.9	72.8	91.4	101.0	110.0
Liabilities	-37.8	-47.7	-42.6	-60.0	-87.7	-89.2	-90.7
Other investment	31.2	45.7	12.6	29.7	-22.0	-23.0	-24.0
Assets	-17.1	-82.4	-119.3	36.8	-34.4	-35.8	-37.5
Liabilities	48.2	128.2	131.9	-7.0	12.3	12.8	13.5
Reserve assets (net change)	-24.3	-7.5	-17.9	-36.4	-1.1	-8.0	-12.4
Net errors and omissions	4.6	6.9	5.5	6.3	0.9	0.0	0.0
Memorandum item:							
Nominal GDP	262.6	275.7	291.4	309.4	320.9	341.2	354.9
	(In percent of GDP)						
Current account	1.6	1.5	1.4	3.3	4.6	3.0	3.1
Goods balance	-7.2	-10.1	-11.1	-7.4	-5.5	-6.9	-7.5
Services balance	8.3	10.7	11.3	9.8	7.6	8.7	9.3
Income balance	0.4	0.9	1.2	0.9	2.5	1.2	1.2
Capital and financial account	-3.3	-4.0	-3.3	-5.4	-4.9	-3.0	-3.0
Capital account	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Financial account	-3.3	-4.0	-3.2	-5.4	-4.9	-3.0	-3.0
Net direct investment	-5.0	-2.3	-3.8	33.1	14.2	18.0	19.0
Portfolio investment	-1.6	-18.1	-2.8	-40.5	-13.1	-13.1	-13.1
Financial derivatives	0.7	2.6	5.2	4.1	1.1	1.2	1.3
Other investment	11.9	16.6	4.3	9.6	-6.9	-6.7	-6.8
Reserve assets (net change)	-9.3	-2.7	-6.2	-11.8	-0.4	-2.3	-3.5
Net errors and omissions	1.7	2.5	1.9	2.0	0.3	0.0	0.0

Sources: CEIC and HKSAR Census and Statistics Department.

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

Table 3. Consolidated Government Account, 2012/13-2022/23 1/

(In percent of Fiscal Year GDP, unless otherwise stated)

					Prov.	Proj.					
	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Consolidated revenue	21.4	21.0	20.8	18.6	22.7	20.7	20.1	20.1	20.2	20.3	20.3
Operating revenue	16.7	16.4	17.2	15.8	16.3	15.2	16.2	16.3	16.4	16.4	16.4
Capital revenue	4.7	4.7	3.7	2.9	6.5	5.6	4.0	3.9	3.8	4.0	4.0
Taxes	13.6	13.3	15.4	14.3	13.7	14.4	14.1	14.2	14.3	14.4	14.4
Of which:											
Salaries tax	2.4	2.6	2.6	2.4	2.3	...	...	...	...	...	...
Profits tax	6.1	5.6	6.0	5.8	5.5	...	...	...	...	...	...
Stamp duties	2.1	1.9	3.3	2.6	2.4	...	...	...	...	...	...
Nontax	7.9	7.7	5.4	4.4	8.9	6.3	6.0	5.9	5.9	5.9	5.9
Of which:											
Land premium	3.4	3.9	3.4	2.5	5.1	4.9	3.5	3.4	3.4	3.4	3.4
Investment income	1.8	1.7	0.0	0.0	0.8	0.7	0.8	0.6	0.6	0.6	0.6
Consolidated expenditure	18.3	20.0	17.3	18.0	18.3	18.1	18.6	18.7	18.9	19.1	19.1
Operating expenditure	14.7	15.6	13.8	14.4	14.0	14.2	14.4	14.6	14.5	14.8	14.8
Of which:											
Personnel related (including pensions)	4.1	4.1	4.2	4.3	4.4	4.4	4.4	4.4	4.5	4.5	4.5
Capital expenditure	3.6	4.4	3.5	3.7	4.3	4.0	4.1	4.1	4.4	4.4	4.4
Of which:											
Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	3.1	1.0	3.2	0.6	4.4	2.6	1.5	1.4	1.3	1.2	1.2
Memorandum items:											
Operating balance 2/	2.0	0.8	3.4	1.4	2.3	1.1	1.8	1.7	1.9	1.6	1.6
Primary balance 3/	1.3	-0.7	3.2	0.6	3.6	1.9	0.7	0.7	0.7	0.6	0.6
Fiscal impulse 4/	-0.6	3.0	-4.7	2.2	-1.3	1.4	0.4	-0.3	0.0	0.2	-0.1
Fiscal reserves	35.6	34.9	36.1	34.9	37.7	37.9	38.1	38.0	37.8	37.3	36.8
(Months of spending)	23.3	20.9	25.1	23.2	24.8	25.1	24.6	24.3	24.0	23.4	23.1

Sources: CEIC; and IMF staff estimates.

1/ Using medium-range forecast as a starting point to make staff adjustments. Fiscal year begins April 1.

2/ Operating balance, as defined by the authorities, is akin to the current balance.

3/ Balance excluding investment income and interest expenditure.

4/ Change in structural primary balance adjusted for one-off factors, non-inflationary output and house price gaps. A positive corresponds to an expansionary fiscal stance.

Table 4. Hong Kong SAR: Monetary Survey, 2012-18

	2012	2013	2014	2015	2016	Proj. 2017	Proj. 2018
	(In billions of Hong Kong dollars)						
Net foreign assets	4447	4866	5064	4991	5293	5853	6388
Monetary authorities	2431	2582	2792	3051	3114	3553	3988
Banks	2016	2285	2272	1940	2179	2300	2400
Domestic credit	4097	4760	5333	5081	5246	5936	6227
Claims on private sector	4044	4665	5271	4986	5076	5751	6027
Claims on government	52	95	63	95	170	185	200
Other items (net)	406	431	614	1546	1969	1969	1969
M2	8950	10056	11011	11618	12508	13759	14584
Of which:							
Deposits in HKD 1/	4256	4481	4896	5416	5890	…	…
Deposits in foreign currencies 1/	4413	5261	5786	5853	6228	…	…
Notes and coins in circulation	282	314	330	349	390	…	…
	(Annual percentage change)						
Domestic credit	2.2	16.2	12.1	-4.7	3.2	13.2	4.9
Claims on private sector	3.3	15.3	13.0	-5.4	1.8	13.3	4.8
M2	11.1	12.4	9.5	5.5	7.7	10.0	6.0
	(Contribution to M2 growth, in percent)						
Net foreign assets	5.9	4.7	2.0	-0.7	2.6	4.5	3.9
Domestic credit	1.1	7.4	5.7	-2.3	1.4	5.5	2.1
Claims on private sector	1.6	6.9	6.0	-2.6	0.8	5.4	2.0
Claims on government	-0.5	0.5	-0.3	0.3	0.6	0.1	0.1
Other items (net)	4.1	0.3	1.8	8.5	3.6	0.0	0.0
	(In percent of GDP)						
Net foreign assets	218.3	227.6	224.1	208.1	212.5	220.1	231.3
Domestic credit	201.1	222.6	236.0	211.9	210.6	223.2	225.5
Other items (net)	19.9	20.1	27.2	64.5	79.0	74.1	71.3
M2	439.4	470.3	487.2	484.4	502.1	517.4	528.1

1/ Includes savings, time, demand, and negotiable certificates of deposits.

Table 5. Hong Kong SAR: Vulnerability Indicators, 2012-17

	2012	2013	2014	2015	2016	2017Q2
Banking sector						
Regulatory capital to risk-weighted assets	15.7	15.9	16.8	18.3	19.2	18.7
Regulatory tier 1 capital to risk-weighted assets	13.3	13.3	13.9	15.3	16.4	16.1
Nonperforming loans net of provisions to capital	1.4	1.5	1.3	1.9	2.0	1.9
Nonperforming loans to total gross loans	0.6	0.5	0.5	0.7	0.9	0.8
Sectoral distribution of total loans: residents	71.5	70.1	69.8	69.7	70.3	69.7
Sectoral distribution of total loans: other financial corporations	5.3	5.5	6.1	6.7	7.6	8.5
Sectoral distribution of total loans: nonfinancial corporations	59.4	57.9	56.9	55.9	55.7	54.5
Sectoral distribution of total loans: other domestic sectors	6.8	6.7	6.8	7.1	7.0	6.8
Sectoral distribution of total loans: nonresidents	28.5	29.9	30.2	30.3	29.7	30.3
Return on assets	0.9	1.1	1.0	1.0	1.1	1.0
Return on equity	15.5	14.4	13.1	13.2	16.0	13.1
Interest margin to gross income	48.0	46.7	51.2	46.5	42.6	49.0
Noninterest expenses to gross income	53.9	48.5	48.9	48.0	42.8	44.5
Liquid assets to total assets (liquid asset ratio)	23.8	21.6	22.3	21.5	21.6	19.1
Liquid assets to short-term liabilities 1/	47.0	44.9	47.0	164.3	180.8	165.2
Net open position in foreign exchange to capital	7.3	3.7	5.3	5.9	4.1	2.4
Public sector						
Fiscal surplus (in percent of fiscal year GDP)	3.1	1.0	3.2	0.6	4.4	…
Fiscal reserves (in percent of fiscal year GDP)	35.6	34.9	36.1	34.9	37.8	…
External sector						
Gross official reserves (in billions of U.S. dollar)	317.4	311.2	328.5	358.8	386.1	…
In percent of GDP	120.9	112.9	112.7	116.0	120.3	…
In months of retained imports	25.6	24.3	23.8	31.6	36.0	…
In percent of monetary base	202.0	192.2	189.3	174.6	183.2	…
In percent of broad money 2/	27.5	24.0	23.1	23.9	24.0	…
In percent of Hong Kong dollar M3	54.2	50.2	48.7	48.1	47.6	…
Short-term debt (in billions of U.S. dollar)	751.6	861.4	928.4	901.4	915.2	…
In percent of gross reserves	236.8	276.8	282.6	251.2	237.0	…
Financial sector						
Hang Seng index (percent change, end-year)	22.9	2.9	1.3	-7.2	0.4	…
House prices (percent change, end-year)	25.7	7.7	13.5	2.4	7.9	…

Sources: CEIC; Hong Kong SAR authorities; Bank for International Settlements; Bloomberg; IFS; and IMF staff estimates.

1/ Composition of liquid assets and short term liabilities changed in January 2015 after the implementation of a new liquidity regime in accordance with the Basel III framework.

2/ Broad Money refers to M2.

PEOPLE'S REPUBLIC OF CHINA—HONG KONG SAR

Appendix I. Risk Assessment Matrix 1/

Likelihood	Risk Assessment Matrix	Policy Response
	Upside	
	High	
Medium	**1. Steadfast implementation of reforms in Mainland China.** Fast progress on enacting structural reform (especially greater progress on resolving weak firms and converging to the cross-country efficiency frontier), together with a change in the composition of fiscal policy to support rebalancing toward consumption, would lift medium-term growth prospects in Mainland with large spillover benefits for Hong Kong SAR. Growth potential for Hong Kong SAR would improve through close trade and financial links.	Continue to undertake reforms and investment to enhance domestic competitiveness and upgrade public infrastructure which would provide an additional impetus to benefit from Mainland China's higher quality growth.
	Medium	
Medium	**2. Robust recovery of global economy.** The implementation of fiscal stimulus in the U.S. as well as a more durable recovery in the euro area, with buoyant market sentiment and reduced political risks, could drive stronger global growth.	Further build up buffers against various challenges ahead by taking advantage of the favorable growth outlook.
	Downside	
	High	
High	**1. Disorderly correction of house prices:** Higher global market volatility and financing costs resulting from resumed Fed tightening lead to an abrupt downturn in property prices. Falling collateral values and negative wealth effect trigger adverse feedback loop between economic activity, bank lending, household indebtedness, and housing market.	Adjust macro-prudential measures and provide targeted fiscal support. Continue to adopt policies to ease housing supply constraints by ensuring an adequate supply of land and public housing.
High	**2. Tighter global financial conditions.** Fed normalization and tapering by ECB increase global rates and term premia, strengthen the U.S. dollar and the euro vis-à-vis the other currencies, and correct market valuations. Adjustments could be disruptive if there are policy surprises. The associated volatility surge prompts globally-active institutions to reduce leverage, maturity transformation, and holdings of risky assets, resulting in a general tightening of global financing conditions, amplified by lower market liquidity.	Safeguard financial stability through macro-prudential measures and provide liquidity through existing facilities.
Medium	**3. Significant China slowdown and its spillovers.** Efforts to rein in financial sector risks, though desirable, expose vulnerabilities of indebted entities and reduce near-term growth. Over the medium term, overly ambitious growth targets lead to unsustainable policies, reducing fiscal space, and further increasing financial imbalances. Should a sharp adjustment occur, this would entail weak domestic demand, and reduce global growth.	Deploy temporary and targeted fiscal stimulus with emphasis on low-income and vulnerable households. Safeguard financial stability through macro-prudential measures and liquidity provision. Work closely with Mainland counterparts to facilitate an orderly resolution of distressed assets and address any weaknesses in bank balance sheets.
	Medium	
High	**4. Structurally weak growth in key advanced economies.** Low productivity growth (U.S., the Euro Area, and Japan), a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation (the Euro Area, and Japan) undermine medium-term growth in advanced economies.	Should domestic demand weaken substantially, temporary and targeted fiscal stimulus needs to be provided with continued efforts on medium-term structural reforms.

1/The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Appendix II. Debt Sustainability Analysis

Hong Kong SAR Public Sector DSA - Baseline Scenario

(In percent of GDP unless otherwise indicated)

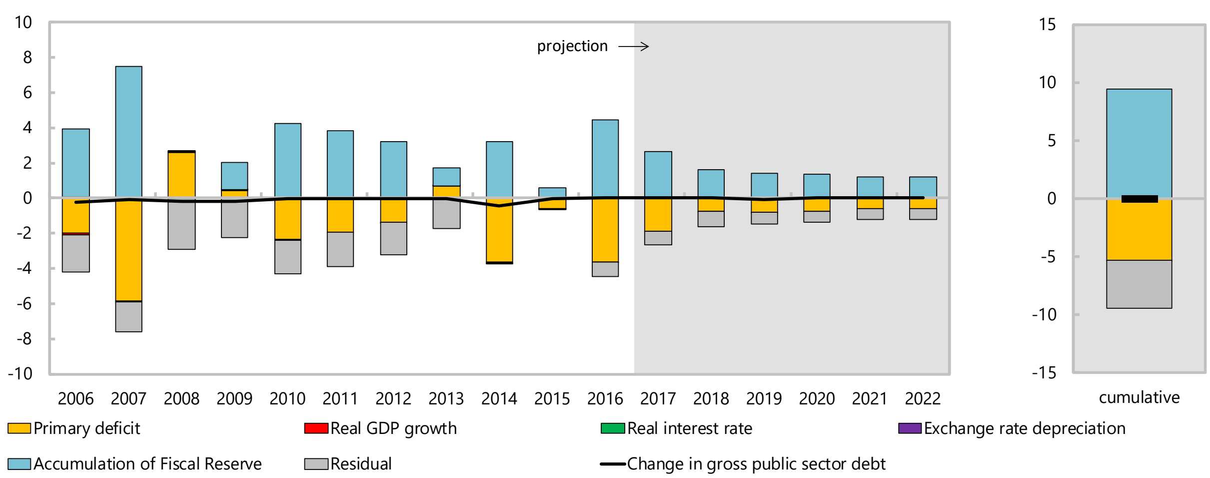
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	0.7	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Public gross financing needs	-3.1	-0.6	-4.5	-2.6	-1.6	-1.4	-1.3	-1.2	-1.2
Real GDP growth (in percent)	3.6	2.4	2.0	3.7	2.8	2.8	2.9	3.0	3.1
Inflation (GDP deflator, in percent)	1.8	3.6	1.8	3.0	1.0	1.1	1.0	1.3	1.5
Nominal GDP growth (in percent)	5.4	6.1	3.9	4.3	3.9	3.8	4.0	4.4	4.5
Effective interest rate (in percent) [4/]	4.5	5.2	5.1	5.1	5.1	5.1	n.a.	n.a.	n.a.

As of November 06, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		...
5Y CDS (bp)		32
Ratings	Foreign	Local
Moody's	Aa2	Aa2
S&Ps	AA+	AA+
Fitch	AA+	AA+

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	Cumulative	Debt-stabilizing Primary Balance [9/]
Primary deficit	-1.5	-0.6	-3.6	-1.9	-0.7	-0.8	-0.8	-0.6	-0.6	-5.3	1.2
Primary (noninterest) revenue and grants	19.0	18.8	22.2	20.7	20.0	20.2	20.4	20.5	20.5	122.4	
Primary (noninterest) expenditure	17.5	18.2	18.6	18.9	19.3	19.5	19.7	19.9	19.9	117.1	
Automatic debt dynamics [5/]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Interest rate/growth differential [6/]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Of which: real interest rate	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Of which: real GDP growth	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Residual, including asset changes [8/]	-1.8	0.0	-0.8	-0.8	-0.9	-0.7	-0.6	-0.6	-0.6	-4.1	
Change in gross public sector debt	-0.1	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	-0.1	
Change of fiscal reserves	3.2	0.6	4.5	2.6	1.6	1.4	1.3	1.2	1.2	9.4	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data. Public debt includes debt identified identified in the consolidated financial statement. It excludes debt issued through the bond fund.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

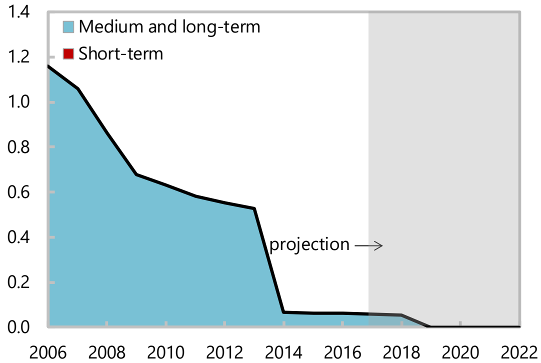
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

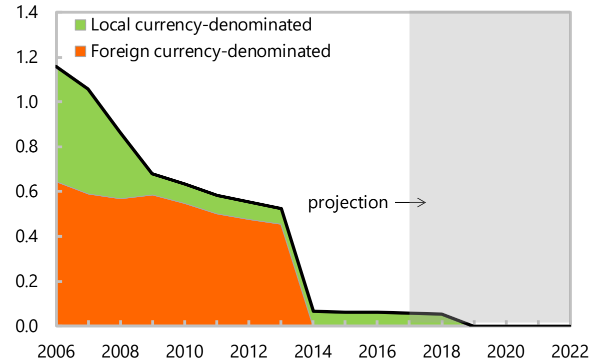
Hong Kong SAR Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(In percent of GDP)



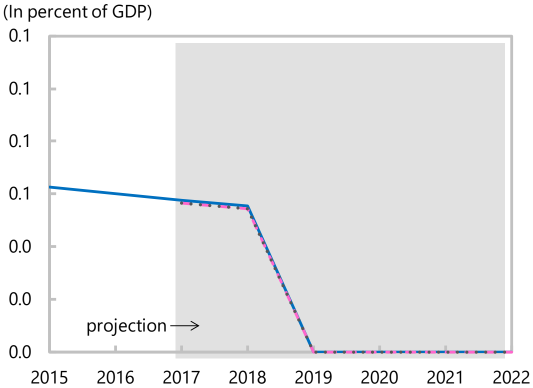
By Currency
(n percent of GDP)



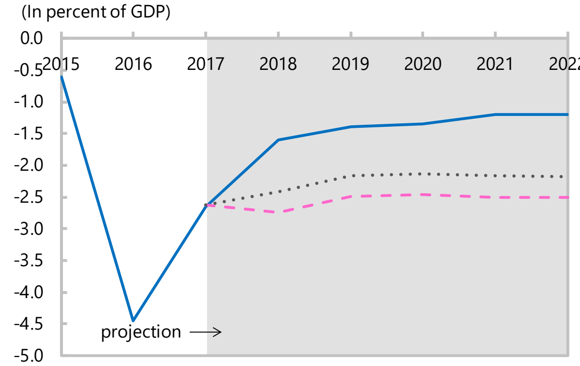
Alternative Scenarios

Baseline ⋯ Historical — — Constant Primary Balance

Gross Nominal Public Debt
(In percent of GDP)



Public Gross Financing Needs
(In percent of GDP)



Underlying Assumptions
(In percent)

Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.7	2.8	2.8	2.9	3.0	3.1
Inflation	3.0	1.0	1.1	1.0	1.3	1.5
Primary balance	1.9	0.7	0.8	0.8	0.6	0.6
Effective interest rate	5.1	5.1	5.1	n.a.	n.a.	n.a.
Constant Primary Balance Scenario						
Real GDP growth	3.7	2.8	2.8	2.9	3.0	3.1
Inflation	3.0	1.0	1.1	1.0	1.3	1.5
Primary balance	1.9	1.9	1.9	1.9	1.9	1.9
Effective interest rate	5.1	5.1	5.1	n.a.	n.a.	n.a.

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.7	3.0	3.0	3.0	3.0	3.0
Inflation	3.0	1.0	1.1	1.0	1.3	1.5
Primary balance	1.9	1.6	1.6	1.6	1.6	1.6
Effective interest rate	5.1	5.1	5.1	n.a.	n.a.	n.a.

Source: IMF staff.

Appendix III. Summary of Property Market Measures Introduced Since 2009

Date	Price Range	LTV CAP	Max Loan Amount	Other
Oct 2009	Greater than or equal to HK$20mn	60 percent (previously 70 percent)		
	Less than HK$20mn	Remains 70 percent	HK$12mn	
Aug 2010	Greater than or equal to HK$12mn	60 percent (previously 70 percent for properties valued between HK$12mn and HK$20mn)		Debt-service-to-income ratio (DSR) capped at 50 percent for all income groups; previously was 60 percent for high income groups; also must be set such that were mortgage rates to go up by 2 percentage points, the stressed DSR would not exceed 60 percent
	Less than HK$12mn	Remains 70 percent	HK$7.2mn	
	Not owner-occupied, any price range	60 percent (previously 70 percent)		
Nov 2010	Greater than or equal to HK$12mn	50 percent (previously 60 percent)		Special Stamp Duty set at 15 percent for residential properties resold within first 6 months of purchase, 10 percent if resold between 6 and 12 months, 5 percent if resold between 12 and 24 months
	Greater than or equal to HK$8mn and less than HK$12mn	60 percent (previously 70 percent)	HK$6mn	
				LTV cap for industrial and commercial properties mortgage loans at 50 percent
	Less than HK$8mn	Remains at 70 percent	HK$4.8mn	
	Not owner-occupied, any price range	50 percent (previously 60 percent)		
June 2011	Greater than or equal to HK$10mn	50 percent		LTV cap lowered by further 10 percentage points for borrowers with main income from outside Hong Kong SAR; LTV cap for net-worth based mortgage loans lowered from 50 percent to 40 percent, irrespective of property value
	Greater than or equal to HK$7mn and less than HK$10mn	60 percent (previously 70 percent for properties valued between HK$7mn and HK$8mn)	HK$5mn	
	Less than HK$7mn	Remains at 70 percent	HK$4.2mn	

Date	Price Range	LTV CAP	Max Loan Amount	Other
Sep 2012	Greater than or equal to HK$10mn	Remains at 50 percent		For borrowers with multiple properties under mortgages, (i) LTV cap lowered by further 20 percentage points for borrowers with main income from outside Hong Kong SAR; (ii) LTV cap for net-worth based mortgage loans lowered from 40 percent to 30 percent, irrespective of property value
	Greater than or equal to HK$7mn and less than HK$10mn	Remains at 60 percent	HK$5mn	
	Less than HK$7mn	Remains at 70 percent	HK$4.2mn	DSR ratio capped at 40 percent for all income groups; previously was 50 percent; also must be set such that were mortgage rates to go up by 2 percentage points, the DSR would not exceed 50 percent; previously was 60 percent; mortgage applicants without outstanding mortgages were not subject to the DSR limits reduction
	Not owner-occupied, any price range	Remains at 50 percent		
				Maximum tenor of all new property mortgage loans capped at 30 years
Oct 2012				Buyer's Stamp Duty set at 15percent for all residential property transactions except Hong Kong SAR permanent resident
				Special Stamp Duty raised to 20 percent for residential properties resold within first six months of purchase, 15 percent if resold between 6 and 12 months, 10 percent if resold between 12 and 36 months

Date	Price Range	LTV CAP	Max Loan Amount	Other
Feb 2013	Greater than or equal to HK$10mn	Remains at 50 percent		LTV cap for standalone car park spaces set at 40 percent with maximum tenor at 15 years; LTV cap for industrial and commercial properties mortgage loans at 40 percent; previous was 50 percent
	Greater than or equal to HK$7mn and less than HK$10mn	Remains at 60 percent	HK$5mn	
	Less than HK$7mn	Remains at 70 percent	HK$4.2mn	DSR ratio capped at 40 percent for all income groups; the stressed DSR would not exceed 50 percent were mortgage rates to go up by 3 percentage points; previously was by 2 percentage points; mortgage applicants without outstanding mortgage were not subject to the DSR limits reduction
	Not owner-occupied, any price range	Remains at 50 percent		Risk weight floor of 15 percent introduced on new residential mortgages for banks using IRB approach Ad valorem Stamp Duty raised to 1.5 percent to 8.5 percent except first-time buyers and replacement of one-home owner

Date	Price Range	LTV CAP	Max Loan Amount	Other
Feb 2015	Greater than or equal to HK$10mn	Remains at 50 percent		DSR ratio capped at 40 percent for all income groups, irrespective of loan purpose; the stressed DSR would not exceed 50 percent were mortgage rates to go up by 3 percentage points; self-occupied or replacement and without outstanding mortgage were exempted
	Greater than or equal to HK$7mn and less than HK$10mn	Remains at 60 percent	HK$5mn	
	Less than HK$7mn	60 percent (previously 70 percent)	HK$4.2mn	
	Not owner-occupied, any price range	Remains at 50 percent		Risk weight floor of 15 percent introduced on all new and existing residential mortgages for banks using IRB approach by Jun 2016; 10 percent for existing mortgage by Jun 2015; previously risk weight only introduced on new mortgages
Nov 2016				Ad valorem Stamp Duty on residential properties raised the DSD rates to a flat 15 percent (also known as the NRSD) except first-time buyers and replacement of one-home owner
Apr 2017				Ad valorem Stamp Duty applied to purchases of multiple new homes under single instrument

Date	Price Range	LTV CAP	Max Loan Amount	Other
May 2017	Greater than or equal to HK$10mn	Remains at 50 percent		LTV cap lowered by 10 percent for borrowers with one or more pre-existing mortgages.
	Greater than or equal to HK$7mn and less than HK$10mn	Remains at 60 percent	HK$5mn	For self-occupied or without outstanding mortgage, DSR ratio capped at 50 percent for all income groups, irrespective of loan purpose; the stressed DSR would not exceed 60 percent were mortgage rates to go up by 3 percentage points;
	Less than HK$7mn	Remains at 60 percent	HK$4.2mn	
	Not owner-occupied, any price range	Remains at 50 percent		DSR ratio caps lowered by 10 percent for pre-existing mortgages or non-self-occupied.
				DSR ratio caps lowered by 10 percent for borrowers whose income is mainly derived from outside Hong Kong SAR.
				Risk weight floor of 25 percent (previously 15 percent) for all new residential mortgages and 15 percent for all existing residential mortgages for banks using IRB approach

Appendix IV. External Sector Assessment

	Hong Kong SAR	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) reached around 368 percent of GDP as of end-2016, up from 291 percent in 2010. Both external financial assets (about 1,425 percent of GDP) and liabilities (about 1,057 percent of GDP) are high, reflecting Hong Kong SAR's status as a major international financial center. Given the large gross assets and liabilities, annual fluctuations in the NIIP due to valuation changes have been sizable and positive. The NIIP to GDP ratio is projected to decline moderately, chiefly driven by the interest-growth differential—as nominal GDP is expected to grow faster than the effective returns on the NIIP. **Assessment**. Vulnerabilities are low given the size of NIIP and its favorable composition, with large and stable stock of reserve assets as a share of total assets, and direct investment accounting for a large and rising share of total assets and liabilities (37.6 and 52.6, respectively in 2016).	**Overall Assessment** *The external position in 2016 was broadly consistent with medium-term fundamentals and desirable policy settings.* Developments through November 2017 do not suggest a change in this assessment. The current account surplus has declined relative to its pre-2010 level on account of structural factors, including opening of the Mainland capital account and changes in offshore merchandise trade activities. As a result of Hong Kong SAR's Linked Exchange Rate System (LERS), short-term movements in the REER largely reflect U.S. dollar developments. After appreciating through much of 2016, the REER peaked in Dec-2016 and has weakened further after May-2017 following the broad movements of the USD. Hong Kong SAR continues to rely on flexible goods, factor, and asset markets to avoid major currency misalignments. 3/ **Potential Policy Responses** Macroeconomic policies are broadly appropriate. Maintaining policies that support wage and price flexibility is crucial particularly as the tightening cycle of U.S. monetary policy continues although risks of a destabilizing dollar appreciation have receded. Robust and proactive financial supervision and regulation, prudent fiscal management, flexible markets, and the Linked Exchange Rate System have worked well to keep the external position broadly in balance. Continuation of these policies, therefore, will help keep the external position broadly in line with medium-term fundamentals.
Current account	**Background**. The current account (CA) surplus increased to 4.6 percent of GDP in 2016 (2.5 percent of GDP after cyclical adjustment), although it continues to be substantially lower than the pre-GFC average (around 10 percent in 2000-08). From a sectoral perspective, the gradual decline of private saving (from the peak of 34.4 percent of GDP in 2006 to 24.6 percent of GDP in 2014 and 2015), driven by robust consumption growth, tight labor market and wealth effects related to strength in the housing market, accounted for most of the drop in the CA surplus. The higher CA surplus in 2016, reflects favorable terms of trade shock from lower commodity prices (1 percent of GDP) and a temporary surge in the primary income balance (contributing 1 percent of GDP to the cyclical adjustment). The CA surplus is projected to be 3.0 percent of GDP in 2017. In 2017:H1, the current account narrowed to 2.7 percent of GDP. **Assessment**. The CA is broadly consistent with medium-term fundamentals and desirable policies. Staff's quantitative assessment finds that the cyclically-adjusted CA is roughly in the mid-point of the CA norm range of 1 to 4 percent of GDP. The CA gap is hence in a range of -1½ to 1½ percent of GDP. The large decline of the CA surplus (relative to pre-2010) is mainly driven by structural changes related to weaker growth and rebalancing in mainland China as well as the opening of the Mainland capital account. Such changes are not fully reflected in the EBA implied norm. 1/	
Real exchange rate	**Background**. The REER appreciated by about 5 percent in 2016, relative to the average REER in 2015. The REER appreciation was mainly driven by the HKD/USD peg and the higher inflation in Hong Kong SAR relative to most other advanced economies. However, the appreciation trend has reversed particularly since May, and by November the REER was about 1.4 percent weaker than its 2016 average, broadly tracking USD movements. The current REER level is broadly the same as the level in 2004-2005 (when the current account surplus of Hong Kong SAR was above 10 percent of GDP). **Assessment**. The real exchange rate is broadly consistent with medium-term fundamentals and desirable policies. Based on elasticity estimates for similar economies and factoring in the uncertainties and variability of an offshore trading and financial center, the exchange rate is assessed by staff to be from -5 to +5 percent different from the level consistent with medium-term fundamentals and desirable policies.	
Capital and financial accounts: flows and policy measures	**Background**. As a financial center, Hong Kong SAR has had a fully open capital account without capital controls. In the past few years, stamp duties on housing market transactions were introduced to curb excessive valuations. Staff assesses the buyer's and double ad-valorem stamp duties to be capital flow measures (CFM) as well as macroprudential measures. Non-reserve financial flows moved from sizeable inflows in 2015 to net outflows in 2016:H2, back to inflows in 2017:Q1. The financial account is typically very volatile both in terms of portfolio and direct investment. 2016 serves as an illustration, with portfolio investment shifting from large inflows in the first half of the year to large outflows in Q3. Direct investment saw almost the reverse pattern with inflows intensifying through the third quarter. These large movements are likely associated with both financial volatility in the Mainland, transmitted through growing cross-border financial linkages 2/ as well as shifting expectations of a U.S. policy rate hike. **Assessment**. Large financial resources and proactive financial supervision and regulation limit the risks from potentially volatile capital flows. The greater financial exposure to mainland China could pose risks to the banking sector if mainland growth slows sharply and financial stress emerges in some key sectors, such as export-oriented manufacturing or real estate. However, given the high origination and underwriting standards that Hong Kong SAR banks have maintained, the credit risk appears manageable. Staff recommends the gradual replacement of stamp duties assessed to be CFMs/MPMs with alternative non-discriminatory measures once systemic risks from the housing market dissipate.	
FX intervention and reserves level	**Background**. Hong Kong SAR has a currency board arrangement. International reserves have been built up in a nondiscretionary way as a result of a long-standing commitment to the Linked Exchange Rate System. The stock of reserves in end-2016 was equivalent to around 120 percent of 2016 GDP and has since grown 8.5 percent by October 2017. **Assessment**. Currently, reserves are adequate for precautionary purposes and should continue to evolve in line with the automatic adjustment inherent in the currency board system. Hong Kong SAR also holds significant fiscal reserves built up through a track record of strong fiscal discipline.	

	Hong Kong SAR (continued)
Technical Background Notes	1/ Hong Kong SAR is not in the EBA sample as it is an outlier along many dimensions of EBA analysis, thus one possibility with obvious drawbacks is to use EBA estimated coefficients and applying them to Hong Kong SAR. Following that approach, the cyclically-adjusted CA is estimated to be about 10 percent of GDP weaker than that consistent with fundamentals and desirable policies. The CA gap was mainly driven by EBA regression residual (about 12 percent of GDP) with the policy gap at around 2 percent of GDP. The large residual likely reflects a combination of structural factors which are relevant for Hong Kong SAR but are not captured by EBA. Two structural factors appear to account for some of the difference: (i) the structural decline in the transport services balance tied to a reduction of re-exporting activity from and to China; and (ii) the structural reversal of Hong Kong SAR's gold trade balance tied to the opening of the Precious Metals Depository. Two additional EBA-specific factors are also of note. First, EBA's adjustment for financial centers (which contributes 2.7 percent of GDP to the norm) should not be applied to HKSAR since the CA likely underestimates (rather than overstates) actual changes in net wealth. Second, EBA's coefficient for NFA to GDP captures average income effects across countries, while in fact Hong Kong SAR has had a systematically lower income balance relative to its NFA compared to other economies. Adjusting for all of these factors, staff estimate that the CA gap is close to zero, corresponding to a norm in the range of 1 to 4 percent of GDP. See SIP in the 2016 AIV staff report for more details. 2/ The financial linkages with the Mainland have deepened in recent years with the increase in cross-border bank lending, securities issuance in Hong Kong SAR by mainland entities and the internationalization of the RMB. As of 2017: Q3, banking system claims, including those of foreign banks, on mainland nonbank entities amounted to HK$5.4 trillion, or about 219 percent of 2016 GDP, up by 30 percentage points from a year earlier. 3/ See SIP in the 2016 AIV staff report and IMF WP17/09.

Appendix V. FSAP Recommendations

Area	Recommendation	Progress
Crisis management and resolution	Establish a fully comprehensive framework for recovery and resolution, in line with emerging international best practices; and Establish recovery and resolution plans for all systemic financial institutions, including financial market infrastructures ("FMIs").	**Framework for recovery and resolution** **Implemented** • The Financial Institutions (Resolution) Ordinance ("FIRO") was enacted by the Legislative Council in June 2016 and came into effect on 7 July 2017, with the exception of certain non-core provisions in relation to clawback of remuneration, winding up petition process, etc. which will commence operation pending the making of the relevant rules. The FIRO provides the statutory backing for a cross-sector resolution regime in Hong Kong SAR that is designed to meet the standards set by the Financial Stability Board ("FSB")'s Key Attributes of Effective Resolution Regimes for Financial Institutions. • The cross-sector regime applies to all banks (authorized institutions ("AIs")), certain securities firms, insurers and financial market infrastructures, holding companies and non-regulated operating entities of within scope financial institutions ("FIs"), and extends to branches of foreign FIs. The Monetary Authority ("MA"), the Securities and Futures Commission ("SFC") and the Insurance Authority are established as resolution authorities under the FIRO with responsibility for the planning for and execution of resolution in respect of those within scope FIs operating under their respective purviews (e.g. the MA is the resolution authority for AIs). The MA has also been designated by the Financial Secretary under the FIRO on 7 July 2017 as the lead resolution authority for 25 cross-sectoral G-SIB groups which include both banking sector entities and securities and futures sector entities. • Further necessary work is underway to make the FIRO regime operational. As part of this work, within the HKMA, a Resolution Office was established on 1 April 2017 with dedicated resources and governance and is working to ensure the Hong Kong SAR resolution regime is operational for banks. Its priorities are to establish resolution policy standards for banks, define resolution strategies and conduct resolvability assessments of banks, work with banks to remove impediments to their orderly resolution, and develop the HKMA's operational capability necessary to execute orderly resolution such as developing operational mechanics to implement transfer and bail-in stabilization options. • On resolution policy, the Resolution Office issued three FIRO Code of Practice Chapters in July 2017 providing guidance on MA functions under FIRO, namely (i) the HKMA's approach to resolution planning for AIs; (ii) resolution planning core information requirements for AIs; and (iii) operational independence of the MA as resolution authority. Forward priorities include the development of key regulations to be made under the FIRO to remove barriers to resolvability such as loss absorbing capacity requirement rules and stay regulations for AIs. • On resolution planning, the Resolution Office continues to advance the resolution planning for G-SIBs that have a higher potential systemic impact on failure via local bilateral programmes with the AIs and cross-border cooperation via Crisis Management Groups. In light of the commencement of the FIRO, the Resolution Office rolled

Area	Recommendation	Progress
		out resolution planning for all D-SIBs formally by requesting submission of core information by Q1 2018. • On the development of the HKMA's operational capability, the Resolution Office is working to strengthen operational readiness for executing resolution transactions, including by establishing and enhancing cross-border arrangements for cooperation in resolution with non-Hong Kong SAR authorities and the practical operation of the resolution tools under the FIRO. On the latter, the Resolution Office is refining the MA's crisis management framework to reflect the establishment of the FIRO and related internal coordination arrangements, including by establishing a "Watchlist Framework" for communicating AIs' proximity to failure and developing internal resolution planning handbook for AIs.
		Recovery planning for banks
		Implemented • The supervisory recovery planning framework for AIs is established in the HKMA's Supervisory Policy Manual module on Recovery Planning (RE-1), which was issued in June 2014. Recovery plans for all key locally incorporated AIs in Hong Kong SAR, including the five domestic systemically important banks, have been submitted to the HKMA ("first two waves"). • All the remaining AIs that were not in the first two waves have been requested to submit their recovery plans to the HKMA within 2018. To assist with the implementation of recovery plans for the remaining AIs, the HKMA has issued further guidance for overseas incorporated AIs with branch operations in Hong Kong SAR and smaller locally-incorporated AIs, in the form of a circular in July 2017. • Further to industry consultation with positive feedback on its proposals, the Government is in the process of amending the Banking Ordinance to incorporate new requirements relating to the maintenance, submission, revision and implementation of recovery plans. This will create a more explicit legal basis for recovery planning for AIs in Hong Kong SAR, primarily to achieve greater certainty and transparency.
		FMIs under the purview of SFC
		• All four existing recognised clearing houses ("RCH") of Hong Kong Exchanges and Clearing Limited ("HKEX") namely, Hong Kong Securities Clearing Company Limited ("HKSCC"), HKFE Clearing Corporation Limited ("HKCC"), The SEHK Options Clearing House Limited ("SEOCH"), and OTC Clearing Hong Kong Limited ("OTC Clear") have each submitted a recovery plan based on their respective existing rules. The RCHs, working in consultation with the SFC, have enhanced their existing recovery plans taking into account the latest guidance on development of recovery plans for FMIs; and the report on "Resilience and recovery of central counterparties ("CCPs"): Further guidance on the Principles for Financial Market Infrastructures ("PFMI")" jointly published by the Committee on Payments and Market Infrastructures and the International Organisation of Securities Commissions. The revised recovery plans of the RCHs are being finalised. • The SFC has commenced discussion internally on the resolution planning for the four RCHs and is considering possible resolution strategies for different scenarios.

Area	Recommendation	Progress
		FMIs under the purview of HKMA
		Implemented • For FMIs under the purview of the HKMA, the requirement to establish a comprehensive framework for recovery and resolution only applies to the settlement institution and system operator of the three foreign-currency Real Time Gross Settlement systems, namely the US Dollar Clearing House Automated Transfer System ("CHATS"), Euro CHATS and renminbi CHATS. • Each of the parties mentioned above has developed its own recovery plan based on PFMI requirements. The recovery plans are updated annually and approved by the respective Boards of the parties concerned.
		• Other FMIs under the purview of the HKMA, namely the Hong Kong Dollar CHATS, the Central Moneymarkets Unit ("CMU"), and the Hong Kong Trade Repository, are FMIs owned and operated by the HKMA. According to a note issued by CPMI-IOSCO on application of the PFMI to central bank FMIs, the requirement to develop a recovery and resolution plan does not apply to central bank-operated FMIs.
		On Track • FSB issued the 'Guidance on Continuity of Access to Financial Market Infrastructures (FMIs) for a Firm in Resolution' on 6 July 2017. The Guidance is also applicable to FMIs. The HKMA is working with the applicable FMIs to ensure that they continue to meet the relevant FSB requirements.
Insurance sector	The authorities should ensure implementation of the independent Insurance Authority ("IIA") as scheduled in 2015.	**Implemented** • The Insurance Authority ("IA"), a statutory body established by the Insurance Ordinance, is a new insurance regulator independent of the Government. It replaced the Office of the Commissioner of Insurance to regulate insurance companies with effect from 26 June, 2017.
	In addition, the legal and regulatory framework should be strengthened	**Implemented** • Enhancements made to the legal and regulatory framework have been in operation since 26 June 2017. These include (i) the requirement to seek IA's approval for appointment is extended beyond controllers, to include directors, key persons in control functions, and appointed actuaries by authorized insurers; (ii) the provision of the definitions of control functions, such as risk management, financial control, compliance, internal audit, actuarial, and intermediary management functions, in the Insurance Ordinance; and (iii) the power of the IA to revoke the appointment of senior management and key persons on fit and proper grounds. Shareholder controllers of authorized insurers, on the other hand, are required under the Insurance Ordinance to report their disposals of shareholding interests in the insurers to the IA as well. • Risk management requirements on insurers as set out in related guidelines are also updated. Insurers are now required under the Guideline on the Corporate Governance of Authorized Insurers (GL10) to have, among others, business continuity planning which covers detailed actions and procedures, including contingency plan,

Area	Recommendation	Progress
		identification of critical business activities, roles and responsibilities of different parties, etc.
	(i) establish a regulatory regime for insurance groups	**On Track** • Apart from the current role of IA in (i) leading the supervisory college of a Hong Kong SAR-incorporated insurance group; (ii) co-leading a regional supervisory college of a Global Systemically Important Insurer with the home regulator; and (iii) actively participating in supervisory colleges of other insurance groups, IA has proposed a regulatory regime for insurance groups and subgroups in the context of developing a risk-based capital ("RBC") regime (see below).
	(ii) implement an RBC regime and	**On Track** • A consultation on the proposed RBC framework was conducted in Q3 2015. Depending on the structure and size of insurance groups, a three-tier approach for supervisory measures for group-wide supervision was proposed. • After taking into account feedback from stakeholders, IA has started Phase 2 of the development of the RBC regime on the development of detailed rules for quantitative requirements (i.e., Pillar 1 requirements under the RBC framework). The IA commissioned a consultancy study to formulate detailed rules for conducting the quantitative impact studies ("QIS"). Four Industry Focus Groups comprising representatives from the industry have been established to discuss technical issues identified. The IA launched the first QIS on 28 July 2017, which seeks to obtain sufficient and appropriate data on quantitative and qualitative impact on insurers. The IA expects receiving data from the insurers on or before 1 December, 2017. It is anticipated that at least two more rounds of QIS would be required. Detailed rules will be drafted and consultation on detailed rules will be conducted after the QIS. • The implementation of the RBC regime will be rolled out in phases. Subject to further consultation with stakeholders, legislative amendments will be introduced. The whole process is expected to take about two to three years from now. • As regards the qualitative and disclosure requirements (i.e., Pillars 2 and 3 requirements under the RBC framework), IA is reviewing the relevant guidelines and drafting the guidelines ahead of the legislative process for Pillar 1. The draft guidelines cover the Pillar 2 requirements relating to enterprise risk management and own risk and solvency assessment. Pillar 2 requirements on groups or subgroups would form part of the draft guidelines. It aims to launch consultation on the draft guidelines by the end of 2017 or early 2018.
	(iii) strengthen supervision of intermediaries.	**On Track** • The Insurance Companies (Amendment) Ordinance 2015 ("Amendment Ordinance") provides for the establishment of a statutory licensing regime for insurance intermediaries and provides IA with express powers to conduct inspection, initiate investigation, and impose a range of disciplinary sanctions (including revocation of licence, issuance of reprimand and imposition of pecuniary penalty of up to HK$10 million) on licensed insurance intermediaries. The broad principles of conduct requirements on the part of a licensed insurance intermediary are stipulated in the Amendment Ordinance.

Area	Recommendation	Progress
		IA is also empowered to make rules for insurance intermediaries to comply with practices and standards relating to conduct requirements, and issue codes or guidelines to facilitate their compliance with the conduct requirements.It is expected that the IA will take over the regulation of insurance intermediaries from the three Self-Regulatory Organizations ("SROs"), and implement a new statutory regulatory and licensing regime within two years. The three SROs are the Insurance Agents Registration Board established under The Hong Kong Federation of Insurers, The Hong Kong Confederation of Insurance Brokers and Professional Insurance Brokers Association. • As regards the conduct of business requirements for insurers, the IA has issued two guidelines for insurers on the underwriting of unit-linked policies and life insurance policies respectively, which are based on Insurance Core Principle 19 on Conduct of Business promulgated by the International Association of Insurance Supervisors. Both guidelines adopt a "cradle-to-grave" approach by requiring insurers to meet regulatory requirements on product design, disclosure of key product features, suitability assessment as well as sales and post-sale control measures to ensure that the products being recommended to clients do suit their needs.
Securities market	Strengthen the oversight regime of the Hong Kong Exchanges and Clearing Limited ("HKEX").	**On Track** • The SFC enhanced its supervisory approach in early 2014 following the announcement by HKEX in 2013 of its strategic plan which would change its business model as it expands into new markets, asset classes and infrastructures. Supervision focused on HKEX's capability to adequately identify, assess, and manage conflicts, business and regulatory compliance risks across the markets in which HKEX operates, and on conducting on-site inspections of the non-listing operations of HKEX. In this regard – (i) The SFC has imposed a gearing ratio requirement and financial resources requirement on HKEX and its subsidiary recognised exchanges ("REC") and recognised clearing houses ("RCH"). The financial resources requirement for RCH was first introduced in the fourth quarter of 2013, when OTC Clear was recognised as an RCH. This was followed by the other three recognised clearing houses in 2014: Hong Kong Securities Clearing Company Limited ("HKSCC"), HKFE Clearing Corporation Limited ("HKFE"), and the SEHK Options Clearing House Limited ("SEOCH"). HKEX and its subsidiary exchanges and clearing houses have fully complied with the requirements. (ii) HKEX agrees on the need to strengthen its compliance function. A Regulatory Compliance Department has been established and is implementing a compliance monitoring programme. (iii) The SFC has put in place a programme for regular on-site inspections of HKEX. Each inspection will focus on a specific aspect of HKEX's operations depending on oversight priorities. The SFC completed the first on-site inspection of HKEX covering cash trading operations and activities in September 2015. HKEX accepted and completed actions to address all of

Area	Recommendation	Progress
		the SFC recommendations. Currently, an on-site inspection of HKEX's cash market clearing operations is in progress. • The Risk Management Committee ("RMC") was established to focus on cross-market risks relating to HKEX in the aftermath of the Asian Financial Crisis in light of the interface between the securities market and the money market. It is essential for the SFC and the HKMA to continue to stay on RMC to provide inputs from the macroprudential and financial stability angles.
	Further develop clear and transparent requirements for the recognition of exchanges and the authorisation of automated trading services.	**Implemented** • The SFC has amended its Guidelines for the Regulation of Automated Trading Services ("ATS Guidelines) to clarify the factors relevant to considering whether a particular operator is more suited to be regulated as a recognised exchange company ("REC") or an authorised ATS provider. The revised ATS Guidelines came into effect on 1 September 2016. The clarification will facilitate understanding of the regulatory differences between the REC and ATS regimes (which are reflected in the Securities and Futures Ordinance) and guide potential applicants who wish to operate a futures market in Hong Kong SAR.
	Improve the oversight of auditors of listed entities.	**On Track** • FSTB launched a public consultation to solicit views on proposals to introduce an independent oversight regime for the regulation of listed entity auditors in June 2014. The consultation conclusions were issued in June 2015.[1] • With general support from the audit profession and the relevant stakeholders, the Government is preparing an amendment bill to implement the reform. The reform will bring Hong Kong SAR into line with the international standards that auditor regulatory regimes should be independent of the profession itself and be subject to independent oversight by bodies acting in the public interest. The Government's target is to introduce the amendment bill into the Legislative Council by the end of 2017. • Under the reform proposals, the Financial Reporting Council ("FRC") will become the independent auditor oversight body vested with direct inspection, investigation and disciplinary powers with regard to listed entity auditors. The enforcement powers to be vested with FRC will also be stronger as compared with those under the present regime. Without compromising the independence of the new auditor regulatory regime, the authorities will leverage on the experience of the Hong Kong Institute of Certified Public Accountants in handling matters pertaining to registration, standard-setting and continuing professional development with regard to listed entity auditors by entrusting the Institute with these statutory functions while being subject to the oversight by the FRC.
	Strengthen enforcement	**Implemented** • The SFC has been using criminal prosecutions, market misconduct proceedings, civil restitutionary proceedings and disciplinary proceedings to tackle different types of financial crime and misconduct. In these proceedings, the SFC sought the imposition of punitive, deterrent sanctions and restitutionary orders, which have

[1] The consultation conclusion is available at http://www.fstb.gov.hk/fsb/ppr/consult/doc/conclu_rpirrlea_e.pdf.

Area	Recommendation	Progress
		been proven to be effective in ensuring that the Hong Kong SAR markets remain safe, fair and efficient. • The SFC has taken tough actions against licensed corporations and registered institutions for breaches of SFC Code of Conduct. Some recent examples of these actions include: ➢ In March 2017 – reprimanded Merrill Lynch and fined it HK$15 million over internal control failures ➢ In March 2017 – reprimanded BOCOM International and fined it HK$15 million for sponsor failures ➢ In April 2017 – reprimanded Guoyuan Securities Brokerage (Hong Kong) Limited and fined it HK$4.5 million for anti-money laundering related regulatory breaches • The SFC has also instituted proceedings before the Court of First Instance and the Market Misconduct Tribunal ("MMT") respectively against Gu Chujun, the former chairman and chief executive officer of Greencool Technology Holdings Limited, for grossly overstating Greencool's financial statements. The MMT ordered Gu to disgorge approximately $481 million profit made. The SFC will seek final restitutionary orders in the Court proceedings. • The SFC and the Department of Justice (DOJ) entered into a memorandum of understanding on 4 March 2016 (MOU). • The MOU sets out: (i) the type of cases that will be referred to the DOJ, (ii) the documents that will accompany each referral, (iii) a fast track referral process where the cases are to be prosecuted summarily by the SFC in the Magistrates' Courts, (iv) the target DOJ response times, (v) procedures to deal with reviews and appeals, (vi) procedures for starting Market Misconduct Tribunal proceedings, (vii) line and format of communications, (viii) consensus and procedures for use of expert evidence, (ix) procedures for requests for granting immunity, and (x) procedures for review of DOJ decisions. • The relationship between the SFC and the DOJ has improved since the MoU was signed and the turnaround time for cases submitted to the DOJ for advice has been reduced.
Financial market infrastructure("FMI")	Develop a clear timetable for each FMI for compliance with the Principles for FMIs ("PFMIs").	**FMI under SFC purview**
		On Track • The SFC and HKEX have agreed on a timetable for the recognised clearing houses in the HKEX Group to comply with the PFMIs in respect of areas where improvements are required. All of the areas identified have been addressed except for two longer-term projects. The first relates to settlement finality of transactions between brokers (other than those guaranteed by the CCP which have already been provided settlement finality) and involves legislative amendments. In preparation, the SFC has had extensive discussions with HKEX and expects the formal market consultation to begin around the end of 2017. The second relates to the use of central bank money for settlement where the SFC is in ongoing discussions with HKEX and HKMA on the most appropriate design and implementation.
		• OTC Clear has implemented a comprehensive risk management framework and has appropriate policies, procedures and controls in place to control and manage the additional risks. OTC Clear's approaches to observing each applicable principle (except 3 of 24

<table>
<tr><th>Area</th><th>Recommendation</th><th>Progress</th></tr>
<tr><td></td><td></td><td>principles not applicable) in the PFMI are summarised in a disclosure document issued in June 2017.
• In light of the PFMI Further Guidance published in July 2017, HKEX is reviewing the PFMI compliance of the recognised clearing houses in the HKEX Group to identify any areas for further improvement.

FMI under HKMA purview
Implemented
• The HKMA required the FMIs under its purview to make changes in accordance with the relevant PFMI requirements, and be generally observant of the PFMI by end-December 2015. Such requirement is stated in the HKMA policy statement on oversight of FMIs, which is available on the HKMA website.[2]
• The HKMA has completed PFMI assessments on all the FMIs under its purview, with the assessment summaries published on the HKMA website.[3] All FMIs under the purview of the HKMA are considered to be generally observant of the PFMI.
• The CMU, Hong Kong dollar CHATS and Trade Repository have all completed a self-assessment on their compliance with the PFMIs, and the disclosure framework for each was first published in October 2014, July 2014 and September 2015 respectively.</td></tr>
<tr><td>Systemic risk analysis</td><td>Strengthening the capacity for systemic risk analysis at the SFC and Insurance Authority ("IA") would help ensure that cross-sectoral interconnections are adequately captured and brought to the attention of the Financial Stability Committee ("FSC").</td><td>On Track
• The SFC has commenced a review of its long-term risk data strategy focusing on identifying data that can be collected in a methodological fashion and that may contribute to the early identification of systemic risk, as well as to the setting of strategic, policy and supervisory priorities. The SFC launched a new risk data strategy which aims to use technology to enhance daily operations, including processes ranging from regulatory risk identification to intermediary monitoring and market surveillance, and to broaden understanding of the latest trends in the markets. Elements of the strategy include reviewing the risk data collected, benchmarking against major overseas regulators and analysing social media information.
• To enhance existing macroprudential surveillance and support policymaking, IA is taking steps to improve its data infrastructure by requiring insurers to provide IA with additional information on risk exposures and interconnections, which will facilitate the assessment of the build-up of risks or vulnerabilities to the industry. For example, with the G20/FSB recommendations and initiatives on macroprudential oversight on shadow banking, IA has been working towards the development of more robust quantitative indicators for assessing the systemic risk of insurers. In this annual exercise, IA collects from insurers data about their financial assets by categories and their shadow banking activities. There is also new data collection for credit exposure conducted by the HKMA, the SFC and the Mandatory Provident Fund Authority at the same time, with specific shadow banking indicators pertinent to their respective businesses.</td></tr>
</table>

[2] The policy statement is available at http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/oversight/FMI_oversight.pdf.

[3] The assessment summaries are available at http://www.hkma.gov.hk/eng/key-functions/banking-stability/oversight.shtml.

Area	Recommendation	Progress
		• Life insurers are required to conduct periodic industry-wide standardised scenario testing as and when required, to enable IA to assess the existence of any vulnerabilities within the industry. On an annual basis, insurers are required to submit the results of Dynamic Solvency Testing under adverse scenarios to IA for ongoing monitoring purpose. IA uses the information contained in quarterly returns from insurers to perform industry-wide resilience tests on a quarterly basis. IA also performs analyses on the asset mix of life insurers to assess their concentration risks and exposure to different sectors. On the information exchange front, IA provides the HKMA with statistics of insurers associated with banking groups to enable the latter to perform its role in macroprudential surveillance. • Besides, IA has been collecting business statistics from insurers and calculating industry-wide claims ratios for specified lines of business. IA also collects burning cost data from the industry. Such information would be used as the reference to test the adequacy of technical provisions for specific lines of business of individual insurers. • As for the macroprudential surveillance from a cross-sectoral perspective, IA liaises with other local financial regulators (such as the HKMA and the SFC) regularly via the Council of Financial Regulators ("CFR") and FSC on supervisory and regulatory issues with cross-market implications. CFR and FSC deliberate on events, issues and developments with possible cross-market and systemic implications. A review would be taken by the financial regulators if any significant risk area of the financial markets is identified.
Cross-border regulatory coordination	Continued active participation in the supervisory colleges and crisis management groups of Globally Systemically Important Financial Institutions.	**Implemented** • HKMA continues its active participation in the supervisory colleges and Crisis Management Groups for cross-border banking groups including a number of Globally Systemically Important Banks to discuss their risk profiles, business strategies, and developments, the supervisory concerns and priorities as well as the development of recovery and resolution plans in accordance with the Key Attributes established by FSB. • Following the coming into force of the main provisions of the FIRO on 7 July 2017, the HKMA has set up a Resolution Office which will lead resolution planning within the HKMA and actively coordinate with overseas resolution authorities in cross-border resolution planning for AIs. The HKMA will also be the primary point of contact for overseas authorities regarding the 25 cross-sectoral G-SIB groups for which it is designated as the lead resolution authority under the FIRO.
	Strong cooperation with regulatory counterparts in mainland China	**Implemented** • The HKMA has been maintaining close communication with the People's Bank of China ("PBC") to exchange views and enhance cooperation on macroeconomic and financial stability surveillance, financial markets supervision, among other things. There are regular and ad-hoc meetings throughout the year between the two sides from senior to working levels to keep each other abreast of the relevant regulatory development and take forward cooperation where appropriate. There are also secondment and training programmes in place to enhance personnel exchange between the two parties. The HKMA has also been maintaining close dialogue with the China Banking Regulatory Commission ("CBRC") on

Area	Recommendation	Progress
		supervisory matters relating to the Mainland bank subsidiaries and branches of Hong Kong SAR banks. In addition to the bilateral meetings held twice a year between the HKMA and the CBRC, the number of working-level meetings has increased either through scheduled meetings or whenever the two sides meet as part of the on-site examinations arranged by either regulator. The secondment programme established with CBRC is currently in place to enhance understanding of banking issues and supervisory approaches of both places. • The SFC has been maintaining constant dialogue with various Mainland authorities including the China Securities Regulatory Commission ("CSRC") on different regulatory matters. For example, the SFC worked closely with different Mainland authorities to launch the Shanghai-Hong Kong Stock Connect in November 2014 and the mutual recognition of funds in July 2015, and the launch of the Shenzhen-Hong Kong Stock Connect in August 2016. The IA has been maintaining close dialogue with the China Insurance Regulatory Commission ("CIRC") on supervisory matters relating to Mainland insurers' subsidiaries and branches operating in Hong Kong SAR, as well as Mainland shareholders and business partners (e.g., reinsurers) of Hong Kong SAR insurers. IA has entered into two MOUs with CIRC on cooperation of insurance supervision and anti-insurance fraud. There are regular meetings between IA and CIRC to enhance understanding of the insurance market of the other side and to enhance regulatory cooperation on cross-border insurance business activities.
	Continued active participation in international regulatory fora is also needed to mitigate potential effects from global regulatory developments.	**Implemented** • The relevant regulators continue to participate actively in international regulatory fora including G20, IOSCO, and FSB to ensure that financial regulation in Hong Kong SAR is on par with the international standards, taking into account the unique background and needs of the financial sectors. • To meet the G20 commitments on over-the-counter ("OTC") derivatives regulatory reform, Hong Kong SAR has implemented mandatory reporting and mandatory clearing as follows: (i) after the two phases of mandatory reporting were implemented in July 2015 and July 2017 respectively, Hong Kong SAR requires the reporting of OTC derivative transactions in five main asset classes (namely interest rate derivatives, foreign exchange derivatives, equity derivatives, credit derivatives and commodity derivatives) to the HKMA's Trade Repository; and (ii) the first phase of mandatory clearing was implemented on 1 September 2016, which requires certain standardized interest rate swaps denominated in Hong Kong dollar or one of the G4 currencies (i.e., USD, EUR, GBP or JPY) to be centrally cleared through central counterparties designated by the SFC. • Studies of the Hong Kong Trade Repository data are being conducted for analysing liquidity (market depth and breadth) of certain standardized interest rate swaps reported in Hong Kong SAR in order to determine how best to implement the trading mandate.

Area	Recommendation	Progress
		• The status of Hong Kong SAR in meeting the requirements of the U.S. and EU OTC regulatory reforms relating to OTC derivatives that are applicable to central counterparties ("CCPs") is as follows: (i) On 21 December 2015, the U.S. Commodity Futures Trading Commission ("CFTC") issued an order of exemption from registration as a derivatives clearing organisation to OTC Clear which permits it to clear proprietary trades for its U.S. clearing members or affiliates of such clearing members subject to certain terms and conditions. The SFC and the CFTC signed an MOU on 21 December 2015 regarding cooperation and the exchange of information in the supervision and oversight of regulated entities that operate on a cross-border basis in Hong Kong SAR and the U.S. The scope of the MOU covers OTC Clear. (ii) On 30 October 2014, the European Commission adopted an equivalence decision for the regulatory regime of CCPs in Hong Kong SAR. The SFC then worked with the European Securities and Markets Authority ("ESMA") on an MOU to establish cooperation arrangements, as it was a pre-condition for the recognition of a non-EU CCP. The MOU was signed and took effect on 19 December 2014. These steps culminated in the ESMA's recognition of the four CCPs in Hong Kong SAR (HKSCC, HKFE, OTC Clear and SEOCH) as third country CCPs to offer services and activities to entities established in the EU in accordance with the European Market Infrastructure Regulation on 29 April 2015. The recognition was granted without conditions. Another MOU was entered between the SFC and the ESMA and became effective on 19 November 2015 to facilitate SFC's indirect access to the EU trade repositories via ESMA. (iii) There are no outstanding requirements of any other overseas regulators on the four CCPs in order to continue providing clearing services. • To meet the G20 commitment on margin requirements for non-centrally cleared OTC derivatives, the HKMA implemented global margin and risk mitigation standards, published by BCBS/IOSCO and IOSCO respectively, by issuing a new supervisory standard on 27 January 2017. In order to achieve a workable cross-border framework, the HKMA has been actively participating in discussions in the BCBS-IOSCO Working Group on Margining Requirements and followed a closely coordinated approach with other Asia-Pacific jurisdictions, notably Australia and Singapore, with regard to the start of the phase-in schedule and necessary transitional arrangements.

Appendix VI. Main Recommendations of the 2016 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal policy:	
• There is a case for a fiscal stimulus given the soft economic outlook, the sizeable output gap, and a difficult external environment. The planned fiscal impulse of around 1.6 percent of GDP in the 2016/17 Budget is therefore appropriate and there would be room for further easing in 2017/18, possibly to total a cumulative 2 percent of GDP over the two fiscal years. • Early follow-through on the recommendations of the 2014 Report on Long-Term Fiscal Planning—reviewing and reprioritizing expenditures to measures that boost labor participation and support growth, raising revenues and managing assets to help alleviate the fiscal impact of aging.	• Fiscal policy continued to be conservative in FY2016/17 with a contractionary impulse of about 1¼ percentage points of GDP due to the strong rebound in property markets and delays in infrastructure projects. But fiscal policy is expansionary in FY2017/18 with an impulse of about 1½ percentage points of GDP, through implementation of delayed projects, temporary tax relief, and temporary measures to support low income or disadvantaged households. • Efforts to continue to rein in non-essential expenditure growth through expenditure reviews and to reprioritize overall spending under progress. • A new tax policy unit is established to review possible broadening of the tax base and study the impact of different revenue measures.
Property market policy:	
The three-pronged strategy to the property market should remain in place. • Accelerating plans to increase supply faces a number of obstacles but, to the extent possible, speeding up processes, making land available, and bringing forward public investment would be a double win—tackling the housing problem and supporting the economy at a time of soft growth. • Loan to value (LTV) or debt service to income (DSI) settings should remain unchanged. • As the distorting costs of stamp duties become more significant the higher they are, they should be rolled back once the trend has shifted toward reduced price and speculative pressures.	• Housing supply has been rising since 2016 with the implementation of the government's Long-Term Housing Strategy which targets providing 460,000 units of housing over the next decade from 2018/19 onwards. The government is finalizing Hong Kong 2030+, which is a longer-term development strategy to provide land and housing on more sustainable basis. • On continued increases in housing prices, in May 2017, the HKMA further tightened the capital requirement for banks on their lending to property developers, lowered the LTV ratio for second property mortgages, and lowered the DSR limit for borrowers whose income is mainly derived from outside Hong Kong SAR. • With surging housing prices, the government increased the ad valorem stamp duty for residential properties from the DSD rates to a flat rate of 15 percent in November 2016 (also known as the NRSD), and removed the stamp duty exemption for "acquisition of multiple residential properties under 1 instrument" in April 2017.
Financial sector policy:	
• The robust regulatory and supervisory framework should help limit the build-up of systemic vulnerabilities. Exposures to mainland China and rapid growth of the asset management industry continue to merit close supervisory attention. • The authorities' plan to raise the countercyclical buffer (CCyB) to 1.25 percent from January 2017 and up to the Basel III maximum appears appropriate • Enhancing stress testing and reviewing financial institutions' plans in response to stress events are crucial for maintaining financial stability.	• Potential systemic vulnerabilities and regulatory arbitrage are closely monitored and addressed through coordination among the government and the regulators in the Financial Stability Committee, close dialogue with Mainland China regulators, and active participation in global fora. • Considering the credit-to-GDP and property price-to-rent gaps, a CCyB was introduced in 2017 (1.25 percent). • A comprehensive framework for recovery and resolution commenced operation in July 2017, under which the authorities will take actions to orderly resolve non-viable systemically important financial institutions to mitigate systematic risks and minimize losses of public funds by imposing losses on shareholders and creditors

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA—HONG KONG SPECIAL ADMINISTRATIVE REGION

December 21, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION DISCUSSIONS—INFORMATIONAL ANNEX

Prepared By | Asia and Pacific Department (in consultation with other departments)

CONTENTS

FUND RELATIONS

Membership Status

As a Special Administrative Region of the People's Republic of China, Hong Kong SAR is not a member of the Fund. However, annual consultation discussions have been held with the Hong Kong SAR authorities since October 1990, and the staff also holds discussions with the authorities in connection with the Fund's *Global Financial Stability* reports. STA has provided Hong Kong SAR with technical assistance in the area of balance of payments statistics and Hong Kong SAR officials have attended IMF Institute courses on balance of payments and monetary statistics, and financial programming. The latest FSAP was undertaken in 2014 at the request of the authorities.

Exchange Rate Arrangement

The Hong Kong dollar has been linked to the U.S. dollar under a currency board arrangement, the Linked Exchange Rate System (LERS), since October 1983 at a rate of HK$7.8/US$1. The Hong Kong Monetary Authority (HKMA) refined the operations of the LERS in May 2005—the first changes since September 1998. For the first time since the introduction of the LERS in 1983, the HKMA explicitly committed to sell Hong Kong dollar at a preannounced price (set at HK$7.75/US$), which is referred to as the strong-side convertibility undertaking. Previously, the HKMA had only committed to buy Hong Kong dollar at a preannounced rate (the weak-side convertibility undertaking introduced in October 1998) and could sell Hong Kong dollar at any price. Along with this two-way convertibility undertaking, the HKMA also introduced a symmetric trading band of 0.6 percent around a central parity of HK$7.8/US$. There are no restrictions on current or capital account transactions in Hong Kong SAR, and the Hong Kong dollar is freely convertible. The People's Republic of China accepted the obligations under Article VIII, Sections 2, 3, and 4 of the Articles of Agreement on December 1, 1996. The exchange regime is free of restrictions and multiple currency practices.

Resident Representative

The Hong Kong SAR sub-office of the Beijing Resident Representative's office was opened on September 23, 2000. Sally Chen is the current Resident Representative.

STATISTICAL ISSUES

(As of December 20, 2017)

I. Assessment of Data Adequacy for Surveillance
General: The economic database is generally comprehensive and of high quality, and data provision is adequate for surveillance.
National Accounts: Hong Kong SAR compiles and disseminates GDP statistics under the production and expenditure approaches on an annual basis, while the expenditure approach is deemed to be the most reliable one. The production and expenditure approaches are also compiled in annual chained volume terms. The statistical discrepancies are explicit under to the production approach in current terms. Quarterly GDP is available by expenditure components (current values and volume) as well as by industry value added (in volume only). GDP compilation is largely in accordance with the 2008 SNA.
Price Statistics: The monthly CPI covers the "expenditure" of all households in Hong Kong SAR, excluding only (i) marine population, (ii) households receiving public assistance, (iii) collective households such as those living in hospitals, prisons and homes for the aged, and (iv) households in the highest or lowest expenditure brackets which together accounted for some 10% of households. It includes 984 items. The weights are based on the Household Expenditure Surveys which is conducted once every five years. The index is disseminated with a lag no longer than 23 days after the end of the reference month. The national PPI convers the industrial sector (manufacturing industries and sewerage, waste management and remediation activities), including about 700 primary products. Weights are updated annual from the Annual Survey of Economic Activities. The index is compiled quarterly. Both price indices follow international standards.
Government Finance Statistics: Hong Kong SAR reports both cash and accrual-based annual data for the general government according to the Fund's Government Finance Statistics Manual (GFSM 1986 and GFSM 2001, respectively). No sub-annual data are provided for publication in the IFS.
Monetary and Financial Statistics: The HKMA reports monetary data for the central bank and banking institutions to STA on a regular monthly basis, which are published in the *IFS*. In late 2009, the HKMA submitted quarterly monetary data (test-data) using Standardized Report Forms (SRFs) that present data consistent with the Monetary and Financial Statistics Manual. However, the SRF data for Hong Kong SAR have not been published in the *IFS*, which requires monthly periodicity for monetary data. The HKMA has been encouraged to compile and submit monthly monetary data using SRFs for dissemination in the *IFS*.
Financial Sector Surveillance: Hong Kong SAR participates in regular reporting of Financial Soundness Indicators (FSIs) to the IMF for dissemination on the FSI website. The reported data are quarterly and cover all core FSIs and 12 additional FSIs for the deposit takers sector.
External sector statistics: Hong Kong SAR publishes comprehensive balance of payments data and international investment position statistics for 2000 onwards. Hong Kong SAR disseminates the international reserves and foreign currency liquidity data template, submits quarterly external debt statistics to the Quarterly External Debt Statistics (QEDS) database, and participates in the Coordinated Portfolio Investment Survey (CPIS) and the Coordinated Direct Investment Survey (CDIS).
II. Data Standards and Quality

Hong Kong SAR subscribes to the Fund's Special Data Dissemination Standard since 1996, and is fully compliant with its requirements.	A data ROSC was disseminated in 1999

Hong Kong SAR—Table of Common Indicators Required for Surveillance
(As of December 20, 2017)

	Date of Latest Observation	Date Received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of Publication[5]
Exchange rates	Nov. 2017	Nov. 2017	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	Oct 2017	Nov 2017	M	M	M
Reserve/base money	Oct. 2017	Nov. 2017	M	M	M
Broad money	Oct. 2017	Nov. 2017	M	M	M
Central bank balance sheet	Oct. 2017	Nov. 2017	M	M	M
Consolidated balance sheet of the banking system	Sep. 2017	Nov. 2017	M	M	M
Interest rates[2]	Nov. 2017	Nov. 2017	D	D	D
Consumer price index	Oct 2017	Nov. 2017	M	M	M
Revenue, expenditure, balance and composition of financing[3]–central government	Oct. 2017	Nov. 2017	M	M	M
Stocks of central government and central government-guaranteed debt[4]	Oct. 2017	Nov. 2017	M	M	M
External current account balance	Q2/17	Sep. 2017	Q	Q	Q
Exports and imports of goods and services	Q2/17	Sep. 2017	Q	Q	Q
GDP/GNP	Q3/17	Nov. 2017	Q	Q	Q
Gross external debt	Q2/17	Sep. 2017	Q	Q	Q
International investment position	Q2/17	Sep. 2017	Q	Q	Q

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] Including currency and maturity composition.
[5] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

Statement by the IMF Staff Representative
January 10, 2018

1. **This statement contains information that has become available since the staff report was finalized on December 19, 2017.** It does not alter the staff's assessment of policy issues and recommendations contained in the report nor does it alter the staff appraisal.

2. **Data releases for November continue to be broadly in line with staff projections**. CPI inflation rose to 1.6 percent (y/y) in November. Growth in tourist arrivals accelerated to 7.0 percent (y/y) in November from 6.6 percent in October, supporting retail sales, which rose from 3.6 percent (y/y) in October to 6.9 percent. House prices increased by 13.1 percent in November, up from 12.8 percent in October. Credit growth slowed down to 15.2 percent (y/y). The current account balance in Q3 strengthened to 8.5 percent of GDP, reflecting seasonality in the goods balance and a larger-than-expected primary income balance, resulting in a slight upside potential to the staff's full year projection of 3 percent of GDP.

Statement by Zhongxia Jin, Executive Director for China, Ping Sun, Alternate Executive Director for China, and Georgina Lok, Advisor to Executive Director
January 10, 2018

On behalf of the Hong Kong SAR authorities, we would like to thank staff for the comprehensive report, and the constructive dialogue during the mission. We broadly agree with staff's assessment of the economic outlook, which faces both challenges and opportunities, and welcome staff's recognition of the strong buffers in place in our economy to help weather challenges ahead.

Latest economic developments and outlook

The Hong Kong SAR economy continued to expand. For the first three quarters of 2017 combined, real GDP grew by 3.9 percent year-on-year. This has been driven by both domestic and external factors. Domestically, demand has attained solid growth on the back of expanding private consumption. More recently, retail sales volume has grown, supported by positive consumer sentiment and revival in inbound tourism. Business sentiment also remained broadly positive. On the external front, demand for goods and services exports has strengthened, thanks to a broad-based global economic upturn. Given the economy is poised to attain solid growth in the rest of the year, the authorities expect the full-year real GDP growth rate to be 3.7 percent for 2017, which is in line with staff's projection.

With muted external price pressures and moderate local cost increases, inflation in the Hong Kong SAR economy stayed fairly modest, with the underlying consumer price inflation rate at 1.6 percent year-on-year as of November 2017, which was lower than the 2.3 percent recorded in 2016. The authorities forecast underlying consumer price inflation at 1.7 percent for 2017 as a whole.

In terms of outlook, the authorities agree with staff's assessment that the balance of risks has improved since last year, and expect solid growth in the economy to continue in the near term. Hong Kong SAR will also continue to benefit from an improving external environment, as well as a steady transition in Mainland China, which is supported by the Chinese government's dedication to deepening structural reforms. Nevertheless, the authorities note the possible downside risks identified by staff, including disorderly adjustments in our housing market, bumps in Mainland China's transition, tighter-than-expected global financial conditions, and reduction in cross-border integration. As staff point out, strong policy frameworks and ample buffers are in place in the Hong Kong SAR economy to help navigate through these challenges. The authorities will also stay vigilant and be prepared to take appropriate actions in a timely manner to safeguard the macroeconomic and financial stability of Hong Kong SAR.

Fiscal Policy

Underpinned by prudent fiscal management, Hong Kong SAR's fiscal position is strong, with fiscal balance expected to be in surplus for a 14th straight year, and fiscal reserves to stand at 37 percent of GDP for FY2017/18. We agree with staff that supportive fiscal policy helps the economy tide over difficulties amid a challenging global economic environment. While being mindful of our constitutional responsibility to uphold fiscal prudence, the authorities strive to spend wisely and flexibly with regard to the overall fiscal position. For example, the counter-cyclical measures introduced after the Global Financial Crisis have been effective in supporting Hong Kong SAR's economy, which has been able to maintain an average growth of 3.4 percent per annum over the past 7 years from 2010-2016.

The authorities note staff's assessment that Hong Kong SAR's long-term fiscal sustainability will face challenges from population aging. In our view, raising the economic growth capacity will be key to meeting the increasing demands on public expenditure. To this end, active efforts are being made to boost this capacity. While staff suggest revenue mobilization as a way to preserve Hong Kong SAR's sound fiscal position over the longer term, it should be noted that as an international financial center, Hong Kong SAR's simple and efficient tax system with low tax rates is one of our key competitive edges. Due regard is therefore needed for maintaining competitiveness when formulating policy response in tax reform.

Property Market

Strong capital inflows following the Global Financial Crisis, an ultra-low interest rate environment, and housing supply-demand imbalance, have contributed to growing exuberance in the property market in Hong Kong SAR. The authorities agree with staff's assessment that disorderly adjustment to house prices could pose systemic risks. On the supply side, efforts have been stepped up through a multi-pronged approach to increase housing land supply in the short, medium, and long term. A Task Force on Land Supply was also established in September 2017 to conduct a comprehensive review of the options and ways to increase land supply, as well as evaluate alternative options and their priorities. Existing efforts to speed up and increase housing land supply (e.g. land use review and rezoning, increasing development intensity, etc.) will also be continued.

It will take time for the effects of supply-side efforts to show. In the meantime, since 2009, the authorities have rolled out successive demand-side management and counter-cyclical macro-prudential measures to safeguard the stability of the banking and financial system, and ensure the healthy development of the property market. We appreciate staff's support for continuing our efforts in this regard.

The various measures implemented by the authorities have had some success in dampening the growing exuberance in the property market and the risks entailed. Nevertheless, driven by the factors mentioned above, property prices continued to face upward pressures. In particular, the authorities observed that the volume of home purchase by non-residents had surged since 2010 and stayed at elevated levels through the better part of 2012. With non-resident home purchases being a key driver to the exuberance in the property market, the Buyer's Stamp Duty (BSD) was introduced in October 2012 as part and parcel of a basket of earlier measures to holistically address the supply-side and demand-side factors underlying the heated property market. In February 2013, a Doubled Ad Valorem Stamp Duty (DSD) which applied to both residential and non-residential properties, except those residential properties acquired by buyers who are Hong Kong SAR Permanent Residents without existing properties at the time of acquisition, was also introduced. In November 2016, the ad valorem stamp duty rate for residential properties was increased to a flat rate of 15 percent (also known as the New Residential Stamp Duty (NRSD)). The authorities agree with staff's assessment that the stamp duties, which are intended to address the overheated property market and safeguard against systemic risks, are appropriate.

Linked Exchange Rate System

The Linked Exchange Rate System (LERS) has been the anchor of Hong Kong SAR's monetary and financial stability for more than 30 years and has proved highly resilient in a series of regional and global financial crises during this period. The authorities welcome staff's positive assessment on the suitability of the LERS, and are fully committed to safeguarding the system. We also appreciate staff's balanced assessment of the external position of Hong Kong SAR.

Financial Sector

As assessed by staff, the regulatory and supervisory frameworks of our financial system are robust, and substantial progress has been made on implementing the 2014 FSAP recommendations. The authorities will continue to implement agreed international regulatory reforms to further strengthen the safety and soundness of our banking system and remain vigilant to risks that may undermine financial stability. The authorities appreciate staff's support for our efforts in enhancing the competitiveness of Hong Kong SAR as an international financial center, and shall continue to strive to capture new opportunities, especially those arising from further financial development in Mainland

China. We will also continue to facilitate healthy development of fintech in Hong Kong SAR, without compromising effective regulation and supervision.

Growth in Mainland China-related lending of the Hong Kong SAR banking sector is a natural consequence of the growth of the Mainland China economy and development of Mainland corporates. As staff point out, the authorities have maintained strong guidance and close monitoring of banks' lending activities. Asset quality associated with Mainland-related lending remains healthy, supported by high credit quality of borrowers, prudent underwriting standards, and a significant portion of the lending being backed by collateral or guarantee. Stress test results also show that the banking system can withstand severe adverse shocks. To this end, the authorities take positive note that staff also assess vulnerabilities arising from Mainland China-related exposure to appear manageable under stressed scenarios.

Ensuring sustainable and inclusive growth

Finally, the authorities recognize the importance of ensuring sustainable and inclusive growth. We have been paying close attention to income disparity and striving to enable society to share the fruits of social and economic development. Our social security system provides a safety net for persons who cannot support themselves financially for reasons such as old age, disability, unemployment, single parenthood, etc., and at the same time, encourages and supports people capable of working to achieve self-reliance through job training and counselling. The authorities have also recently announced a series of improvements to the Low-Income Working Family Allowance Scheme, which is a scheme aimed at encouraging self-reliance through employment and easing intergenerational poverty.

The authorities share staff's view that multiple considerations are involved in working hours policy, including implications for labor market flexibility and competitiveness. Having regard to the recommendations of the Standard Working Hours Committee, the authorities will carefully consider the views of the community and explore possible ways to improve the working hours policy of Hong Kong SAR. Abolishing the "offsetting" arrangement in the Mandatory Provident Fund (MPF) system is a priority of the authorities, and a proposal taking into account the interests of both the business and labor sectors is expected to be drawn up in the coming months.