INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/11

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

2016 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

January 2017

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 2016 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**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis. It is based on information available at the time it was completed on December 19, 2016.
- An **Informational Annex** prepared by the IMF staff.

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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 17/09
FOR IMMEDIATE RELEASE
January 12, 2017

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

IMF Executive Board Concludes 2016 Article IV Consultation Discussions with People's Republic of China—Hong Kong Special Administrative Region

On January 6, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions[1] with Hong Kong Special Administrative Region (SAR), and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

With a soft global trade environment and a downturn in tourism arrivals from Mainland China, Hong Kong SAR's growth rate is expected to have slowed to 1.5 percent in 2016. Growth is likely to pick up modestly to about 2 percent in 2017, with private consumption continuing to be a main driver supported by a steady labor market. The current account surplus remained below 3 percent of GDP, and is projected to improve to around 3.5 percent over the medium term as the global economy recovers.

With a more challenging external environment, with the U.S. rate cycle moving up, global trade growth tepid and Mainland China rebalancing, the growth recovery may be gradual. Over the longer term aging pressures may weaken the structural fiscal position, requiring fiscal planning to alleviate the decline; and a housing supply shortage also needs to be tackled.

Prudent fiscal policy and intensive supervision of the financial system have built buffers that can be drawn on to weather a less favorable environment. Fiscal reserves amount to 35 percent of GDP or 23 months of expenditures and the net international investment position is positive at 355 percent of GDP. The banks are capitalized well above Basel III levels; liquidity cover and the use of stable funding have increased. 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.

---

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

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

Executive Board Assessment

In concluding the 2016 Article IV consultation with Hong Kong Special Administrative Region (SAR), Executive Directors endorsed staff's appraisal, as follows:

Growth and outlook. Growth has slowed since 2015 and the external outlook is more challenging with the U.S. rate cycle is edging up, global trade growth tepid and mainland China rebalancing. With soft external conditions, the growth recovery is likely to be gradual with the output gap closing slowly. Over the medium term population aging pressures may affect potential growth and weaken the structural fiscal position. On the upside, the economy is highly flexible and large potential can be tapped from the further development of Hong Kong SAR as a global financial center. Strong policy frameworks and ample buffers are in place to weather a less favorable environment. Prudent fiscal policy and intensive supervision of the financial system have built buffers that can be drawn on when needed. The Linked Exchange Rate System (LERS), provides a credible anchor for a small open economy with a large globally integrated financial services industry.

There are three main risks. Growing economic linkages mean that changes in mainland China's growth prospects spill over to Hong Kong SAR's financial and real sectors. With a large globally integrated financial sector and a currency board arrangement, the economy is exposed to U.S. developments and global market volatility. The property market is also a source of downside risk. With strong buffers in place these risks are manageable and should not adversely affect the economy provided that, as anticipated, interest rates rise at a moderate pace and mainland China's transition to a more sustainable growth path remains orderly.

Fiscal policy. As the main demand management lever, fiscal policy needs to strike a balance between supporting aggregate demand and preserving a buffer for the longer-run challenge posed by aging. In the near term with a significant and persistent output gap, a difficult external environment, and weak automatic stabilizers, there is a case for further fiscal impetus which can be removed as the economy recovers. The planned impulse in the 2016–17 Budget is appropriate but if it undershoots and growth remains weak, additional stimulus will be needed in fiscal year 2017–18. Aligning short-term fiscal measures to long-term goals and shifting spending forward would help ensure that cyclical support does not exacerbate the long-term fiscal trend.

Long-term fiscal challenges. 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 would help alleviate the fiscal impact of aging. Measures to broaden the tax base may also be needed. The aim for balance and keeping overall government expenditure growth in line with GDP growth over the medium term is appropriate, while taking early action to alleviate the structural deficit problem. A drawdown of the fiscal reserves could be accommodated as the economy adjusts, but a positive fiscal buffer is desirable to cope with adverse shocks, provide room for countercyclical fiscal policy, and sustain confidence.

Property market measures. With renewed signs of overheating in the property market, the three pronged approach to limiting risks—boosting housing supply, macroprudential measures to limit stability risks, and stamp duties to contain speculative activity and external demand— is well placed. Current macroprudential settings have done their job of limiting financial system exposure to the asset price boom and LTV and DSR settings should remain unchanged. Stamp duties can be an effective part of the toolkit to stem excessive price increases and speculation in the real estate market. As the distorting costs of 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. The Long-Term Housing Strategy and Hong Kong 2030+ are aimed at addressing the housing shortage in an integrated manner by guiding land, planning and infrastructure development. Accelerating plans to increase supply, speeding up processes, making land available, bringing forward public investment would be a double win—tackling the housing problem and supporting the economy at a time of soft growth.

Financial sector policies. The robust regulatory and supervisory framework should help limit the buildup of systemic vulnerabilities. The authorities have a track record as a global standard setter in regulation and supervision and in addressing data gaps. Substantial progress has been made on implementing the 2014 FSAP recommendations. An independent insurance authority has been established, strengthened standards for securities listing have been implemented, and legislation has been put in place for a resolution framework for financial institutions which is designed to implement the Financial Stability Board's Key Attributes. There is substantial coordination among government and regulators domestically, there are close links with mainland regulators and the authorities are active in international fora, including in supervisory colleges for cross border banking and insurance groups, on global systemically important financial institutions, and in crisis management groups. Areas for continued attention include further enhancing stress testing and reviewing financial institutions' plans in response to stress events.

Exchange rate regime and external position. The LERS remains the best arrangement for Hong Kong SAR backed by the credibility built up over three decades and tested through crises. The LERS is underpinned by the flexible economy, ample reserves buffers and strong financial regulation and supervision. Wage and price flexibility allows the economy to adapt quickly to cyclical conditions and structural change. The external position is broadly in line with medium-term fundamentals and desirable policies.

Contingency planning. As a trading hub and global financial center, the economy is inevitably exposed to global external shocks. In the event of an adverse shock, a comprehensive and coordinated policy approach similar to the 2008/9 response would be appropriate: including large fiscal stimulus, loosening of macroprudential policies, expanded credit guarantees, emergency liquidity provision and close international supervisory coordination. The recently introduced crisis resolution framework is strengthening the ability to respond to strains in the banking, corporate and household sectors

Table. Hong Kong SAR: Selected Economic and Financial Indicators, 2011–21

	2011	2012	2013	2014	2015	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.
NATIONAL ACCOUNTS											
Real GDP (percent change)	4.8	1.7	3.1	2.7	2.4	1.5	1.9	2.4	3.0	3.0	3.1
Contribution											
Domestic demand	6.1	3.7	4.0	2.9	1.6	2.2	2.4	2.4	3.4	3.6	3.7
Private consumption	5.2	2.6	3.0	2.2	3.1	0.8	1.3	1.8	2.5	2.6	2.6
Government consumption	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Gross fixed capital formation	2.2	1.6	0.7	0.0	-0.5	-0.2	0.2	0.3	0.5	0.6	0.8
Inventories	-1.5	-0.8	0.1	0.4	-1.3	1.4	0.7	0.0	0.0	0.0	0.0
Net exports	-1.3	-2.0	-0.9	-0.2	0.8	-0.7	-0.5	0.0	-0.3	-0.5	-0.6
Potential GDP growth	3.4	3.1	3.0	2.8	2.7	2.7	2.7	2.7	2.6	2.5	2.5
Output gap (in percent of potential)	1.5	0.1	0.2	0.1	-0.2	-1.2	-2.0	-2.2	-1.8	-1.2	-0.5
Saving and investment (percent of GDP)											
Gross national saving	29.7	26.8	25.5	25.1	24.8	25.4	25.7	25.6	25.3	25.1	25.0
Gross domestic investment	24.1	25.2	24.0	23.8	21.7	22.7	22.8	22.3	22.0	21.7	21.6
Saving-investment balance	5.6	1.6	1.5	1.3	3.1	2.8	2.9	3.2	3.3	3.4	3.4
LABOR MARKET											
Employment (percent change)	2.9	2.4	1.8	0.6	0.8	0.5	0.9	0.7	0.7	0.8	0.7
Unemployment rate (percent, period average)	3.4	3.3	3.4	3.3	3.3	3.3	3.2	3.2	3.2	3.1	3.1
Real wages (percent change)	2.7	1.6	0.1	-2.4	0.6	0.6	0.9	1.1	1.3	1.5	1.6
PRICES											
Inflation (percent change)											
Consumer prices	5.3	4.1	4.3	4.4	3.0	2.5	2.6	2.7	2.8	2.9	3.0
GDP deflator	3.9	3.5	1.8	2.9	3.6	1.8	2.0	2.1	1.4	1.3	1.6
GENERAL GOVERNMENT											
Consolidated budget balance	3.8	3.2	1.0	3.7	0.6	1.6	1.5	0.1	0.6	1.4	1.4
Revenue	22.6	21.7	21.3	21.2	18.8	21.1	20.4	20.3	20.3	20.3	20.3
Expenditure	18.8	18.5	20.3	17.5	18.2	19.5	18.9	20.2	19.7	18.9	18.9
Fiscal reserves as of March 31	34.6	36.0	35.3	36.7	35.2	35.6	35.8	34.3	33.4	33.4	33.2
FINANCIAL											
Interest rates (percent, end-period)											
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	0.4	0.6	...	...	...	...	...
10-year Treasury bond yield 1/	1.5	0.9	2.7	2.0	1.7	1.2	...	...	...	...	...
MACRO-FINANCIAL											
Loans for use in Hong Kong SAR (not including trade financing) 2/	12.5	7.0	10.6	13.5	6.3	6.3	4.0	4.5	5.5	6.0	6.0
House prices (end of period, percent change)	11.1	25.7	7.7	13.5	2.4	-4.0	-5.0	-3.0	-3.0	0.0	2.0

Mortgage payment to income ratio 3/	39.9	43.6	45.7	44.7	48.9	44.3	46.4	47.1	47.4	45.4	43.5
Household debt (in percent of GDP)	58.4	60.6	61.9	64.9	66.5	64.4	61.2	59.4	57.6	57.6	58.7
Nonfinancial corporate debt (in percent of GDP)	175.5	195.7	212.1	224.6	213.7	205.7	202.8	198.4	197.0	196.1	198.0
Hang Seng stock index (percent change) 4/	-20.0	22.9	2.9	1.3	-7.2	1.3	...	...	...	...	...
EXTERNAL SECTOR											
Merchandise trade (percent change)											
Export volume	3.5	1.9	6.5	0.8	-1.9	0.3	2.1	2.7	2.8	2.6	2.6
Domestic exports	-0.6	10.1	-1.6	2.3	-12.9	14.2	2.1	2.7	2.8	2.6	2.6
Re-exports	3.6	1.7	6.8	0.8	-1.6	0.6	2.1	2.7	2.8	2.6	2.6
Import volume	4.7	3.0	7.2	0.9	-2.7	-0.3	2.6	2.7	2.9	2.8	2.8
Export value	11.5	5.0	6.3	1.6	-2.5	0.4	2.8	3.9	3.7	3.2	2.8
Import value	13.3	7.0	6.8	1.7	-4.1	0.3	3.7	3.9	4.0	3.6	3.4
Terms of trade	-0.1	0.1	0.4	0.1	0.5	-0.4	-0.3	0.0	-0.2	-0.2	-0.3
Current account balance (percent of GDP) 5/	5.6	1.6	1.5	1.3	3.1	2.8	2.9	3.2	3.3	3.4	3.4
Foreign exchange reserves 5/											
In billions of U.S. dollars, end-of-period	285.4	317.4	311.2	328.5	358.8	390.1	418.9	431.3	446.2	457.8	466.7
In percent of GDP	114.6	121.3	112.9	112.8	116.1	122.0	126.3	124.2	122.8	119.6	115.7
Net international investment position (percent of GDP)	285.5	274.5	274.9	298.9	316.6	309.0	300.3	290.3	281.3	272.9	264.0
Linked rate (fixed)											
Market rate (HK$/US$1, period average)	7.784	7.756	7.756	7.754	7.752	7.757	...	...	...	...	...
Real effective rate (period average, 2010=100)	96.6	98.7	102.2	105.6	113.9	117.3	...	...	...	...	...

Sources: CEIC; HKSAR Census and Statistics Department; and IMF staff estimates.

1/ For 2016, average for the first 10 months.

2/ For 2016, as of September.

3/ CentaData, HIBOR-based for all households.

4/ For 2016, as of October.

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

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

December 19, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION DISCUSSIONS

KEY ISSUES

- **Overview.** The vibrant Hong Kong SAR economy has been supported by low interest rates and mainland China's economic development over the past decade. But the external outlook is now more challenging. Long-term issues such as aging and a housing supply shortage also loom. Strong policy frameworks and ample buffers are in place to weather a less favorable environment. Prudent fiscal policy and intensive supervision of the financial system have built buffers that can be drawn on when needed.
- **Policies.** To address the challenges and provide a platform for sustained growth:
  - **Fiscal position.** A fiscal impulse broadly in line with the 2016/17 budget, and some additional next year, to support the economy through subdued conditions.
  - **Long-term fiscal challenges.** 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.
  - **Exchange rate regime.** The strong policy framework of the Linked Exchange Rate System, together with flexibility and ample buffers, should be preserved.
  - **Property market.** The three-pronged strategy to the property market (boosting supply, macroprudential policies to manage risks, and stamp duties to contain speculative activity and external demand) should remain in place.
  - **Financial sector policies.** 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. Enhancing stress testing and reviewing financial institutions' plans in response to stress events are crucial for maintaining financial stability.
  - **Potential.** There are opportunities to further develop Hong Kong SAR's role as a global financial center building on its comparative advantages.

Approved By
Markus Rodlauer and Alfred Kammer

The mission team comprised Alison Stuart (head), Joong Shik Kang, and Rui Mano (all APD), Sally Chen and Daniel Law (Hong Kong SAR Resident Representative Office), Si Guo (APD) contributed from headquarters and the mission was supported by Lesa Yee and Xinhao Han (both APD). Markus Rodlauer joined the concluding meetings with Financial Secretary John Tsang and HKMA Chief Executive Norman Chan. Zhongxia Jin and Raymond Yuen (OED) attended the official meetings.

CONTENTS

FIGURES

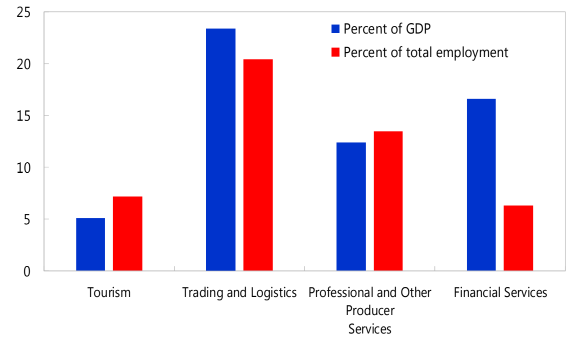
TABLES

APPENDICES

CONTEXT: TESTING TIMES AFTER A DECADE OF ROBUST GROWTH

1. Hong Kong SAR is a vibrant trading and financial gateway between mainland China and the rest of the world. Traditionally the economy was mainly driven by the United States, the global economic cycle and financial conditions; but over time it has become increasingly linked to mainland China's rapidly evolving economy. The financial services industry ranks fourth in the Global Financial Centers Index and fourth by scale of foreign exchange turnover. Four industries—financial services, tourism, trading and logistics, and professional and other producer services—account for over half of GDP and employ just under half of the workforce. Financial services accounts for around 18 percent of value added but just 7 percent of employment.

Share of Four Key Industries
(In percent)



Sources: Hong Kong Monthly Digest of Statistics, March 2016; and IMF staff calculations.

2. Prolonged low interest rates and mainland China's economic development have supported growth and credit over the past decade. With positive spillovers from mainland China, growth has averaged 4.1 percent between 2005 and 2013 and unemployment has remained low. Credit grew rapidly, house prices nearly tripled between 2008 and 2015 for the mass market and doubled for the luxury segment.

3. But growth has slowed since 2015 and the outlook is more challenging. The U.S. rate cycle has turned up, global trade growth is tepid and mainland China is rebalancing. Post-election uncertainty about U.S. economic policies has been accompanied by market volatility which may also weigh on trade and financial conditions. Domestically, the tide also appears to be turning with the financial cycle past its peak and swings in the housing market—with a price correction in the early part of the year followed by resurgent demand. In a longer perspective (though no less urgent), the economy needs to adapt to population aging and mainland China's move up the value chain and a shortage of housing supply relative to demand needs to be addressed.

4. Strong policy frameworks and ample buffers are in place to weather a less favorable environment. Prudent fiscal policy and intensive supervision of the financial system have built buffers that can be drawn on when needed. The Linked Exchange Rate System (LERS) provides a credible anchor for a small open economy with a large globally-integrated financial services industry that is exposed to cross-border portfolio shifts. Fiscal buffers and a positive net international investment position (35 percent and 315 percent of GDP, respectively) enable the economy to navigate shocks. Wage and price flexibility allows the economy to adapt quickly to cyclical conditions and structural changes. The strong regulatory and supervisory framework is aimed at limiting the build-up of systemic vulnerabilities.

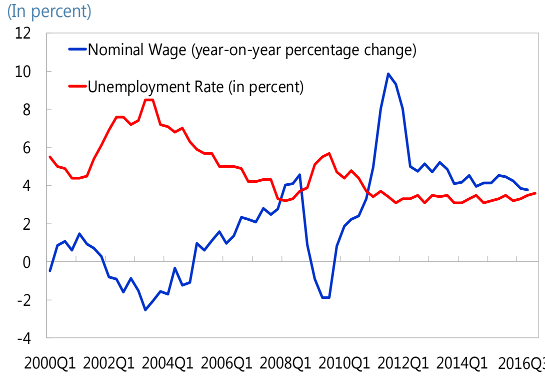
RECENT DEVELOPMENTS

5. The real economy has been operating below trend:

- **Subpar growth.** Growth has been below potential since the beginning of 2015 and is expected to be around 1.5 percent in 2016. An anemic global trade environment and a sharp downturn in tourism arrivals from mainland China over the past two years have depressed retail spending, private investment and exports. The decline in tourism has shown signs of bottoming out since the middle of the year and consumption has turned around alongside rebounding house prices. Nonetheless, business activity indicators, retail sales, and consumer confidence continue to point to a slow recovery (Figure 1).

- **Labor market steady.** Labor market quantity indicators have been resilient to slower growth. The unemployment rate stayed at 3.4 percent in Q3 and employment has remained robust, though vacancies have declined. Public construction investment appears to have supported employment. Earnings growth has adjusted, slowing to 3.8 percent in 2016:H1 from 4.3 percent in 2015:H1. CPI inflation has remained contained at 2.1 percent (y/y) in October.

Nominal Wage and Unemployment Rate
(In percent)

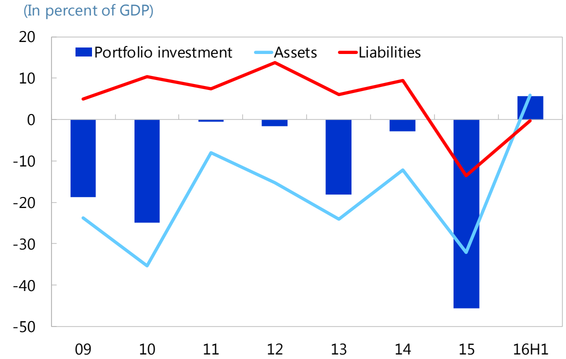


- **Subdued external sector.** The real exchange rate has appreciated at a more moderate pace in 2016, in line with the U.S. dollar. After January's volatile external financial conditions, market sentiment improved and the Hong Kong dollar returned to the strong side of the convertibility undertaking. The current account surplus narrowed to around 2.6 percent of GDP in 2016:H1, and goods trade remained subdued in Q3.

- **Equity markets**. The Hang Seng index fell to a four-year low in February 2016 following concerns about China's growth outlook. More recently, Brexit, post-U.S. election volatility and December's Fed rate hike, and the imposition of higher property stamp duties also triggered brief market declines, but equities are currently 20 percent higher than February's trough.

- **Capital flows moved with market volatility.** Portfolio investment outflows increased substantially in 2015 as residents and nonresidents reduced their equity and investment fund holdings following the stock market decline. This reversed in 2016:H1 as markets stabilized, and equity and bond inflows have increased since August. However, the shift in expectations from RMB appreciation to depreciation has continued to lead to a sharp reduction in offshore RMB liquidity with deposits down by about 35 percent from the 2014 peak.

Portfolio Investment
(In percent of GDP)

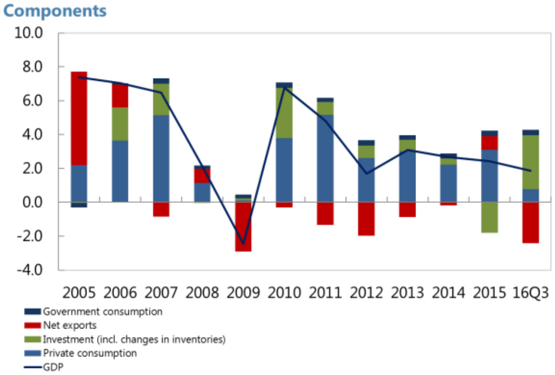


Sources: Haver Analytics; and IMF staff estimates

Figure 1. The Real Economy is Subdued

Growth has been below trend since 2014.

Contribution to Real GDP Growth by Major Expenditure Components

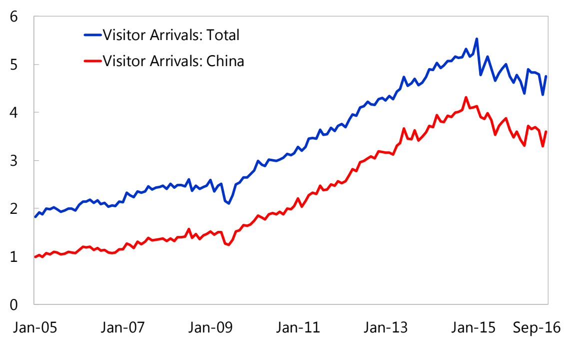


Exports of goods and services have slowed.

Exports of Goods and Services
(In percent (yoy), BPM6)

The decline in tourism from mainland China appears to be bottoming out.

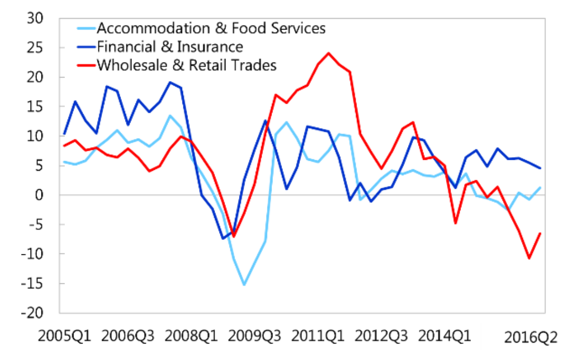
Visitor Arrivals 1/
(Person Mn)



1/ These two series are both seasonally adjusted.

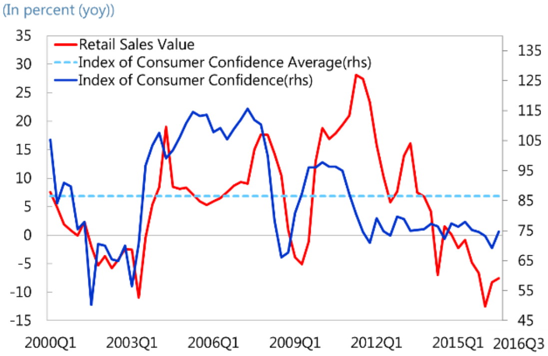
Wholesale, retail, and tourism were hit.

Industry Performance
(In percent (yoy))



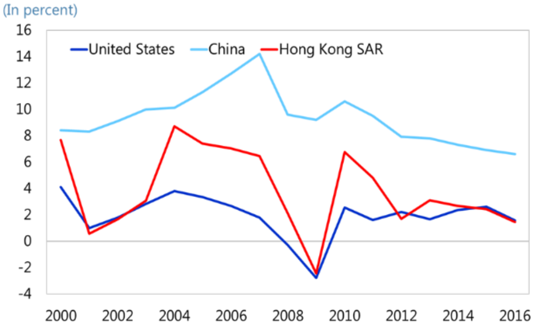
Consumer confidence remains below trend.

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



Sluggish U.S. growth and China's rebalancing have weighed on growth.

Hong Kong SAR and Main Trading Partners Real GDP Growth
(In percent)



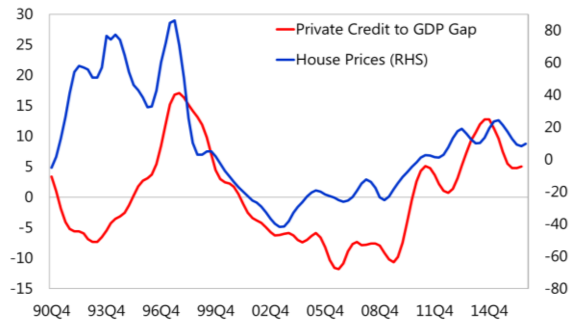
Sources: CEIC Data Company Ltd.; WEO.

- **Fiscal position.** With a softer economic outlook, the 2016/17 Budget included measures to support small and medium-sized enterprises, incentives for the tourism industry, tax cuts and an increase in social security allowances. A fiscal impulse of 1.6 percent of GDP is projected by the authorities for 2016/17, although the actual impulse may fall short of this, as revenues usually out-perform forecasts.

6. Signals from the financial cycle are mixed (Figure 2):

- **Credit growth has slowed**. Lending for use outside Hong Kong SAR fell back in 2016:H1 as mainland Chinese residents repaid external debt, but has since recovered. Domestic lending for wholesale, retail and manufacturing contracted while mortgages and personal loan growth was relatively subdued until the summer. Measures of the credit cycle point to a still positive but narrower credit gap. And respondents to the HKMA Opinion Survey expect a further decline in loan demand.

Financial and Housing Cycles 1/ 2/
(In percent)



1/ A deviation from the trend using a band-pass filter (Christiano-Fitzgerald).
2/ 16Q4 data is based on Centa-City leading index for October.

- **But the property market has rebounded.** Residential house prices fell by more than 10 percent in the early part of the year following the first Fed rate hike and amid uncertainty about mainland China's growth prospects. But prices have since recovered and were just 3.3 percent off the peak in September. Transactions also bounced back with the monthly average in August to October almost doubling compared to the first seven months of this year (Figure 3). The rebound followed growing market conviction, post Brexit, that the pace of U.S. rate tightening would be gradual. House price valuations still look over stretched—with staff models and user cost measures pointing to overvaluation of around 10–20 percent. To contain speculation, in November, the authorities sharply raised the ad valorem stamp duty for residential property transactions to a flat rate of 15 percent from a scale of 1.5–8.5 percent, affecting all nonresidents and residents owning more than one property (see Appendix IV). This took steam out of the market, with shares in property developers falling on the news.

- **The cost of credit is compressed.** Price indicators are liquid and competition among mortgage lenders has resulted in mortgage rates being lowered in 2016 and are currently about 2 percent.

Liquidity Map: Quantity Indicators Tightening but Price Indicators Are Liquid

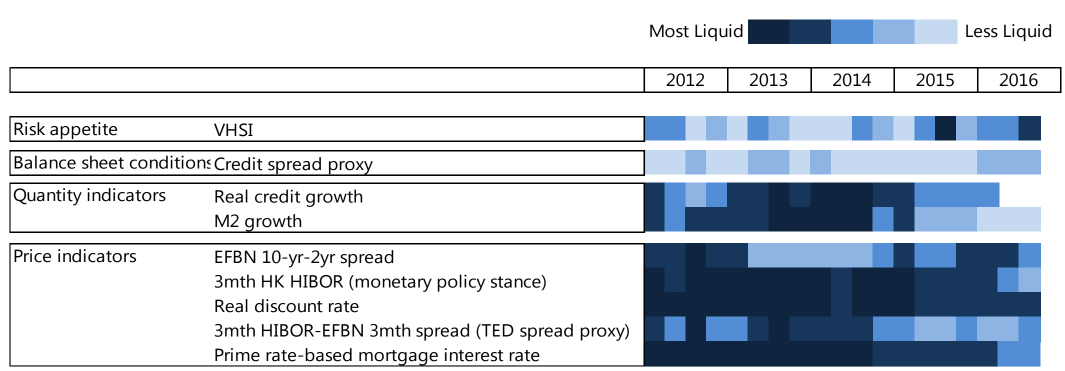
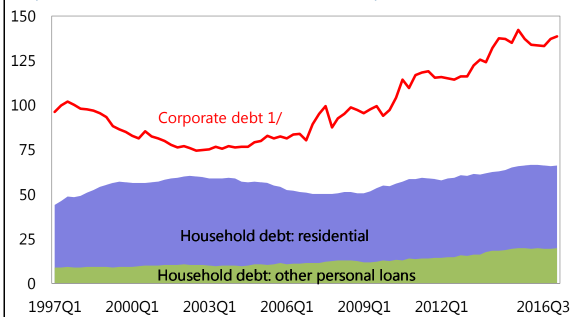


Figure 2. A Turning Credit Cycle?

Household and corporate debt are at high levels.

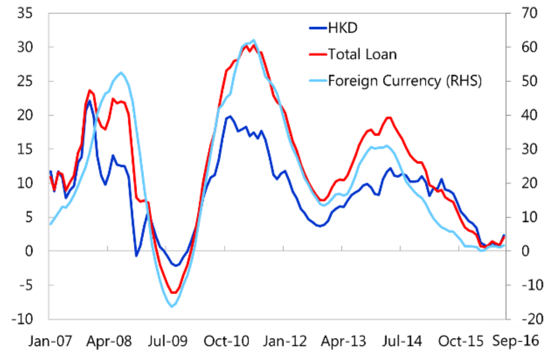
Household and Corporate Debt
(In percent of annual nominal GDP, sum of last four quarters)



1/ Corporate debt defined as loans of all authorized institutions - loans to professional and private individuals + loans to professional and private individuals for other business purposes.

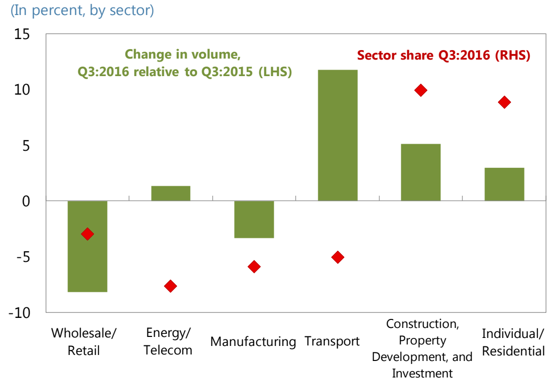
Credit growth (including financial institutions) has fallen back, especially for foreign currency loans…

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



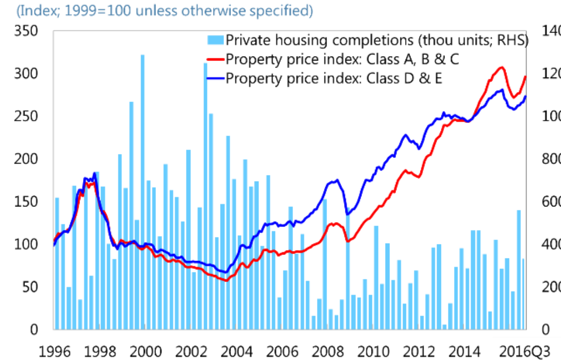
…with weakening in most sectors outside property and construction

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



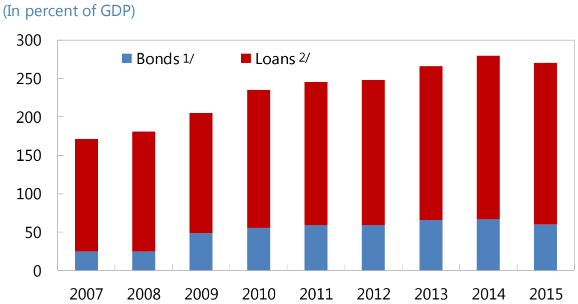
House prices have picked up again and completions have lagged through 2016…

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



…the volume of loans and bonds outstanding whose domicile of risk is in Hong Kong SAR has flattened off.

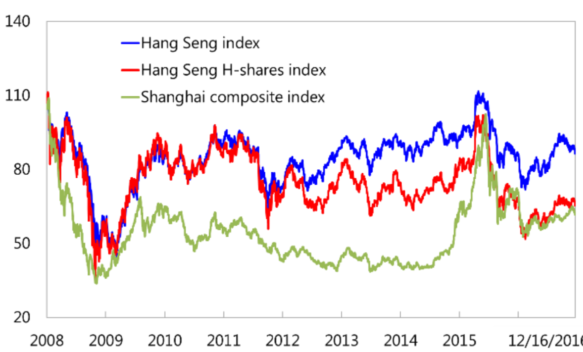
Loans and Bonds Outstanding, Domicile of Risk in Hong Kong SAR
(In percent of GDP)



1/ Bonds issued by entities incorporated in Hong Kong SAR with domicile of risk in Hong Kong SAR.
2/ Loans for use in Hong Kong SAR.

Equities recovered post Brexit and eased back after the U.S. elections.

Stock Price Index
(Index, January 2008=100)

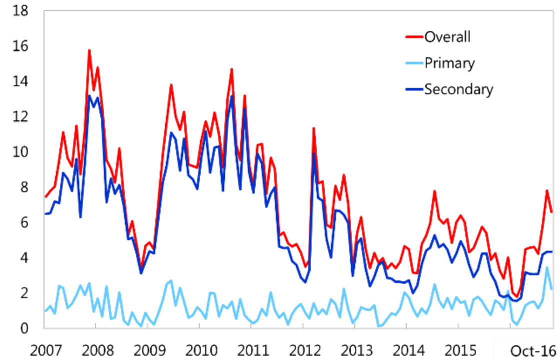


Sources: CEIC Data Company Ltd.; HKMA; Haver Analytics; and IMF staff calculations.

Figure 3. Property Market Outlook—Acceleration Poses a Challenge

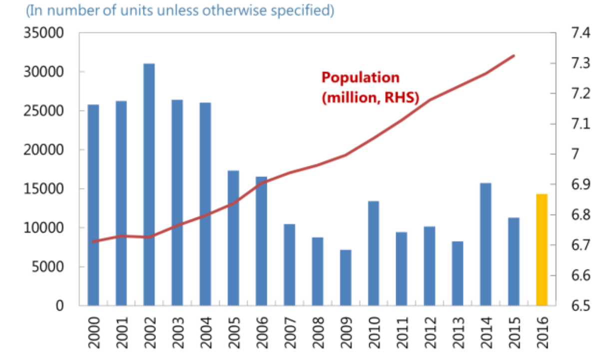
Transactions rebounded sharply from lows.

Domestic Residential Property Sales Transactions
(In thousands)



Completions have picked up a little but are short of likely demand…

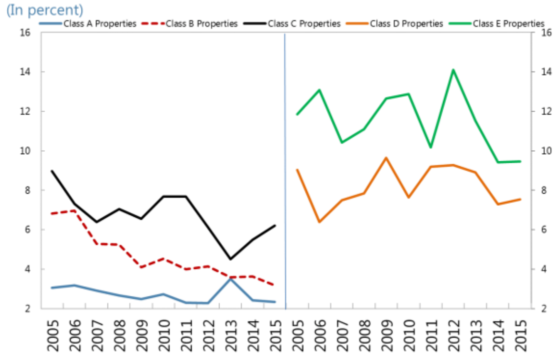
Private Property Completions 1/
(In number of units unless otherwise specified)



1/ 2016 figure is based on actual data up to Q3, and staff projection for Q4.

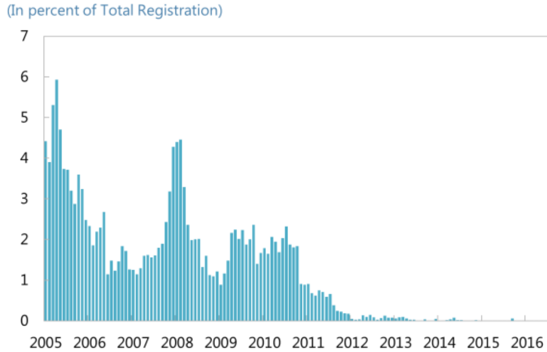
…and vacancy rates remain tight.

Vacancy Rate
(In percent)



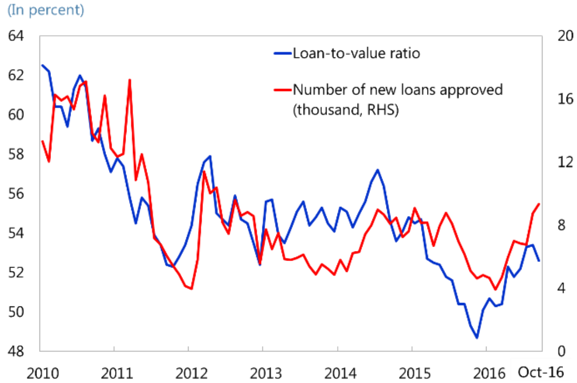
Few confirmor transactions (properties resold before the original sale is completed) after stamp duties were imposed.

Confirmor Registration
(In percent of Total Registration)



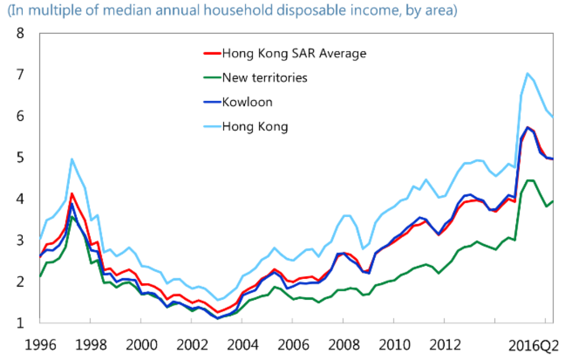
Demand has risen recently and been accompanied by higher LTVs on new loans.

Loan-to-Value Ratio and New Loans Approved
(In percent)



The scale of down payments has dropped back.

Minimum Down Payment-to-Income
(In multiple of median annual household disposable income, by area)

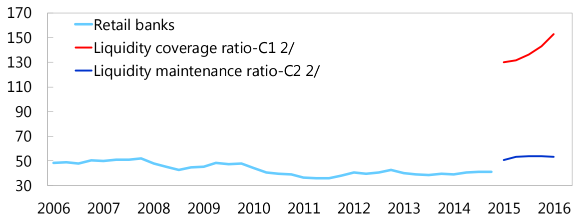


Note: For 45 sq.m. flat, assuming 70 percent LTV and 5 percent income tax rate.

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

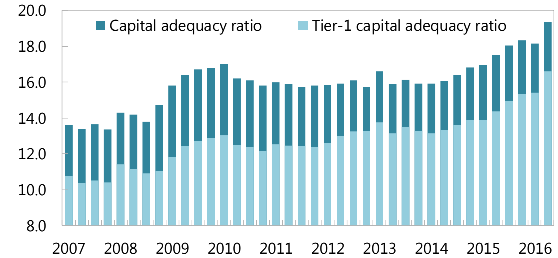
7. Strict macroprudential measures have contained bank exposure to the property boom. Since 2009 limits on loan-to-value ratios, debt service-to-income ratios, higher risk weight floors on property loans, and interest rate buffer stress tests have helped contain exposures. Banks continue to maintain healthy liquidity profiles (the liquidity cover ratio rose to 158 percent in 2016:Q2) and high capital buffers with a CET1 ratio of 15.8 percent. In line with Basel III, The HKMA will raise the countercyclical capital buffer (CCYB) to 1.25 percent of total risk weighted assets from January 2017. The HKMA's assessment is that indicators still point to a positive credit gap and a need to continue to raise the CCYB towards the Basel III maximum of 2.5 percent.

Liquidity Ratio of Retail Banks 1/
(In percent; quarterly average)



1/ The ratio of liquefiable assets to qualifying liabilities.
2/ A new data series was introduced for liquidity ratios which are defined in accordance with the Basel III ramework starting from January 2015. For a category 1 institution, the minimum requirement for liquidity coverage ratio began at 60% on January 1, 2015, rising in equal annual steps of 10 percentage points to reach 100% on January 1, 2019. A category 2 institution must maintain a liquidity maintenance ratio of not less than 25% on average in each calendar month.

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.

MACROECONOMIC OUTLOOK

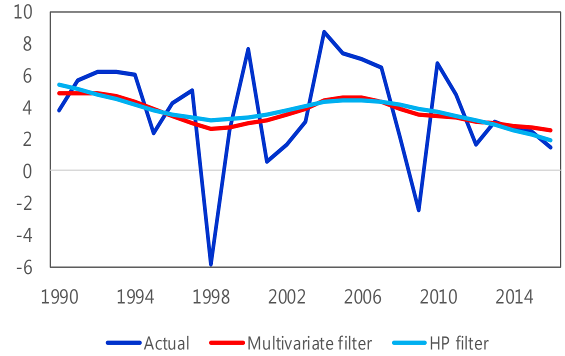
8. With soft external conditions, the growth recovery is likely to be gradual. Private consumption will remain the main driver in the near term, accounting for more than a half of overall growth, supported by a steady labor market. Overall growth is projected to pick up from 1.5 percent in 2016 to 1.9 percent in 2017; the output gap closes slowly.

- Interest rates rise in line with a gradual U.S. rate tightening cycle.
- World trade picks up with global growth, but is unlikely to achieve pre-crisis rates.
- Growth in mainland China in the near term is steady but moderates over the medium term.
- Credit growth remains moderate and following the increase in stamp duties, house prices ease back in an orderly manner, steadily reducing the overvaluation gap. With a small correction in house prices in 2017, credit growth is likely to remain at around 4 percent in 2017.
- Consumption is supported by a steady labor market, but is partly offset by falling house prices as the overvaluation gap erodes. Investment is supported by public infrastructure though the private investment outlook is subdued.
- Based on the 2016/17 Budget, and adjusting for revenue performance in line with past trends, little additional fiscal support is projected for this year and next (Table 3, Appendix I). However, further fiscal measures and support may be needed in the 2017/2018 Budget if growth remains soft and the global external environment remains difficult (paragraph 28).

9. Medium-term potential output growth edges down.

- Aging reduces estimates of potential growth over the medium term. Recent weaker growth outturns have reduced current potential growth estimates to around 2.5–2.7 percent.

Actual and Potential Output Growth
(In percent year on year)



- The medium-term primary surplus is somewhat lower than in the past. But this still leaves fiscal reserves in a comfortable position in 2021. In the baseline (with zero fiscal impulse) fiscal reserves decline slightly from 35 percent of GDP in 2015 to 33 percent in 2021 (or to around 30 percent of GDP, if the authorities adopted the staff's proposed near-term fiscal stance).

Authorities' Views

10. Outlook. The authorities generally agreed with the staff's assessment that the economy could attain further moderate growth next year, notwithstanding an outlook clouded by uncertainties. Fiscal stimulus in the last few budgets was able to provide relief to those at the lower end of the income scale and support small and medium-sized enterprises (SMEs) thereby alleviating uncertainty and creating a stable environment. Looking ahead, private consumption and ongoing infrastructure spending would help maintain momentum and support employment. In addition, the resilience of the economy, marked by highly efficient and flexible markets, robust regulatory framework, and sound macroeconomic policy, would enable Hong Kong SAR to sail through the challenges. The authorities were confident that the continuous rebalancing of the Mainland would lend further opportunities and stability to Hong Kong SAR's economy. Over the medium-term, an aging population could impinge on growth, but continued development of Hong Kong SAR as a global financial center, investment in infrastructure and fiscal buffers would help offset the effects.

RISKS TO THE OUTLOOK

11. There are three main risks. Growing economic linkages mean that changes in mainland China's growth prospects inevitably spillover to Hong Kong SAR's financial and real sectors. With a large globally-integrated financial sector and a currency board, the economy is also exposed to U.S. developments and global market volatility. The property market is the main domestic source of downside risk. On the upside, the economy is highly flexible and large potential can be tapped from the further development as a global financial center (see Risk Assessment Matrix, Appendix II).

A. Mainland China's Bumpy Transition or Slow Reform

12. Connections with mainland China's economy and the financial sector are important for future growth but also add risk transmission channels. A bumpy mainland China transition to sustainable growth would feed through the tourism, trade and financial channels.

13. Tourism and trade contribute significantly to activity and employment. A further slowdown in tourism and trade would dent retail sales, logistics and wholesale warehousing. SME links to mainland China are high, and a downturn in profitability combined with higher interest rates could stretch their debt servicing capacity.

14. Financial linkages have intensified over the past decade. Bank lending to mainland China plus trade finance account for around half of Hong Kong SAR banks' lending. RMB internationalization, equities market linkages, securities issuance by mainland corporates and asset management activity have all grown.

- **Banking system exposure to mainland banks**. External claims on onshore Chinese banks remain sizeable at HK$1.5trillion (62 percent of GDP) (Figure 4). The mainland is the largest systemically important source of potential shock to interbank markets. Banking sector exposure through lending and bond markets expanded rapidly over 2010–2014 as the offshore renminbi market developed and activity was spurred in part by steady gains from RMB appreciation plus the limited options for RMB investments. From late 2014, the change in RMB outlook, lower funding costs onshore, and a fall in RMB deposit pool offshore, led to a scale back in lending to mainland banks. However, the position stabilized in 2016:Q2 and more recent data points to modest pickup in lending to onshore banks once again.

- **Banking system exposure to mainland nonfinancial corporates.** Hong Kong SAR banks' nonbank China exposure—a broad measure including lending, off-balance sheet items and trade finance to mainland Chinese firms and overseas firms operating there—remains close to its historically-high level of HK$4.6 trillion (187 percent of GDP). After increasing rapidly since 2010, the rate of growth has eased since 2015 as mainland companies began to repay foreign currency debt, but the level of exposure is still high. HKMA analysis suggests that leverage has been increasing for nonlocal corporates (i.e., mainland China and overseas) since the Global Financial Crisis, and debt at risk is higher than for domestic firms. Still, the HKMA's stress tests suggest that the potential credit loss for Hong Kong SAR banks from a China growth slowdown remains manageable. Staff's analysis (Selected Issues Paper 1) provides support for this view, though banks should remain alert to rising credit risk.[1,2,]

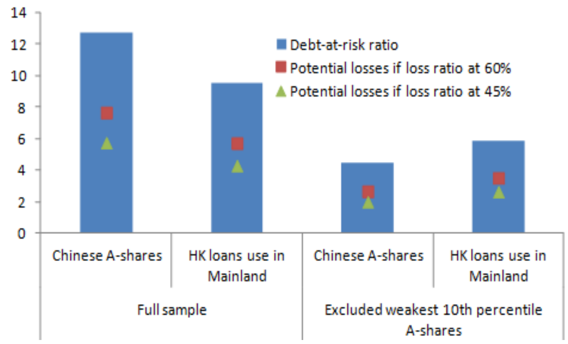
    - *Hong Kong SAR banks currently have less direct exposure to riskier mainland corporates than the average of A shares*. Based on staff's analysis, debt at risk could amount to 9 percent of Hong Kong SAR banks' mainland China corporate loan book or 4.5 percent of their total loan book.

[1] Prepared by Sally Chen and Tak Daniel Law (Resident Representatives' Office, Hong Kong SAR).

[2] The April 2016 GFSR analysis is applied to look at debt at risk (measured by an ICR<1) across Hong Kong banks' lending portfolios.

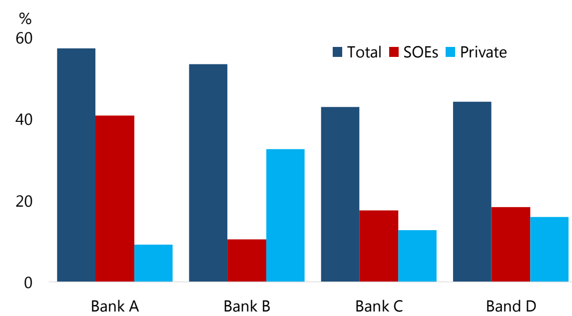
- *The HKMA has required banks to maintain prudent lending standards.* Hong Kong SAR banks' focus on large state-owned enterprises (SOEs), multinationals operating in mainland China and Hong Kong SAR-based conglomerates suggests that they are also not lending to the weakest listed corporates. A significant proportion of the loan book is also backed by bank guarantees or secured by collateral.
- *However, continued caution and monitoring remain warranted.* Conditions across banks vary. Some banks are more exposed to mainland SOEs and others to the private sector. While SOEs may enjoy an implicit government guarantee, this may not always be available—for example, as a result of SOE reform in the mainland. The analysis is based on current rather than stressed conditions. If the global environment deteriorated, nonlocal corporates' earnings would be hit and the impact on the real economy could be sizeable, with second-round knock-on effects on the banks.

Debt-at-Risk Ratio and Potential Losses
(4-quarter moving average)



Sources: HKMA; WIND; IMF staff estimates.
Note: The debt at risk ratio of HK loans used in the Mainland is calculated as the percentage of the sum of the sectoral debt at risk in the total. The sectoral debt at risk is estimated as the product of the share of liabilities by firms with interest rate coverage of less than one in the sector (estimated from A shares) and the loan amount of this sector.

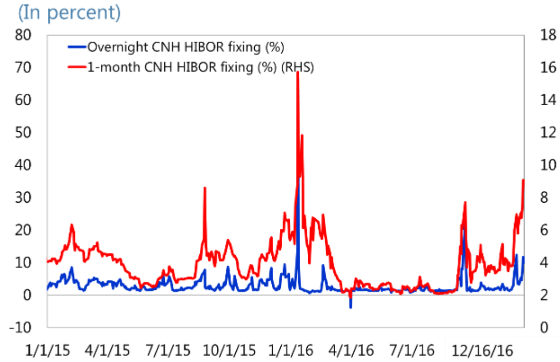
Lending Share Mainland China Corporates in Risk-Weighted Assets



Source: Citi Research.

- **Offshore RMB market.** Hong Kong SAR is the premier offshore RMB center and the net provider of liquidity to other markets (Figure 5). Around 70 percent of the global value of RMB settlement is handled by banks in Hong Kong SAR. This has been facilitated by market infrastructure including an RMB real time gross settlement system, the provision of liquidity facilities, and CNH-HIBOR fixing. This market should continue to grow further over the medium term as RMB internationalization continues and mainland China opens up. However, RMB activity has contracted since August 2015 following the shift in expectations from RMB appreciation to depreciation and with lower cross-border trade settlement. Spikes in the CNH-HIBOR rates in January, September, and December 2016 illustrate the potential for volatility and pressures to emerge with thin liquidity or changes in mainland management of capital outflows.

CNH Interbank Interest Rates
(In percent)



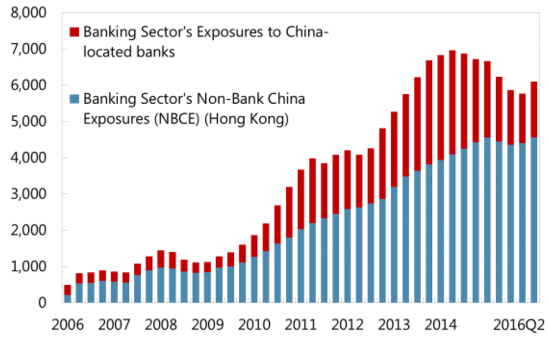
Sources: TMA; and Bloomberg.

Figure 4. Exposure to Mainland: Financial Channels

Hong Kong banks' exposure to mainland banks and corporates is high—though it has eased since 2014.

Exposure to China

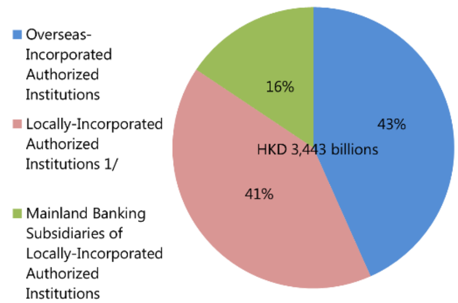
(In billions of HKD)



Locally incorporated banks and subsidiaries in the mainland account for almost 60 percent of the loans.

Mainland-related Lending

(In percent as of 2016Q2)

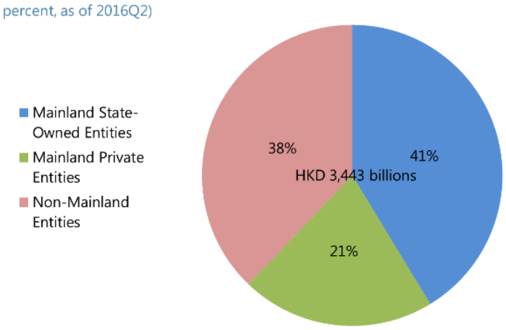


1/ Including loans booked in their Mainland branches

Lending is focused on SOEs and foreign companies operating in mainland China.

Mainland-related Lending

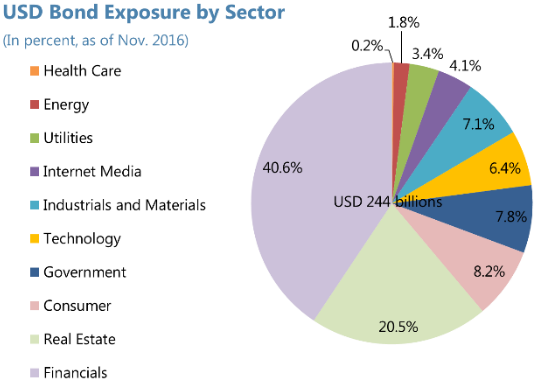
(In percent, as of 2016Q2)



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

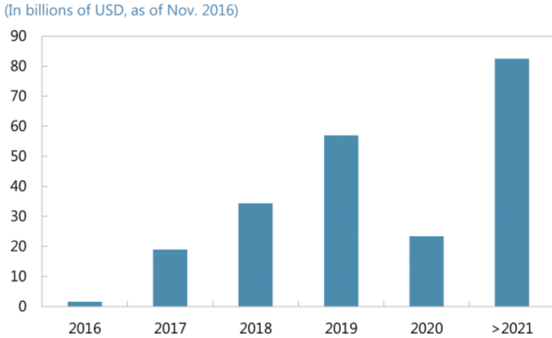
(In percent, as of Nov. 2016)



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. 2016)

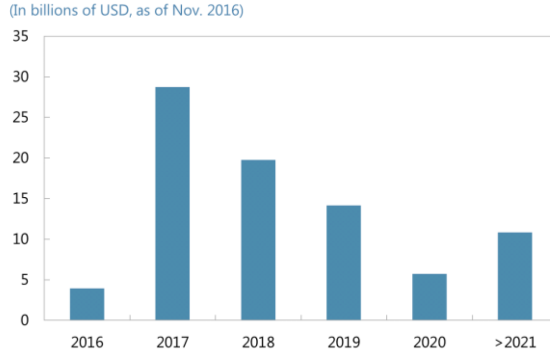


1/ All bonds issued by entities incorporated in Hong Kong SAR, Mainland China, and Cayman Islands with domicile of risk in Mainland China, excluding CDs.

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. 2016)

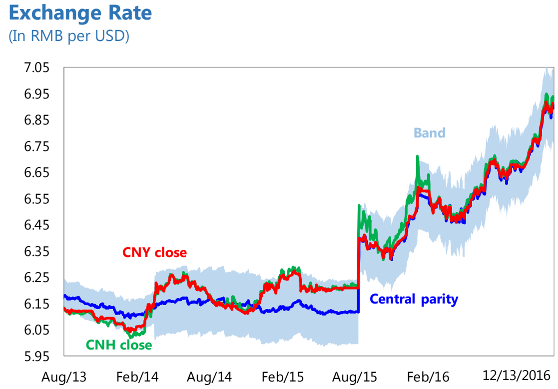


1/ All RMB bonds issued in Hong Kong SAR, excluding CDs.

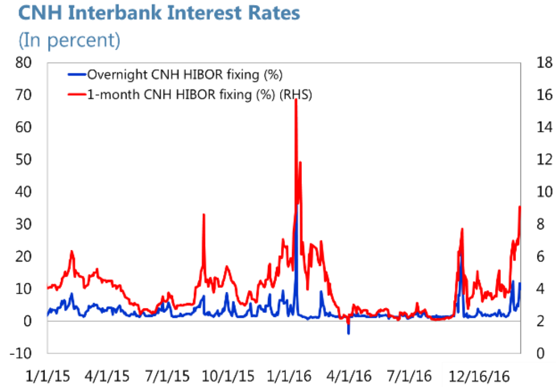
Sources: Bloomberg; CEIC Data Company Ltd.; HKMA; and IMF staff estimates.

Figure 5. Developments in the Offshore RMB Market

The RMB rates to the U.S. dollar have shown more daily volatility since the change to the central parity fixing in August 2015.

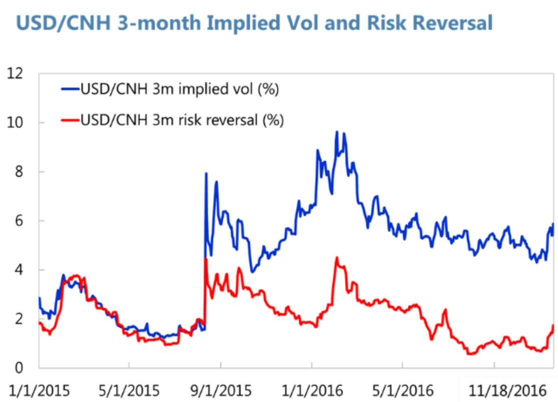


CNH interbank rates have spiked occasionally most recently in December.

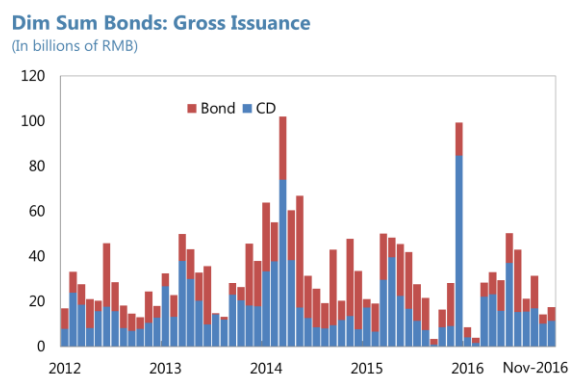


Sources: TMA; and Bloomberg.

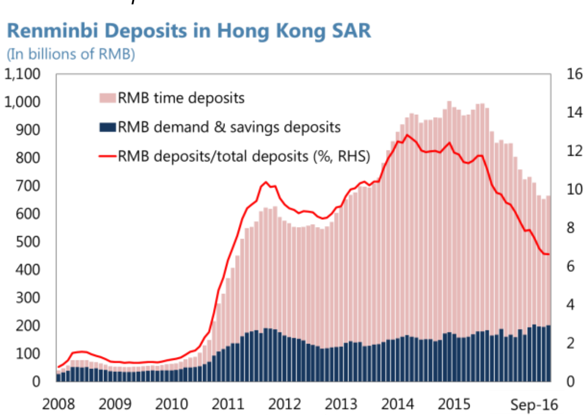
But volatility and USD/CNH risk reversals were lower during the recent interest rate spike.



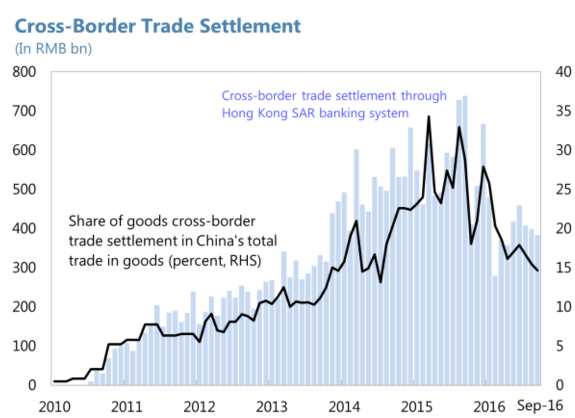
Dim Sum bond issuance has picked up from a trough.



The shift in exchange rate expectations has led to a marked fall in RMB deposits...



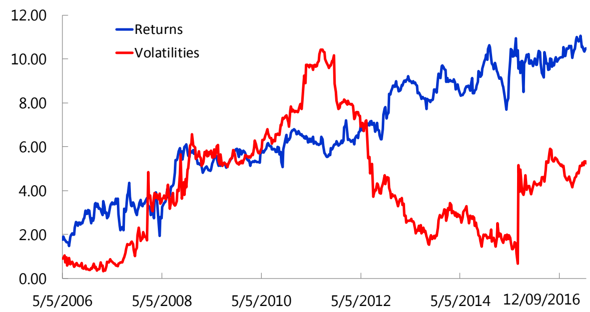
...accompanied by a slowdown in trade settlement volumes.



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

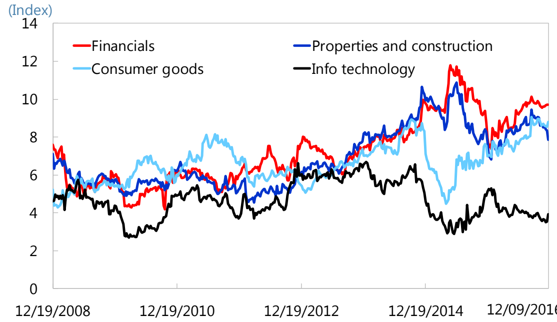
- **Stock market connections.** The Connect scheme allows individuals/institutions with brokerage accounts in Hong Kong SAR or Shanghai to trade stocks in the other market up to a limit—the new Hong Kong SAR-Shenzhen link (which opened in early December) has broadened access to hi-tech mainland stocks and increased the number of mainland small stocks covered from 560 to over 1000. The Mutual Recognition of Funds permits mutual funds in each location to mobilize investment from the other jurisdiction, subject to regulatory approval and an aggregate and daily quota. These schemes boost market activity and enhance liquidity in both markets, and they have prompted closer coordination between the regulators, but they also intensify possible risk transmission between the equities markets. With increased market connections, correlations and spillovers (on returns and volatilities) have been increasing over time across a broad range of sectors.

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



Sources: Haver Analytics and IMF staff calculations

Gross Spillover of Equity Returns: Mainland China to Hong Kong SAR
(Index)



Sources: Haver Analytics; and IMF staff calculations

- **The asset management industry** has expanded rapidly with total assets under management almost tripling over the past seven years, although values steadied in 2015. Combined fund management business amounted to HK$17.4 trillion in 2015 and the proportion of assets managed in Hong Kong SAR rose to 55.7 percent of the total, or equivalent to about 50 percent of total banking assets. The authorities are promoting the development of Hong Kong SAR as a global full-service asset management center to enable investors to manage complex risks—including from mainland onshore activity—through risk management products, hedging and derivatives. Legal and tax changes have been made to encourage global corporate treasuries, the private equity industry and open ended funds to domicile in Hong Kong SAR. Continued development of asset management is important for future growth (paragraph 46) but it will also heighten the sensitivity of capital flows to global shocks or shifts in Chinese investor sentiment.

Authorities' views

15. Bank exposures to mainland China banks and corporates. The authorities viewed the mainland China-related risks as manageable. Their heightened attention to the risks introduced four years ago spurred the monitoring of a broad range of exposure indicators to capture all the mainland-related linkages, and had required banks to maintain prudent lending standards. Frequent credit reviews had allowed HKMA to remain attuned to possible vulnerabilities. They agreed that the downturn in the credit cycle and slowing in mainland China's growth could prove to be a test over the next two years. Thus far, the classified loan ratio of mainland-related lending had remained low (less than 1 percent in June 2016).

Mainland lending exposures were typically directed to large SOEs and multinational corporates whose income streams tended to be diversified and balance sheets more insulated from specific mainland China-related factors. Moreover, the introduction of the stable funding requirement and countercyclical buffers meant the banks were well positioned to absorb materializing risks.

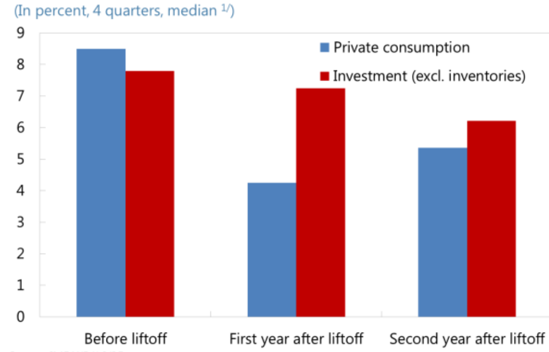
16. RMB offshore business. The authorities attributed the decline in RMB activity to a temporary cyclical shift in expectations from RMB appreciation to depreciation. This resulted in a tightening of liquidity which had led to occasional temporary spikes in the CNH-HIBOR rates. While the episode in January was pronounced and related to uncertainty about the Mainland's growth prospects, September and December's spikes were more contained. In fact, the Hong Kong SAR market remained a net provider of liquidity in the offshore RMB market as a whole, lending RMB to banks in other centers such as Singapore and London. To facilitate the smooth and efficient operation of the offshore RMB money market in Hong Kong SAR, the HKMA had recently expanded the number of primary liquidity providers in the RMB offshore market and its scale; and had introduced disclosure of the usage of intraday and overnight RMB liquidity facilities. Over the longer term asset allocation to the RMB would continue to rise as mainland China continued to open up, and inclusion of the RMB in the SDR basket had been an important step in carrying this forward.

17. Asset management industry. The authorities viewed the orderly functioning of markets through episodes of turbulence in mainland China's markets as an indication of the resilience of Hong Kong SAR's financial system. More broadly, Hong Kong SAR's economy would benefit by continuing to play its pivotal role as the financial hub and intermediary between mainland China and the rest of the world, as a place to manage onshore China risks, and as an international asset management and offshore RMB center. To make this a success, the authorities were focused on ensuring that the regulatory regime keeps pace and is resilient to fast moving and challenging market conditions. Work was underway to enhance asset management regulation in respect of securities lending and repurchase agreements, custody of fund assets, liquidity risk management and disclosure of leverage by fund managers.

B. U.S. Rate Cycle and Global Market Volatility

18. Rising U.S. interest rates. A gradual, anticipated rise in U.S. interest rates should not unduly dampen domestic demand; and the steepening of the U.S. yield curve following the presidential election has not affected confidence thus far, Hong Kong SAR interbank rates and major trading partner bilateral exchange rates have been broadly stable. Following Fed rate hikes, consumption typically grows at an orderly but slower pace. However, an unanticipated tightening of stance could have a bigger-than-usual adverse impact on consumption and domestic demand given the high level of household debt and low income growth. The leverage and debt service ratio of nonfinancial corporates in Hong Kong SAR has also been rising since 2010, and prolonged low interest rates may have encouraged them to take on excessive foreign exchange risk, with external debt by nonfinancial corporations rising from 30 percent of GDP in 2010 to 80 percent in 2015. U.S. rate hikes

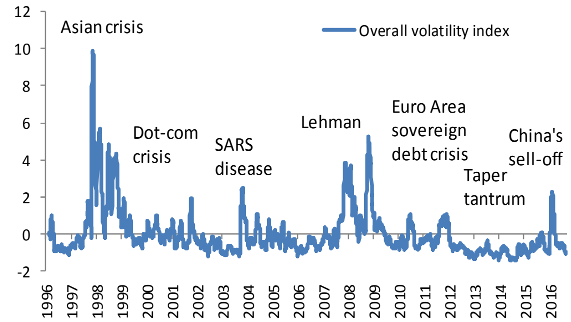
Growth in Private Domestic Demand
(In percent, 4 quarters, median 1/)



Source: IMF WP/16/35.
1/ Median of previous 6 rate-hike episodes.

combined with U.S. dollar appreciation could result in significant losses, increasing default risks. The rising cost of refinancing and rolling over corporate debt could also inhibit investment.

Volatility Index
(Hist. vol. of HSI returns, 1y EFBN yield and daily changes in USD/HKD)



19. European banks, Brexit or emerging market growth uncertainties could also tighten financial conditions. Market volatility has remained contained post-Brexit and lower than in previous stress episodes. Share prices of the major U.K. banks which have a large market presence in Hong Kong SAR quickly returned to pre-Brexit levels. However, high connectedness with the U.K. financial sector (with liabilities to the United Kingdom of 111 percent of GDP) means that shocks impinging on the U.K. financial system or on European banks could have large spillovers to Hong Kong SAR. Second-round effects could emerge from funding strains at bank group level, foreign exchange mismatch or from credit risks in locally incorporated banks' overseas loan books.

C. Property Market

20. With a persistent housing supply shortage and high levels of demand, the property market has faced a number of boom bust cycles. The rebound in the housing market since the summer has further stretched valuations. Relatively high household debt levels (66 percent of GDP) and high income gearing heighten the risk of an accelerated house price adjustment should interest rates rise faster than expected. Sensitivity to interest rate changes is also likely to be high with over 90 percent of new mortgage loans on floating interest rates. While the debt service index eased to 44 percent in 2016:Q2, sensitivity tests show it would rise sharply to around 60 percent in response to a 300 basis point interest rate shock. Although the buffers built up following macroprudential tightening is likely to ensure that the financial system would be resilient to a sharp house price adjustment, there is a risk to the real economy from an adverse spiral of negative wealth effects, lower collateral values, slower credit growth and weaker household spending.

Authorities' Views

21. Global financial conditions. While expecting a gradual pace of monetary policy tightening by the U.S. Fed, the authorities viewed the possibility of a faster-than-expected rise in Hong Kong SAR long yields as a material risk. If this resulted in capital flows out of emerging markets and a heightening in financial market volatility, it would have further knock-on effects to Hong Kong SAR's domestic economy. In aggregate, banks' liquidity coverage ratios were at a high level and had increased over time. Recent stress tests also showed that banks typically were holding highly liquid instruments, suggesting that they could withstand a sudden capital outflow. Banks' asset quality was healthy and banking sector capital remained well above minimum international standards.

22. Property market risks. The authorities agreed that the financial sector was relatively well insulated from shocks to the housing market, following seven rounds of macroprudential measures and the use of stamp duties to curb speculative and external demand. A correction in the property market would have effects on the real economy but such effects would differ across economic and property market cycles and would be difficult to measure.

23. Spillovers from the U.K or Europe. Although the banking system had not been much affected by the Brexit vote, the role of the U.K. banking system in distributing international banking flows and the linkages between the financial systems of Hong Kong SAR and the United Kingdom meant that developments were being closely monitored in case of international spillover risks. Similarly, the authorities were monitoring developments in European banks.

D. Amplification of Risks

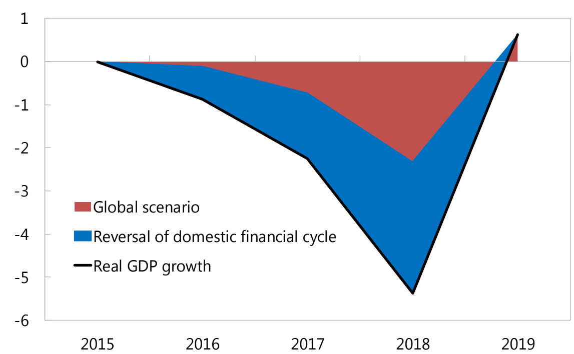
24. Under a severe low-probability scenario growth would fall sharply. In a low-probability scenario, heightened policy uncertainty in the U.S., Europe, and the United Kingdom could reduce global growth and be accompanied by a hard landing in mainland China.

- **Global shock.** In these circumstances external demand could subtract up to 3 percentage points from growth relative to the baseline over the next few years, reflecting the large openness of the economy and close links to mainland China.

- **Domestic economy**. Such an external shock would weigh on equities and the household sector, especially against a backdrop of already high household and corporate debt levels. HKMA work illustrates channels via which banks may rein in lending in response to macro shocks, further dampening growth and adding to the property price decline. Staff's scenario of a cumulative 35 percent decline in stock and house prices could generate significant negative wealth effects on consumption and investment, reducing the contribution of domestic demand to growth by more than 2 percentage points in the near term.

- **Overall growth impact.** Without a domestic policy response, overall growth could fall by 3.5-5.5 percentage points relative to baseline over the first two years after the shock. A downturn would also hit fiscal outturns, as they are relatively dependent on property-related revenues.

Downside Scenario: Impact on Real GDP Growth
(Percentage points difference from baseline)



Source: IMF staff estimates.

25. While vulnerability to shocks is high, there are large buffers to cope with adverse events. Fiscal reserves are 35 percent of GDP and foreign exchange reserves cover seven times currency in circulation and around 48 percent of Hong Kong dollar money supply. Banks' liquidity and high capital buffers should help contain the exposure of the financial system to adverse shocks—although they do not neutralize the effect on the real economy. The IMF's FSAP stress tests (2014) found that the banking sector was sufficiently capitalized and liquidity risks were low.

Authorities' views

26. The authorities considered an adverse scenario a low probability event. Substantial buffers were in place to weather a severe shock. As a small open economy with a large financial sector, they had in place contingency planning to ensure crisis preparedness and they were well placed to coordinate both domestically and internationally (see paragraph 43). The financial system was significantly better placed to cope with external shocks than it was at the time of the Asian Financial Crisis, although overall economic activity would inevitably slow.

POLICIES TO SUPPORT THE RECOVERY

A. Fiscal Policy: Near-Term Space, Longer-Run Challenge

27. Context. Fiscal policy is the main demand management tool, since monetary policy is determined through the direct link to U.S. interest rates through the currency board (LERS). Fiscal policy therefore needs to support economic stabilization, when there is a sizeable output gap and when external demand is weak. With a comfortable level of fiscal reserves, there is scope for near-term support which can be removed as the economy recovers (Figure 6). However, over the longer run the structural fiscal position will weaken as the economy faces rapid population aging with one in six people currently 65 or above rising to one in three by 2034. Pensioner poverty and inequality are also issues that the government is tackling. Fiscal policy needs to balance near-term needs against the longer-term weakening of the structural fiscal position and the commitment, enshrined in the Basic Law, to preserve low taxes and fiscal prudence. This can be achieved by aligning short-term fiscal measures to long-term goals and shifting spending forward to help ensure that cyclical support does not exacerbate the long-term fiscal trend.

Near-Term Fiscal Policy

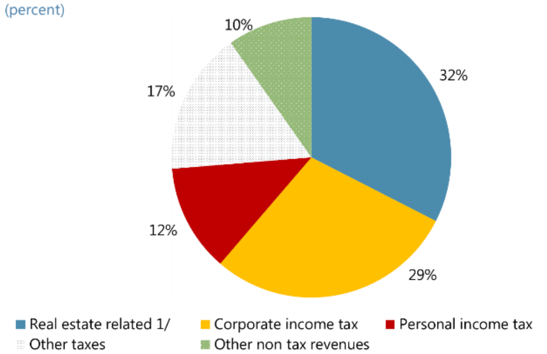
28. There is a case for a fiscal stimulus given the soft economic outlook, sizeable output gap, and difficult external environment. The planned fiscal impulse of around 1.6 percent of GDP in the 2016–17 Budget is therefore appropriate and there would be room for further easing in 2017/18, possibly to total a cumulative 2 percent of GDP over the two fiscal years. However, based on past conservative performance, staff's baseline projection is that the actual fiscal impulse will turn out to be lower than this and close to zero in 2016/17 as a result of both overachievement of revenues (which has been a persistent trend, given conservative forecasts) and underachievement of expenditures. If growth remains weak, additional discretionary stimulus would be needed in 2017–18. A fiscal package in line with staff's proposal would still leave fiscal reserves at a comfortable level of around 30 percent of GDP in 2021 and public debt close to zero. Measures could comprise:

- support to vulnerable households, and the elderly, in the lower income deciles, for example through allowances, rental relief and measures to help keep women and elderly workers connected to the workforce (which would also help the long-run position);
- support for small businesses which has been effective in previous Budgets; and
- bringing forward capital spending to boost housing supply and accelerate urban renewal, to the extent feasible.

Figure 6. Fiscal Policy: Room for Maneuver in Near Term but then Aging Takes Hold

A significant proportion of revenues is directly related to real estate...

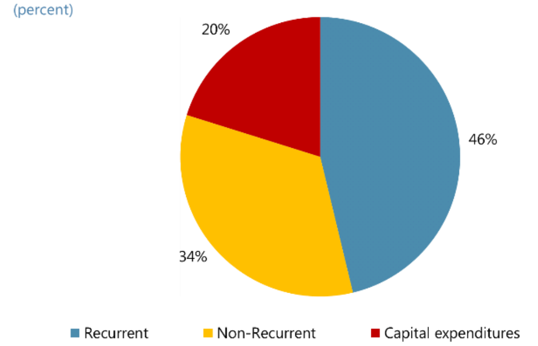
Revenue breakdown in FY2014/15
(percent)



1/ Includes land premium, stamp duties, and property tax. Sources: CEIC, IMF.

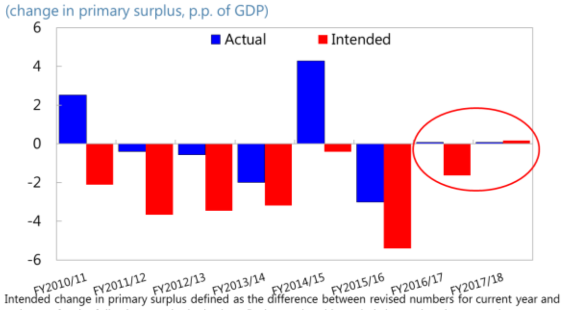
...and nonrecurrent expenditures are high.

Expenditure breakdown in FY2014/15
(percent)



The 2016/2017 fiscal outturn may not be as supportive as intended...

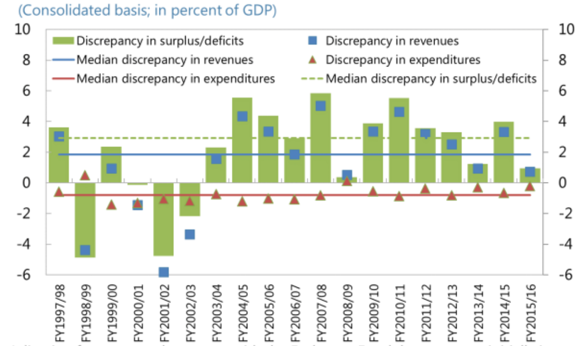
Fiscal Support in 2016/17 May Not Be As Large As Intended; Room in 2017/18 Though
(change in primary surplus, p.p. of GDP)



Intended change in primary surplus defined as the difference between revised numbers for current year and estimates for the following year in the budget. Both actual and intended change in primary surplus are divided by actual fiscal year nominal GDP. Adjusting for ex-post placements with the Exchange Fund not initially in the budget. Sources: CEIC, Government budget statements.

...because the authorities have systematically underestimated revenues.

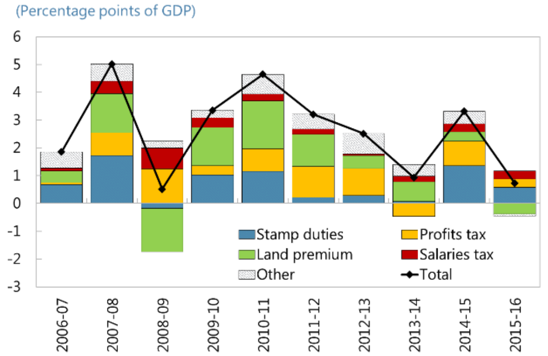
Discrepancy of Fiscal Outturn and Budget
(Consolidated basis; in percent of GDP)



Adjusting for ex-post placements with the Exchange Fund that were not initially in the budget. Sources: Government budget statements; and IMF staff estimates.

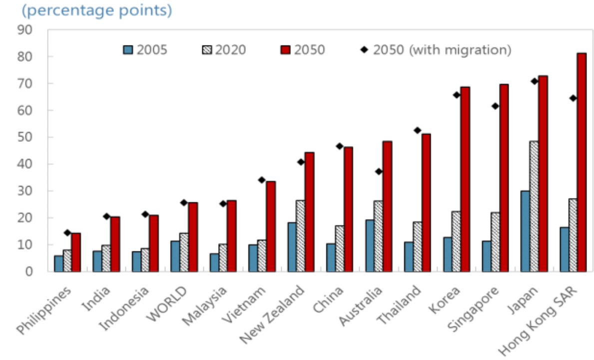
Revenues are underestimated consistently across major categories.

Discrepancy between Actual and Budgeted Revenues
(Percentage points of GDP)



Hong Kong SAR's old age dependency is among the highest in Asia.

Asia: Old-Age Dependency Ratios
(percentage points)

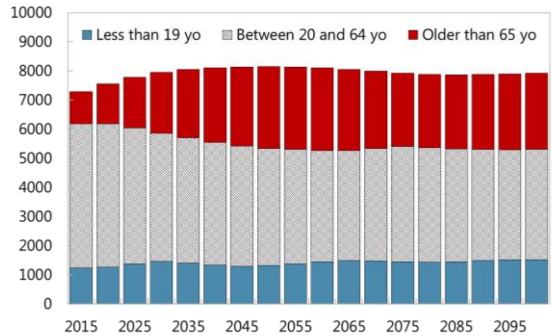


Sources: Bloomberg; CEIC Data Company Ltd.; HKMA; UN World Population Prospects 2015; and IMF staff estimates.

Long-Term Fiscal Challenge

29. An aging population could lead to structural fiscal deficits within a decade. The labor force will start declining after 2018 and population aging is most marked through to 2045. Rapid population aging will create rising demands for social expenditure and could potentially lower growth and fiscal revenues. Without policy changes, the structural fiscal balance is likely to weaken and deplete the fiscal reserves buffer. These challenging demographics set in against a backdrop of already slowing potential growth in a maturing economy that is close to the knowledge frontier.

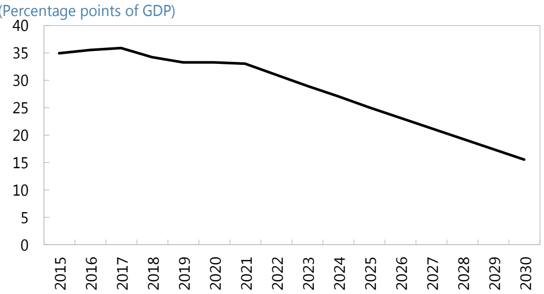
Population Projections
(Thousands)



Sources: UN population projections, medium fertility scenario.

30. These pressures will test the fiscal framework. The Basic Law stipulates that (i) expenditure must be kept within the limits of revenue; (ii) fiscal deficits should be avoided; (iii) the budget should be kept commensurate with the growth rate of GDP. Early action is needed before fiscal reserves start depleting rapidly. In 2013, the authorities established a working group on long-term fiscal planning (WGLTFP) which issued a report studying the impact of aging on fiscal outlays. The report found that under current policies reserves would be depleted by 2035-40 with the start of structural deficits at around 2025-2030. That leaves some time to implement corrective measures, although implementation should start as soon as possible since the demographic transition will be frontloaded. Moreover, early measures will have the largest cushioning effect as they rein in spending at lower levels.

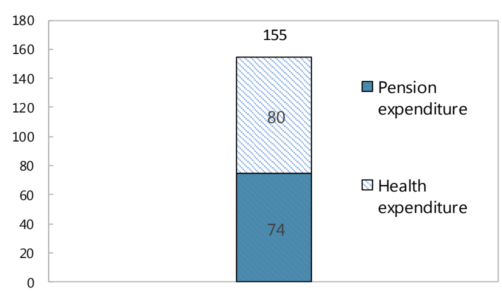
Fiscal Reserves after 2022
(Percentage points of GDP)



Source: Report of the working group on long-term fiscal planning, IMF.
Note: Scenario uses (i) staff baseline prior to 2022; (ii) a constant primary balance set to match fiscal reserves projection in 2041-42 in the "No service enhancement" scenario from the report of the working group on long-term fiscal planning; and (iii) real interest rate and GDP growth of 1 percent and 2 percent.

31. Efforts should concentrate on tackling the impending structural deficits. Under current policies, structural deficits could set in soon and remain in place beyond the end of the demographic transition. Recurrent spending tied to aging could represent an additional cost of 155 percent of GDP over the next 85 years, or 1.9 percent of GDP in constant equivalent flow per year.

Present Value of Age-related Increased Spending
(In precent of 2015 GDP)



Source: IMF staff estimates.
Note: Calculations based on UN medium-fertility demographic scenario, IMF pension expenditure projections and health expenditures based on no

- ***On the expenditure side***, fundamental expenditure reviews to rein in expenditure growth should be accompanied by a reprioritization towards measures that boost labor force participation and promote growth. The June 2015 change in civil service retirement age for new recruits (from 60 to 65) is a welcome step.

- ***Revenue raising measures*** should also be considered, including reinforcing user-pay fees, better administration, avoiding overreliance on direct taxation, and extending revenue expenditure measures tied to labor participation such as tax deductions for child bearing and education.

32. Long-run fiscal anchor. The aim for fiscal balance and keeping overall government expenditure growth in line with GDP growth over the medium term is appropriate, while taking early action to alleviate the structural deficit problem. A drawdown of fiscal reserves could be accommodated as the economy adjusts, but a positive fiscal buffer is desirable to cope with adverse shocks, provide room for countercyclical fiscal policy, and sustain confidence in fiscal strength, the Hong Kong dollar and monetary stability.

33. Measures to boost GDP growth can also help stem the deterioration in the fiscal position. A recommendation of the WGLTFP was to set up a Future Fund, to allow a portion of fiscal reserves to be directed to longer-dated, higher-return investments. Rather than conducting purely financial investments, the Future Fund could also be channeled to local real investments in physical and human capital. Tax policies to encourage labor participation, particularly among women and the elderly and to promote active aging are also key. Sustaining a flexible economy and continuing to have an "open doors" policy and integrate foreign workers are also important. Directing more resources towards the provision of land for construction could have a large impact on growth, although current constraints are often not financial but at the regulatory, procedural and planning stages.

34. Monitoring and communication of the long-term fiscal challenge should be stepped up. Producing an independent report every three to five years that updates projections, takes stock of measures undertaken and discusses options, would help demonstrate progress and educate the public on the long run fiscal challenge. It would also illustrate how the authorities balance out long-term concerns against the justified short-term concerns of providing support to the economy and helping those at the bottom of the income distribution. The report could follow the model of Australia's intergenerational reports or the European Union's Aging Report.

Authorities' Views

35. The authorities agreed that fiscal policy must balance short-term needs with longer-term structural headwinds from population aging.

- **Near term.** The last few budgets had featured considerable supporting measures—in particular, infrastructure investment and transfers to households in particular—that successfully shielded the economy from growing uncertainty and helped to sustain high employment, while inflation remained contained. The fiscal impulse in the current budget was seen as appropriate, but further easing could be considered in the forthcoming 2017/2018 Budget if external conditions remained challenging.

- **Longer term.** The authorities were considering policy options to address population aging, while adhering to the principles for fiscal policy set out in the Basic Law. The establishment of the Future Fund would also help generate higher returns on investment. An important part of the policy response to aging would be to maintain economic flexibility and open to foreign workers and to creating incentives to encourage higher labor participation. With respect to fiscal policy, they had already initiated a program within the government to contain the growth of government expenditure and would proceed with expenditure reviews and a reprioritization of spending. Measures to broaden the tax base could also be considered. Maintaining a positive fiscal reserve position was important to retain the credibility needed to operate countercyclical fiscal policy. They were open to the idea of periodic reporting on long-run fiscal sustainability but noted that this would be an intensive exercise and they would need to consider the resource costs, frequency and the scale.

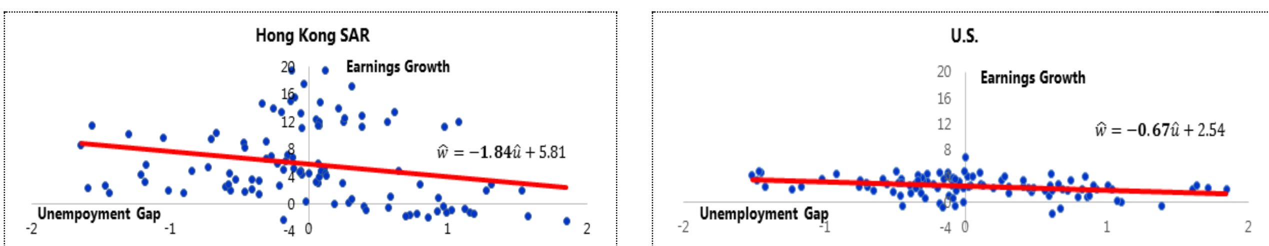
B. Preserving Strengths

36. The exchange rate regime has been supported by coherent and strong policy frameworks that help the economy adapt to changing global conditions. The LERS is underpinned by the flexible economy, ample fiscal and reserve buffers and strong financial regulation and supervision. These features anchor the stability of Hong Kong SAR's small open economy and its large, globally integrated financial services industry.

- **Exchange rate regime.** The LERS has been in place for thirty-three years, has been tested through crises, and remains the best arrangement for Hong Kong SAR. The supporting institutional and policy frameworks, including the preservation of fiscal and reserves buffers, ensure the smooth functioning of the currency board. The link to the U.S. dollar is appropriate, given that Hong Kong SAR is most affected by trade and financial flows *between* advanced economies and mainland China rather than just the fluctuations of the Mainland economy.

- **Flexibility**—through labor, product and asset markets—is critical to the successful operation of the LERS, enabling speedy adjustment through relative prices in the absence of the nominal exchange rate channel. This is important given that U.S. dollar appreciation may initially reduce Hong Kong SAR's competitiveness. Staff's study shows that at an aggregate level Hong Kong SAR's prices and wages adjust more strongly than in either the United States or the United Kingdom (selected Issues Paper 2).[3] The industry level evidence also points to flexible adjustment with downward wage rigidity less binding in Hong Kong SAR than in the United States.

Labor Earnings Adjust Faster in Hong Kong SAR



Sources: Haver; and IMF staff calculations.

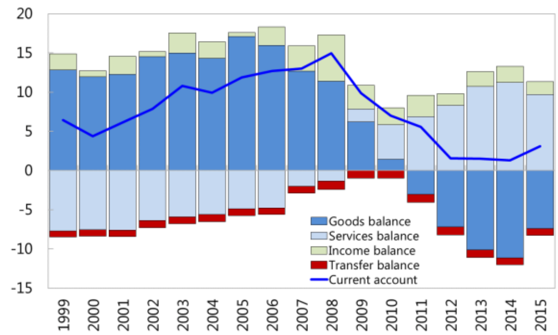
37. External sector assessment. The structure of Hong Kong SAR's trade has been adapting to the shift in China's trade patterns and capital account liberalization, with the trade-in-goods surplus switching to a deficit and the trade-in-services deficit to a surplus (Figure 7). The structural current account surplus is now significantly lower (a current account surplus norm of around 1–4 percent of GDP), and the current

[3] Wage and Price Flexibility in Hong Kong SAR Prepared by Si Guo (Selected Issues and Forthcoming Working Paper).

Figure 7. External Sector: A Structural Shift to a Lower Current Account Surplus

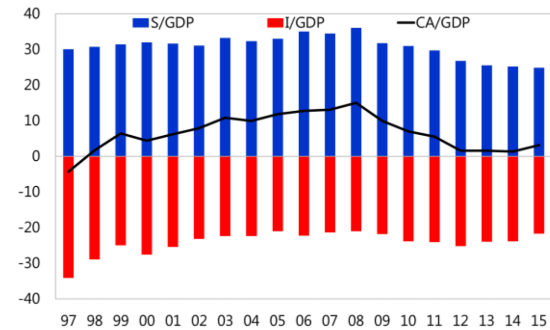
The current account surplus is substantially lower than prior to the GFC.

Current Account Balance
(in percent of GDP)



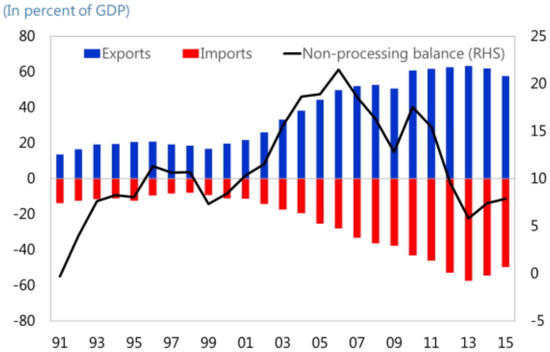
More than three quarters of narrowing CA surplus was due to large private sector dissaving.

Investment, Savings, and Current Account
(In percent of GDP)



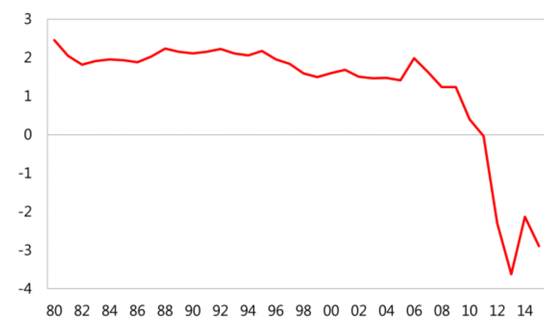
Several structural factors have contributed, including external rebalancing of mainland China…

Merchandise "Non-processing" Trade vis-a-vis China
(In percent of GDP)



…reversal of gold trade balance due to the opening of a Precious Metals Depository…

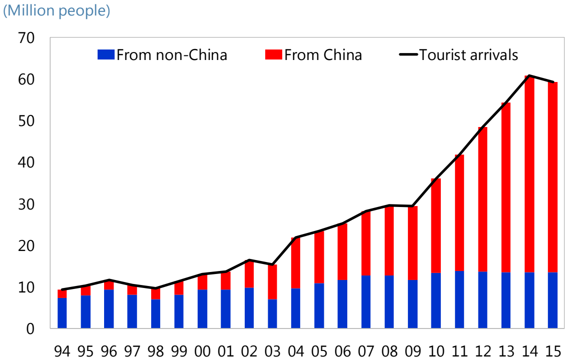
Trade Balance of Gold [1/]
(in percent of GDP)



1/ Proxied by the difference between merchandise trade balance and goods trade balance under BPM6 without adopting change of ownership principle.

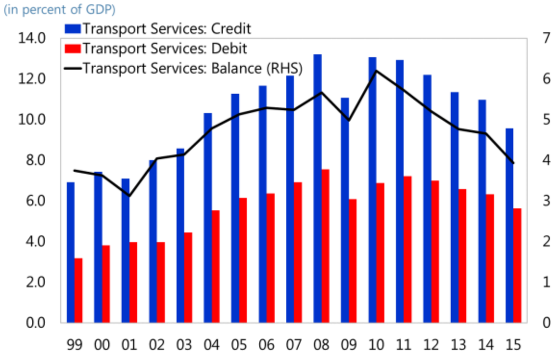
…rising imports to meet increased tourist arrivals from mainland China, and…

Tourist Arrivals
(Million people)



…steady decline in transport services.

Transport Services
(in percent of GDP)



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

account surplus is projected to remain in the 2–4 percent of GDP range over the medium term (Selected Issues Paper 3).[4] The July 2016 External Sector Report concluded that the external position was broadly in line with medium term fundamentals and desirable policy settings. Since then the real effective exchange rate has remained broadly stable, and analysis through October 2016 delivers the same results (see Appendix III).

Authorities' Views

38. The authorities emphasized that the LERS remained the cornerstone of the financial system and the best monetary arrangement for Hong Kong SAR. Stability played an important role in supporting Hong Kong SAR's role as a trading and financial center. The credibility of the LERS had stood the test of time through a number of global crises and was supported by a sizable net international investment position, prudent fiscal policy and a flexible economy. The anchor to the U.S. dollar remained most appropriate as it is the most commonly used currency in international trade and for cross border financial transactions, and given the depth, breadth and liquidity of U.S. dollar denominated transactions and low inflation track record. They viewed the exchange rate as being in line with fundamentals. They noted that the current account surplus had narrowed since the GFC not because of a loss in competitiveness arising from the currency board but because of several structural factors including subdued global trade flows and the external rebalancing of mainland China. The authorities concurred with staff's work which showed that wages and prices were flexible when compared with international peers. Following the introduction of the statutory minimum wage in May 2011 the labor market had still remained broadly stable. Wage and price flexibility had enabled the reallocation of resources across sectors without costly disruptions to activity.

PROTECTING FINANCIAL SYSTEM RESILIENCE

A. Financial System

39. The robust regulatory and supervisory framework should help limit the build-up of systemic vulnerabilities. The authorities have a track record as a global standard setter in regulation and supervision and in addressing data gaps. Substantial progress has been made on implementing the 2014 FSAP recommendations (see Appendix V). An independent insurance authority has been established and the new risk-based capital regime for insurance companies is being put in place which will take two to three years to complete. The process of strengthening standards for securities listing is underway. Legislation has been put in place for a resolution framework for financial institutions which is designed to implement the Financial Stability Board's Key Attributes—an impressive step forward. The HKMA has stepped up guidance and monitoring of bank lending activities, including to mainland China and for property-related activities; is closely checking liquidity risks; and is encouraging banks to reinforce cyber security. Coordination among Government and regulators in the Financial Stability Committee promotes discussion of risks that could transmit across the financial system. The authorities have close links with mainland regulators

[4] External Sector Developments in Hong Kong SAR, prepared by Joong Shik Kang.

and are active in international fora, including supervisory colleges for cross-border banking and insurance groups, for global systemically important financial institutions, and in crisis management groups.

40. Countercyclical prudential policy. Although credit growth has slowed, there is still a positive credit gap. Risks from high corporate leverage and the housing market have not subsided but may actually increase as U.S. interest rates rise. Thus 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. The CCYB could be paused or reversed only once the credit gap is eliminated and it becomes apparent that there has been a clearly established change of trend and financial cycle downturn.

41. While the financial system is resilient and prudential policy settings are appropriate, with an uncertain external setting, heightened attention is advisable in several areas:

- Completing the strengthening of the nonbank oversight regime.
- Further enhancing stress testing and risk analysis across the financial system. This could include complementing the individual risk analyses of the HKMA, the Securities and Futures Commission and the Insurance Authority, with coordinated work in line with emerging best practices.
- Continuing to increase coordination among regulators, especially on liquidity monitoring, as new markets grow.
- Reviewing financial institutions' plans in response to stress events globally or in mainland China.
- Continued efforts to enhance transparency related to legal persons and trusts and effective implementation of anti-money laundering and countering the financing of terrorism controls in line with the 2012 Anti-Money Laundering Ordinance (AMLO) and international standards underpin Hong Kong SAR's reputation as a premier global financial center.

42. Contingency planning. In the event of a large adverse shock, a comprehensive and coordinated policy approach similar to the 2008/9 response would be appropriate, combining fiscal stimulus, loosening of macroprudential policies, expanded credit guarantees and HKMA emergency liquidity assistance. Strong collaboration among regulators and counterparts in other jurisdictions would be needed to monitor cross-border risks and provide liquidity support and backstopping of liabilities. The recently introduced crisis resolution framework is strengthening the availability of tools and ability to respond to strains in the banking, corporate and household sectors.

Authorities' Views

43. The authorities' welcomed the positive assessment of the progress made on implementing the 2014 FSAP recommendations. Approaches to the risk-based capital regime for insurance companies were being put in place and would take two to three years to complete formulating the regulatory framework—mainly due to establishing detailed capital requirements and carrying out quantitative impact studies for each company based on its risk exposure. Coordination among the regulators and government in the Financial Stability Committee promoted discussion of risks that could transmit across the financial system, closely following the emergence of best practices on stress testing and risk analysis emerging from leading central banks, the FSB and IOSCO.

B. Property Market Related Measures

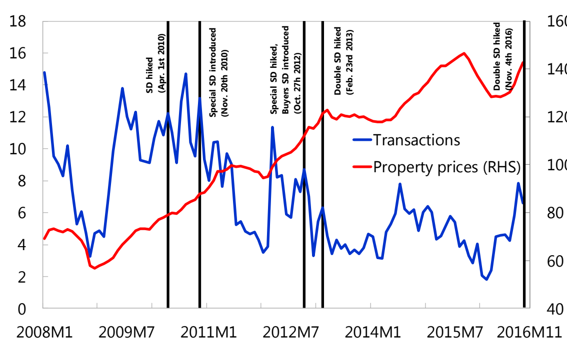
44. With renewed signs of overheating in the property market, the three-pronged approach to limiting risks is as important as ever. This involves boosting housing supply to match demand, macroprudential measures to limit stability risks, and stamp duties to contain speculative activity and external demand.

- **Tackling housing supply shortage.** The Long-Term Housing Strategy and Hong Kong 2030+ are aimed at addressing the housing shortage in an integrated manner by guiding land, planning and infrastructure development (see Box 1). Beyond the ten-year rolling target, continued efforts are needed over a longer horizon to keep pace with household formation and the need for urban renewal. Accelerating plans to increase supply faces a number of obstacles—such as the lack of ready projects, planning restrictions and legal and community objections. Nonetheless, 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.

- **Macroprudential measures for housing.** Current settings have done their job of limiting financial system exposure to the asset price boom. With house prices rising once more, and valuations stretched, a further orderly house-price adjustment would be helpful. Loan to value (LTV) or debt service to income (DSI) ratio settings should remain fixed. Only once it is clear that the trend has firmly turned down, the overvaluation gap is eliminated, credit conditions tighten and an undervaluation gap opens up together with lower new housing transactions, would there be a case to ease LTV and DSI limits (which are conservative by international standards).

- **Stamp duties have helped contain speculative demand and curbed demand from cash buyers**. November's increase in ad valorem stamp duty for residential property transactions had an immediate impact on sentiment and appears to have curbed market exuberance. Stamp duties can be an effective part of the toolkit to stem excessive price increases and speculation in the real estate market. However, as the distorting costs of duties become more significant the higher they are, they should be rolled back once the trend has shifted towards reduced price and speculative pressures. The authorities should also monitor their effects to make sure it does not negatively affect the supply of smaller housing units, given the need to encourage relatively high density housing and provide affordable housing.

Residential Property Transactions and Price 1/



1/ Transactions are in thousands. Centa-city leading property price index (1997=100).

Box 1. Housing and Land Supply, and the Development Strategy 1/

Housing supply dropped sharply in the 2000s, leading to an acute housing shortage which the authorities are now seeking to address.

Household formation increased by 40 percent over the past twenty years but the supply of housing was cut sharply following the early 2000s-housing market downturn. New public housing was cut from an average of about 50,000 a year in the early 2000s to less than 15,000 in recent years and private housing was cut from 25,000 to 10-15,000. The private domestic vacancy rate almost halved. Land reclamation and site formation also slowed. This led to a growing demand supply imbalance. Projections point to a further expansion of households by 20 percent through to 2044. Compounding this, the housing stock is aging with close to 20 percent of it expected to reach aged 70 or above by 2046.

Tackling the housing shortage is now an important goal of government policy:

- *The Long-Term Housing Strategy* plans to build 460,000 units over the next ten years from 2017/18 to 2026/27 with a public/private split of 60:40. The strategy includes building more public rental units; expanding subsidized home ownership; and steady provision of land supply for private residential properties and tenancy, keeping supply in sync with demand.
- The longer-term development strategy is being revised in *Hong Kong 2030+*. It has been issued for public consultation and is expected to be finalized in 2018. It contains a vision to become a livable, high-density city in an environmentally friendly way.

Development of Hong Kong SAR's land area is challenging with only a quarter of the land supply already developed. Up to 30 percent of the land area is planned or under study for development, other areas face major development, environmental or geographical constraints or are country parks or special areas. Land development typically takes 11–14 years from the preliminary stage to final construction and requires the development of ancillary transport and community services.

To push forward a pipeline of land supply the authorities adopted a multi-pronged strategy:

- *Near and medium term*. (i) increasing development density if the traffic and environment conditions permit, (ii) changing land use if the provision of public/community facilities and open space is adequate, and (iii) reviewing land use of currently vacant government land and green belt sites
- *Medium to long term*. (i) developing five new areas and (ii) extending new towns adding around 200,000 units starting from 2023–2026 (towards the end of the ten-year plan).
- *Longer term*. (i) developing Lantau island and New Territory North, (ii) reclamations, and (iii) developing cavern and underground spaces.

1/ Prepared by Joong Shik Kang.

Authorities' Views: Property Market

- **Raising housing supply.** This was a central focus for policy and supply was being increased as quickly as possible without compromising planning principles. The authorities were skeptical that there was much scope to bring forward investment given long time lags for development. The long-term housing strategy aims to gradually avert the supply-demand imbalance in housing, while Hong Kong 2030+ would address the need to step up urban regeneration efforts and result in sustained economic development and better quality living.

- **Macroprudential measures.** The authorities viewed the current settings of macroprudential policies as appropriate. Since macroprudential measures were first introduced, at an early stage in 2009, the average LTV on new loans had fallen back from 64 percent immediately before the imposition of tightening measures to around 52 percent in 2016. The measures ensured that banks had sufficient buffers to handle potential shocks matching the worst cycles of the past.

- **Stamp duties.** Alongside the HKMA's imposition of macroprudential measures, the government had used stamp duties to contain speculative and external demand for property. The recent increase in the ad valorem stamp duty rate for residential property transactions had been necessary to manage demand, particularly from investors, in an overheated market.

SECURING LONG-TERM POTENTIAL

45. Opportunities and challenges. In addition to the long-term fiscal challenge, the economy will need to adapt to mainland China's rebalancing and move up the value added chain. This will bring vast opportunities but also requires the same adept flexibility that has helped Hong Kong SAR to successfully navigate change over the course of its history. Reducing inequality (especially from aging and pensioner poverty) and supporting labor participation will also be important for an aging population.

46. Building on Hong Kong's role as a global financial center will be critical for growth. Hong Kong SAR has comparative advantages of geographical location, skilled and well educated workforce, high legal standards and a common language with its main trading partners. Leveraging its strong position as a regional financial hub, opportunities can be tapped from mainland China's growth, global integration and capital account liberalization. As well as maintaining its position as the leading RMB offshore center, the authorities have a strategy of developing the asset management industry, encouraging corporate treasury centers to domicile in Hong Kong SAR and enabling healthy development of Fintech without compromising consumer and investor protection. There will be opportunities for global companies to conduct business through Hong Kong SAR, both to continue to establish Hong Kong SAR as a financial center for mainland China but also to become more of a global center for finance broadening international activity. The HKMA's Infrastructure Financing Facilitation Office should help facilitate Hong Kong SAR's role as a financing center for regional infrastructure investment, and mainland China's "One Belt One Road initiative" will help expand activity. There is also scope to further develop professional services exports. Innovation should continue to be accompanied by strong regulation and supervision over the whole financial system.

47. Inequality, aging, and labor force participation. A number of the authorities' policies are targeted to supporting those at the bottom end of the income deciles (Box 2) including through increasing the supply of public housing and increasing labor force participation. The low income Working Family

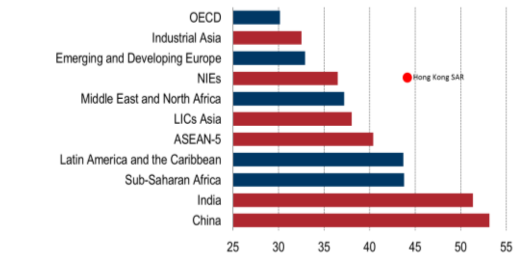
Box 2. Inequality in Hong Kong SAR 1/

Hong Kong's income inequality as measured by the Gini index appears high in international comparisons, but may have declined recently as the authorities targeted policies at supporting the bottom of the income distribution.

Hong Kong SAR's inequality looks high when comparing Gini indices across economies. The market Gini index measures inequality in market outcomes prior to taxes and transfers, while the net Gini index measures inequality in post-tax and post-transfers outcomes. Hong Kong SAR's market index and net index of 54 and 44, respectively, in 2011 look relatively high when compared with other economies.

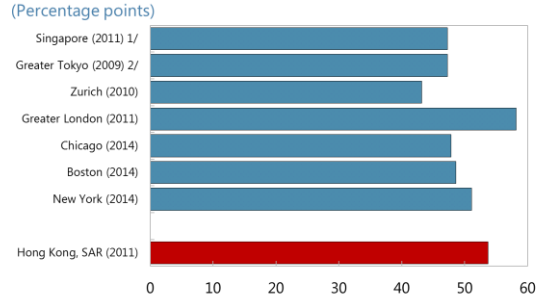
However, comparisons of Gini indices across economies are not straightforward. National statistics offices compute different concepts of the Gini, for example, based on market or net basis, on full income or just wage income, on consumption or income, adjusting for household size or not, and other ad hoc adjustments. When comparing across economies, one needs to use the same concept, which at times may not be possible. Beyond that, comparing Hong Kong's Gini index to large countries with different urban and economic structures may not be appropriate. For example, Hong Kong SAR's market Gini index seems in line with that of other cities with a sizable financial sector.

Regional Comparison: Income Inequality Level
(Net Gini Index; in Gini points; year of 2011; average across the region)



Sources: SWIID Version 5.0; IMF, WEO database; and IMF staff calculations.
Note: ASEAN = Association of Southeast Asian nations; LIC = low-income county; NIE = newly industrialized economy; OECD = Organization for Economic Cooperation and Development

Market Gini Index of Hong Kong Comparable to Other Cities with a Sizable Financial Industry
(Percentage points)



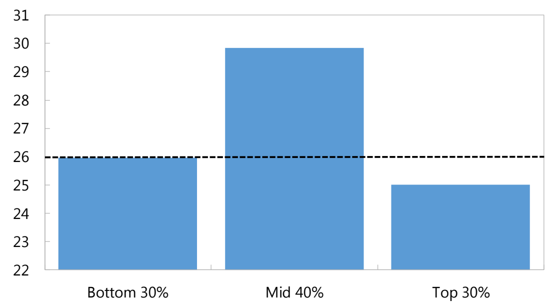
Sources: U.S. Census, Statistics Singapore, Hong Kong CSD, OECD.
1/ Not entirely comparable due to methodological differences.
2/ Southern Kanto region.

Inequality has declined recently as the authorities implemented policies targeted at the bottom of the income distribution. The net Gini index has come down from above 50 in 2002–03 to 44 in 2011, the last year for which data are available. 2/ It has likely declined further as income has grown more rapidly at the bottom of the income distribution compared to the top since 2010. The authorities have implemented targeted policies like the introduction of a statutory minimum wage in 2011 and subsequent increases, the implementation of the Low-Income Working Family and Old-Age Living Allowances, transport subsidy, and expanding the supply of public rental housing. They also established a Commission on Poverty that devised Hong Kong SAR's first official poverty line. These policies and increased scrutiny explain why Hong Kong SAR has a larger degree of redistribution compared to the Asia region.

1/ Prepared by Rui Mano.
2/ New data should be available in 2017 using the results of the 2016 census.

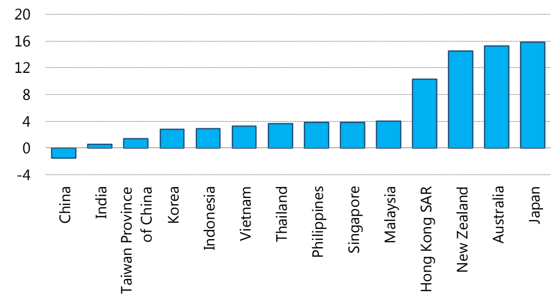
Box 2. Inequality in Hong Kong SAR *(continued)*

Higher Growth at the Bottom of the Income Distribution Than at Top Three Deciles
(Average growth rate of median income 2010–2014, percentage points)



Source: HKSAR Census and Statistics Department.

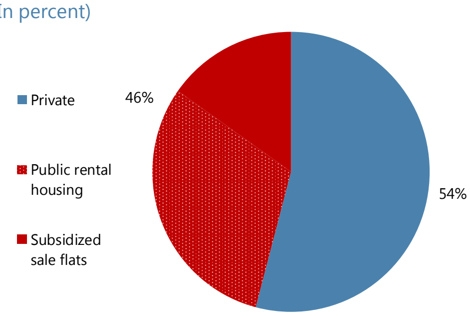
Selected Asia: Redistribution
(Difference between market Gini and net Gini; year of 2013 or latest available)



Sources: SWIID Version 5.0; and IMF staff estimates.

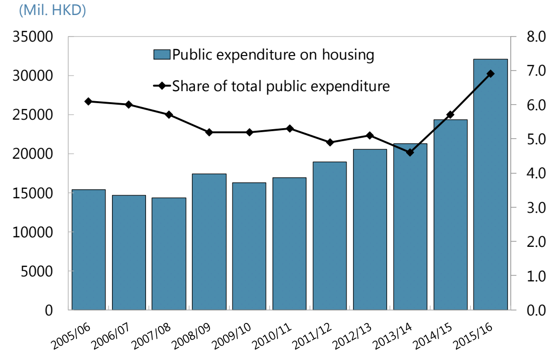
Public housing provision will continue to be a major policy priority to alleviate inequality. Public housing provision has long been a policy priority in Hong Kong SAR, as illustrated by the fact that almost half of all households lived in public housing. The 2014 Long-Term Housing strategy renews and reinforces this long-standing effort, by setting a supply target of completing 460,000 units in the next 10 years, more than 60 percent of which public. 3/ Public expenditure in housing has increased steadily and reached about 7 percent of total public expenditure in 2015/16. These efforts are essential to curb the supply-demand imbalance as well as allow access to affordable housing to lower income households.

Domestic Households by Type of Housing in 2015
(In percent)



Sources: HKSAR Census and Statistics Department.

Public Expenditure on Housing
(Mil. HKD)



Sources: Financial Services and the Treasury Bureau.

3/ Initial target of 480,000 (of which 290,000 public provision) for 2015/16 to 2024/25 was changed to 460,000 for 2017/18 to 2026/27 due to revised demand estimates, see Box 1 for further details.

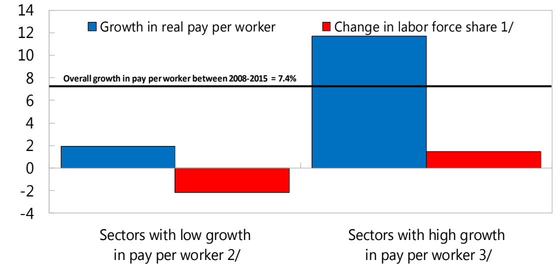
Box 2. Inequality in Hong Kong SAR *(concluded)*

Going forward, structural changes in the economy may not lead necessarily to higher inequality because of offsetting shifts in the labor force…

The pattern of wage growth across industries varies widely: while some have seen high growth in pay per worker, others have not. The latter are mostly tied to the "old" economy and thus have underperformed due to the ongoing structural rebalance. At face value this could be driving income inequality, given that industries that have had low pay growth still account for more than half of the labor force in the private sector. However, at the same time, the labor force has shifted away from some these industries, likely a reflection of the flexible labor market. These patterns are expected to continue as the economy transforms and moves up the value chain. Maintaining flexibility in the labor market is therefore crucial.

Labor Force is Shifting towards Jobs with Higher Real Pay Growth

(Percentage points)

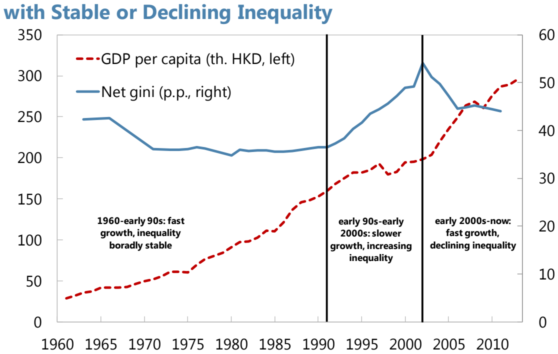


Sources: HKSAR Census and Statistics Department; and IMF staff estimates.
1/ Labor force excluding civil servants.
2/ Social and personal services, manufacturing, wholesale trade, transportation, and professional services.
3/ Retail, Accomodation and food, Information and communications, Financial and insurance and Real estate.

…but a low growth environment has been accompanied by an increase in inequality in the past.

Hong Kong SAR's recent economic history can be divided into three main periods. From the 1960s to early 1990s, income per capita grew rapidly while inequality, measured by the net Gini index, remained stable. Between the early nineties and early 2000s, Hong Kong SAR's per capita income growth declined and inequality increased rapidly. Since the early 2000s, income growth has picked markedly up and inequality has declined significantly. Income growth is slowing once more, which raises the concern that inequality may also rise.

Periods of Faster Economic Growth Have Been Associated with Stable or Declining Inequality



Sources: SWIID Version 5.0; WEO.

Allowance Scheme provides supplementary income to individuals and families with income and assets under a certain threshold and is targeted to encourage those on low incomes to stay in or reconnect to the workforce. The statutory minimum wage has helped boost labor supply without damaging wage flexibility and a further moderate increase could be accommodated. Working hours and overtime pay policy could also help encourage participation by those at the lower end of the income and skills distribution, but would need to take into account other pressures on the labor market. Policies that encourage active aging can also improve the fiscal position and help reduce health spending relative to a counterfactual.

STAFF APPRAISAL

48. Growth and outlook. Growth has slowed since 2015 and the external outlook is more challenging with the U.S. rate cycle is edging up, global trade growth tepid and mainland China rebalancing. With soft external conditions, the growth recovery is likely to be gradual with the output gap closing slowly. Over the medium-term population aging pressures may affect potential growth and weaken the structural fiscal position. On the upside, the economy is highly flexible and large potential can be tapped from the further development of Hong Kong SAR as a global financial center. Strong policy frameworks and ample buffers are in place to weather a less favorable environment. Prudent fiscal policy and intensive supervision of the financial system have built buffers that can be drawn on when needed. The Linked Exchange Rate System (LERS), provides a credible anchor for a small open economy with a large globally integrated financial services industry.

49. There are three main risks. Growing economic linkages mean that changes in mainland China's growth prospects spill over to Hong Kong SAR's financial and real sectors. With a large globally-integrated financial sector and a currency board arrangement, the economy is exposed to U.S. developments and global market volatility. The property market is also a source of downside risk. With strong buffers in place these risks are manageable and should not adversely affect the economy provided that, as anticipated, interest rates rise at a moderate pace and mainland China's transition to a more sustainable growth path remains orderly.

50. Fiscal policy. As the main demand management lever, fiscal policy needs to strike a balance between supporting aggregate demand and preserving a buffer for the longer-run challenge posed by aging. In the near term with a significant and persistent output gap, a difficult external environment, and weak automatic stabilizers, there is a case for further fiscal impetus which can be removed as the economy recovers. The planned impulse in the 2016–17 Budget is appropriate but if it undershoots and growth remains weak, additional stimulus will be needed in fiscal year 2017–18. Aligning short-term fiscal measures to long-term goals and shifting spending forward would help ensure that cyclical support does not exacerbate the long-term fiscal trend.

51. Long-term fiscal challenges. 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—would help alleviate the fiscal impact of aging. Measures to broaden the tax base may also be needed. The aim for balance and keeping overall government expenditure growth in line with GDP growth over the medium term is appropriate, while taking early action to alleviate the structural deficit problem. A drawdown of the fiscal reserves could be accommodated as the economy adjusts, but a positive fiscal buffer is desirable to cope with adverse shocks, provide room for countercyclical fiscal policy, and sustain confidence.

52. Property market measures. With renewed signs of overheating in the property market, the three-pronged approach to limiting risks—boosting housing supply, macroprudential measures to limit stability risks, and stamp duties to contain speculative activity and external demand—is well placed. Current macroprudential settings have done their job of limiting financial system exposure to the asset price boom and LTV and DSI settings should remain unchanged. Stamp duties can be an effective part of the toolkit to stem excessive price increases and speculation in the real estate market. As the distorting costs of duties become more significant the higher they are, they should be rolled back once the trend has shifted toward reduced price and speculative pressures.

53. Housing supply. The Long-Term Housing Strategy and Hong Kong 2030+ are aimed at addressing the housing shortage in an integrated manner by guiding land, planning and infrastructure development. Accelerating plans to increase supply, speeding up processes, making land available, bringing forward public investment would be a double win—tackling the housing problem and supporting the economy at a time of soft growth.

54. Financial sector policies. The robust regulatory and supervisory framework should help limit the build-up of systemic vulnerabilities. The authorities have a track record as a global standard setter in regulation and supervision and in addressing data gaps. Substantial progress has been made on implementing the 2014 FSAP recommendations. An independent insurance authority has been established, strengthened standards for securities listing have been implemented, and legislation has been put in place for a resolution framework for financial institutions which is designed to implement the Financial Stability Board's Key Attributes. There is substantial coordination among government and regulators domestically, there are close links with mainland regulators and the authorities are active in international fora, including in supervisory colleges for cross-border banking and insurance groups, on global systemically important financial institutions, and in crisis management groups. Areas for continued attention include further enhancing stress testing and reviewing financial institutions' plans in response to stress events.

55. Exchange rate regime and external position. The LERS remains the best arrangement for Hong Kong SAR backed by the credibility built up over three decades and tested through crises. The LERS is underpinned by the flexible economy, ample reserves buffers and strong financial regulation and supervision. Wage and price flexibility allows the economy to adapt quickly to cyclical conditions and structural change. The external position is broadly in line with medium-term fundamentals and desirable policies.

56. Contingency planning. As a trading hub and global financial center, the economy is inevitably exposed to global external shocks. In the event of an adverse shock, a comprehensive and coordinated policy approach similar to the 2008/9 response would be appropriate: including large fiscal stimulus, loosening of macroprudential policies, expanded credit guarantees, emergency liquidity provision and close international supervisory coordination. The recently introduced crisis resolution framework is strengthening the ability to respond to strains in the banking, corporate and household sectors.

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

Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 2011–21

						Proj.					
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
NATIONAL ACCOUNTS											
Real GDP (percent change)	4.8	1.7	3.1	2.7	2.4	1.5	1.9	2.4	3.0	3.0	3.1
Contribution											
Domestic demand	6.1	3.7	4.0	2.9	1.6	2.2	2.4	2.4	3.4	3.6	3.7
Private consumption	5.2	2.6	3.0	2.2	3.1	0.8	1.3	1.8	2.5	2.6	2.6
Government consumption	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Gross fixed capital formation	2.2	1.6	0.7	0.0	-0.5	-0.2	0.2	0.3	0.5	0.6	0.8
Inventories	-1.5	-0.8	0.1	0.4	-1.3	1.4	0.7	0.0	0.0	0.0	0.0
Net exports	-1.3	-2.0	-0.9	-0.2	0.8	-0.7	-0.5	0.0	-0.3	-0.5	-0.6
Potential GDP growth	3.4	3.1	3.0	2.8	2.7	2.7	2.7	2.7	2.6	2.5	2.5
Output gap (in percent of potential)	1.5	0.1	0.2	0.1	-0.2	-1.2	-2.0	-2.2	-1.8	-1.2	-0.5
Saving and investment (percent of GDP)											
Gross national saving	29.7	26.8	25.5	25.1	24.8	25.4	25.7	25.6	25.3	25.1	25.0
Gross domestic investment	24.1	25.2	24.0	23.8	21.7	22.7	22.8	22.3	22.0	21.7	21.6
Saving-investment balance	5.6	1.6	1.5	1.3	3.1	2.8	2.9	3.2	3.3	3.4	3.4
LABOR MARKET											
Employment (percent change)	2.9	2.4	1.8	0.6	0.8	0.5	0.9	0.7	0.7	0.8	0.7
Unemployment rate (percent, period average)	3.4	3.3	3.4	3.3	3.3	3.3	3.2	3.2	3.2	3.1	3.1
Real wages (percent change)	2.7	1.6	0.1	-2.4	0.6	0.6	0.9	1.1	1.3	1.5	1.6
PRICES											
Inflation (percent change)											
Consumer prices	5.3	4.1	4.3	4.4	3.0	2.5	2.6	2.7	2.8	2.9	3.0
GDP deflator	3.9	3.5	1.8	2.9	3.6	1.8	2.0	2.1	1.4	1.3	1.6
GENERAL GOVERNMENT											
Consolidated budget balance	3.8	3.2	1.0	3.7	0.6	1.6	1.5	0.1	0.6	1.4	1.4
Revenue	22.6	21.7	21.3	21.2	18.8	21.1	20.4	20.3	20.3	20.3	20.3
Expenditure	18.8	18.5	20.3	17.5	18.2	19.5	18.9	20.2	19.7	18.9	18.9
Fiscal reserves as of March 31	34.6	36.0	35.3	36.7	35.2	35.6	35.8	34.3	33.4	33.4	33.2
FINANCIAL											
Interest rates (percent, end-period)											
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	0.4	0.6	...	...	...	...	...
10-year Treasury bond yield 1/	1.5	0.9	2.7	2.0	1.7	1.2	...	...	...	...	...
MACRO-FINANCIAL											
Loans for use in Hong Kong SAR (not including trade financing) 2/	12.5	7.0	10.6	13.5	6.3	6.3	4.0	4.5	5.5	6.0	6.0
House prices (end of period, percent change)	11.1	25.7	7.7	13.5	2.4	-4.0	-5.0	-3.0	-3.0	0.0	2.0
Mortgage payment to income ratio 3/	39.9	43.6	45.7	44.7	48.9	44.3	46.4	47.1	47.4	45.4	43.5
Household debt (in percent of GDP)	58.4	60.6	61.9	64.9	66.5	64.4	61.2	59.4	57.6	57.6	58.7
Non-financial corporate debt (in percent of GDP)	175.5	195.7	212.1	224.6	213.7	205.7	202.8	198.4	197.0	196.1	198.0
Hang Seng stock index (percent change) 4/	-20.0	22.9	2.9	1.3	-7.2	1.3	...	...	...	...	...
EXTERNAL SECTOR											
Merchandise trade (percent change)											
Export volume	3.5	1.9	6.5	0.8	-1.9	0.3	2.1	2.7	2.8	2.6	2.6
Domestic exports	-0.6	10.1	-1.6	2.3	-12.9	14.2	2.1	2.7	2.8	2.6	2.6
Reexports	3.6	1.7	6.8	0.8	-1.6	0.6	2.1	2.7	2.8	2.6	2.6
Import volume	4.7	3.0	7.2	0.9	-2.7	-0.3	2.6	2.7	2.9	2.8	2.8
Export value	11.5	5.0	6.3	1.6	-2.5	0.4	2.8	3.9	3.7	3.2	2.8
Import value	13.3	7.0	6.8	1.7	-4.1	0.3	3.7	3.9	4.0	3.6	3.4
Terms of trade	-0.1	0.1	0.4	0.1	0.5	-0.4	-0.3	0.0	-0.2	-0.2	-0.3
Current account balance (percent of GDP) 5/	5.6	1.6	1.5	1.3	3.1	2.8	2.9	3.2	3.3	3.4	3.4
Foreign exchange reserves 5/											
In billions of U.S. dollars, end-of-period	285.4	317.4	311.2	328.5	358.8	390.1	418.9	431.3	446.2	457.8	466.7
In percent of GDP	114.6	121.3	112.9	112.8	116.1	122.0	126.3	124.2	122.8	119.6	115.7
Net international investment position (percent of GDP)	285.5	274.5	274.9	298.9	316.6	309.0	300.3	290.3	281.3	272.9	264.0
Linked rate (fixed)											
Market rate (HK$/US$1, period average)	7.784	7.756	7.756	7.754	7.752	7.757	...	...	...	...	...
Real effective rate (period average, 2010=100)	96.6	98.7	102.2	105.6	113.9	117.3	...	...	...	...	...

Sources: CEIC; HKSAR Census and Statistics Department; and IMF staff estimates.
1/ For 2016, average for the first 10 months
2/ For 2016, as of September
3/ CentaData, HIBOR-based for all households
4/ For 2016, as of October
5/ Data published using the Balance of Payments Statistics Manual 6 (BPM6) format

Table 2. Hong Kong SAR: Balance of Payments, 2011–17 1/

	2011	2012	2013	2014	2015	Proj. 2016	Proj. 2017
			(In billions of U.S. dollars)				
Current account	13.8	4.1	4.1	3.8	9.6	8.8	9.5
Goods balance	-7.5	-18.9	-27.9	-32.4	-22.8	-22.1	-27.5
Services balance	17.0	21.9	29.5	32.7	30.0	27.2	32.6
Income balance	4.2	1.2	2.5	3.5	2.4	3.7	4.5
Primary income balance	6.8	3.8	5.2	6.0	5.1	6.6	7.5
Secondary income balance	-2.5	-2.6	-2.7	-2.6	-2.7	-2.9	-3.0
Capital and financial account	-14.5	-8.7	-11.1	-9.5	-17.0	-8.8	-9.5
Capital account	-0.3	-0.2	-0.2	-0.1	0.0	0.0	0.0
Financial account	-14.3	-8.5	-10.9	-9.4	-17.0	-8.8	-9.5
Net direct investment	0.2	-13.2	-6.5	-11.1	119.7	15.7	11.5
Assets	-95.9	-88.1	-83.3	-140.9	-61.1	-128.1	-138.0
Liabilities	96.1	74.9	76.9	129.8	180.9	143.8	149.5
Portfolio investment	-1.4	-4.1	-49.8	-8.3	-141.2	-9.2	-9.6
Assets	-20.0	-40.1	-66.4	-35.6	-99.2	-39.3	-40.9
Liabilities	18.6	36.0	16.6	27.3	-42.0	30.1	29.0
Financial derivatives	2.7	2.0	7.0	15.3	15.2	2.9	3.1
Assets	46.2	39.7	54.8	57.9	73.4	65.5	70.6
Liabilities	-43.5	-37.8	-47.7	-42.7	-58.3	-62.6	-64.1
Other investment	-4.7	31.2	45.8	12.6	25.7	13.6	13.9
Assets	-100.3	-17.1	-82.4	-119.3	26.6	-114.4	-116.6
Liabilities	95.7	48.2	128.2	131.9	-0.8	128.0	130.5
Reserve assets (net change)	-11.1	-24.4	-7.5	-17.9	-36.4	-31.8	-28.4
Net errors and omissions	0.7	4.6	7.0	5.7	7.3	0.0	0.0
Memorandum item:							
Nominal GDP	248.5	262.6	275.7	291.2	309.2	319.6	331.7
			(In percent of GDP)				
Current account	5.6	1.6	1.5	1.3	3.1	2.8	2.9
Goods balance	-3.0	-7.2	-10.1	-11.1	-7.4	-6.9	-8.3
Services balance	6.9	8.3	10.7	11.2	9.7	8.5	9.8
Income balance	1.7	0.4	0.9	1.2	0.8	1.2	1.3
Capital and financial account	-5.9	-3.3	-4.0	-3.3	-5.5	-2.8	-2.9
Capital account	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
Financial account	-5.7	-3.3	-4.0	-3.2	-5.5	-2.8	-2.9
Net direct investment	0.1	-5.0	-2.3	-3.8	38.7	4.9	3.5
Portfolio investment	-0.6	-1.6	-18.1	-2.9	-45.7	-2.9	-2.9
Financial derivatives	1.1	0.7	2.6	5.2	4.9	0.9	0.9
Other investment	-1.9	11.9	16.6	4.3	8.3	4.3	4.2
Reserve assets (net change)	-4.5	-9.3	-2.7	-6.2	-11.8	-10.0	-8.6
Net errors and omissions	0.3	1.7	2.5	2.0	2.4	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. Hong Kong SAR: Consolidated Government Account, 2012/13–2021/22 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
Consolidated revenue	21.4	21.0	20.9	18.7	20.8	20.2	20.1	20.1	20.0	20.0
Operating revenue	16.7	16.4	17.2	15.8	16.7	17.2	16.7	16.7	16.7	16.7
Capital revenue	4.7	4.7	3.8	2.9	4.2	3.1	3.4	3.4	3.4	3.4
Taxes	13.6	13.3	15.4	14.3	15.9	15.5	15.4	15.4	15.3	15.3
Of which:										
Salaries tax	2.4	2.6	2.6	...	...	...	...	...	...	...
Profits tax	6.1	5.6	6.0	...	...	...	...	...	...	...
Stamp duties	2.1	1.9	3.3	...	...	...	...	...	...	...
Nontax	7.9	7.7	5.4	4.4	4.9	4.7	4.7	4.7	4.7	4.7
Of which:										
Land premium	3.4	3.9	3.4	2.5	3.7	2.7	3.0	3.0	3.0	3.0
Investment income	1.8	1.7	0.0	0.0	0.8	0.7	0.8	0.6	0.5	0.5
Consolidated expenditure	18.3	20.0	17.3	18.1	19.3	18.7	20.0	19.5	18.7	18.7
Operating expenditure 2/	14.7	15.6	13.8	14.4	15.0	14.7	15.8	15.1	14.4	14.4
Of which:										
Personnel related (including pensions)	4.1	4.1	4.2	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Capital expenditure	3.6	4.4	3.5	3.7	4.2	4.0	4.2	4.4	4.3	4.3
Of which:										
Interest expenditure	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	3.6	0.6	1.6	1.5	0.1	0.6	1.3	1.3
Memorandum items:										
Operating balance 3/	2.0	0.8	3.4	1.4	1.7	2.5	0.9	1.7	2.3	2.3
Primary balance 4/	1.3	-0.7	3.6	0.6	0.7	0.8	-0.7	0.0	0.8	0.9
Structural balance	0.4	-1.8	2.8	0.0	0.5	0.9	0.5	0.4	0.3	0.2
Cyclically adjusted primary balance 5/	1.3	-0.7	3.6	0.6	0.4	0.8	0.4	0.2	0.3	0.2
Fiscal reserves	35.6	34.9	36.1	34.9	35.2	35.4	33.9	33.0	33.0	32.9
(Months of spending)	23.3	20.9	25.1	23.2	22.0	22.7	20.4	20.3	21.2	21.1

Sources: CEIC; and IMF staff estimates.

1/ Assuming expenditure as in the latest medium-term budget document and staff adjusted revenue. Fiscal year begins April 1.
2/ Expenditure in 2016/20 is temporarily higher due to additional provisions for healthcare reform and retirement protection.
3/ Operating balance, as defined by the authorities, is akin to the current balance.
4/ Balance excluding investment income and interest expenditure.
5/ Primary balance adjusted to exclude one-off provisions for healthcare reform and retirement protection.

Table 4. Hong Kong SAR: Monetary Survey, 2011–17

						Proj.	
	2011	2012	2013	2014	2015	2016	2017
	(In billions of Hong Kong dollars)						
Net foreign assets	3975	4447	4866	5064	4991	5923	7014
Monetary authorities	2178	2431	2582	2792	3051	3723	4764
Banks	1797	2016	2285	2272	1940	2200	2250
Domestic credit	4007	4097	4760	5333	5082	5009	4913
Claims on private sector	3913	4044	4665	5271	4987	4912	4814
Claims on government	94	52	95	63	95	97	99
Other items (net)	76	406	431	614	1545	1500	1500
M2	8058	8950	10056	11011	11618	12432	13426
Of which:							
Deposits in HKD 1/	3798	4256	4481	4896	5416	...	...
Deposits in foreign currencies 1/	4011	4413	5261	5786	5853	...	...
Notes and coins in circulation	248	282	314	330	349	...	...
	(Annual percentage change)						
Domestic credit	15.5	2.2	16.2	12.1	-4.7	-1.4	-1.9
Claims on private sector	18.7	3.3	15.3	13.0	-5.4	-1.5	-2.0
M2	12.9	11.1	12.4	9.5	5.5	7.0	8.0
	(Contribution to M2 growth, in percent)						
Net foreign assets	2.7	5.9	4.7	2.0	-0.7	8.0	8.8
Domestic credit	7.5	1.1	7.4	5.7	-2.3	-0.6	-0.8
Claims on private sector	8.6	1.6	6.9	6.0	-2.6	-0.6	-0.8
Claims on government	-1.1	-0.5	0.5	-0.3	0.3	0.0	0.0
Other items (net)	2.7	4.1	0.3	1.8	8.5	-0.4	0.0
	(In percent of GDP)						
Net foreign assets	205.5	218.3	227.6	224.3	208.2	239.0	272.5
Domestic credit	207.1	201.1	222.6	236.2	212.0	202.2	190.8
Other items (net)	3.9	19.9	20.1	27.2	64.5	60.5	58.3
M2	416.5	439.4	470.4	487.6	484.7	501.7	521.6

Sources: IMF, *International Financial Statistics*; Haver Analytics, and staff calculation.
1/ Includes savings, time, demand, and negotiable certificates of deposits.

Table 5. Hong Kong SAR: Vulnerability Indicators, 2011–16

	2011	2012	2013	2014	2015	2016Q2
Banking sector						
Regulatory capital to risk-weighted assets	15.8	15.7	15.9	16.8	18.3	19.4
Regulatory tier 1 capital to risk-weighted assets	12.4	13.3	13.3	13.9	15.3	16.6
Nonperforming loans net of provisions to capital	1.6	1.4	1.5	1.3	1.9	2.0
Nonperforming loans to total gross loans	0.7	0.6	0.5	0.5	0.7	0.9
Sectoral distribution of total loans: residents	73.2	71.5	70.1	69.8	69.7	70.4
Sectoral distribution of total loans: other financial corporations	5.8	5.3	5.5	6.1	6.7	7.3
Sectoral distribution of total loans: nonfinancial corporations	60.8	59.4	57.9	56.9	55.9	56.3
Sectoral distribution of total loans: other domestic sectors	6.6	6.8	6.7	6.8	7.1	6.9
Sectoral distribution of total loans: nonresidents	26.8	28.5	29.9	30.2	30.3	29.6
Return on assets	0.8	0.9	1.1	1.0	1.0	1.5
Return on equity	17.2	15.5	14.4	13.1	13.2	21.0
Interest margin to gross income	45.3	48.0	46.7	51.2	46.5	37.1
Noninterest expenses to gross income	54.8	53.9	48.5	48.9	48.0	37.2
Liquid assets to total assets (liquid asset ratio)	22.3	23.8	21.6	22.3	21.5	21.7
Liquid assets to short-term liabilities	44.0	47.0	44.9	47.0	164.3	178.0
Net open position in foreign exchange to capital	2.8	7.3	3.7	5.3	5.9	3.1
Public sector						
Fiscal surplus (in percent of GDP)	3.8	3.2	1.0	3.7	0.6	...
Accumulated fiscal surplus (in percent of GDP)	34.6	36.0	35.3	36.7	35.2	...
External sector						
Gross official reserves (in billions of U.S. dollar)	285.4	317.4	311.2	328.5	358.8	...
In percent of GDP	114.6	120.7	112.9	112.8	116.0	...
In months of retained imports	25.9	27.9	26.2	26.3	32.1	...
In percent of monetary base	206.5	201.8	192.2	189.3	174.6	...
In percent of broad money 1/	27.5	27.5	24.0	23.1	23.9	...
In percent of Hong Kong dollar M3	54.7	54.1	50.2	48.7	48.1	...
Short-term debt (in billions of U.S. dollar)	718.1	752.3	861.8	928.3	904.1	...
In percent of gross reserves	0.3	0.2	0.3	0.3	0.3	...
Financial sector						
Hang Seng index (percent change, end-year)	-20.0	22.9	2.9	1.3	-7.2	...
Residential property prices (percent change, end-year)	11.1	25.7	7.7	13.5	2.4	...

Sources: CEIC; Hong Kong SAR authorities; Bank for International Settlements; Bloomberg; IFS; and IMF staff estimates.
1/ Broad Money refers to M2.

Appendix I. Debt Sustainability Analysis

Hong Kong SAR Public Sector DSA - Baseline Scenario

(In percent of GDP unless otherwise indicated)

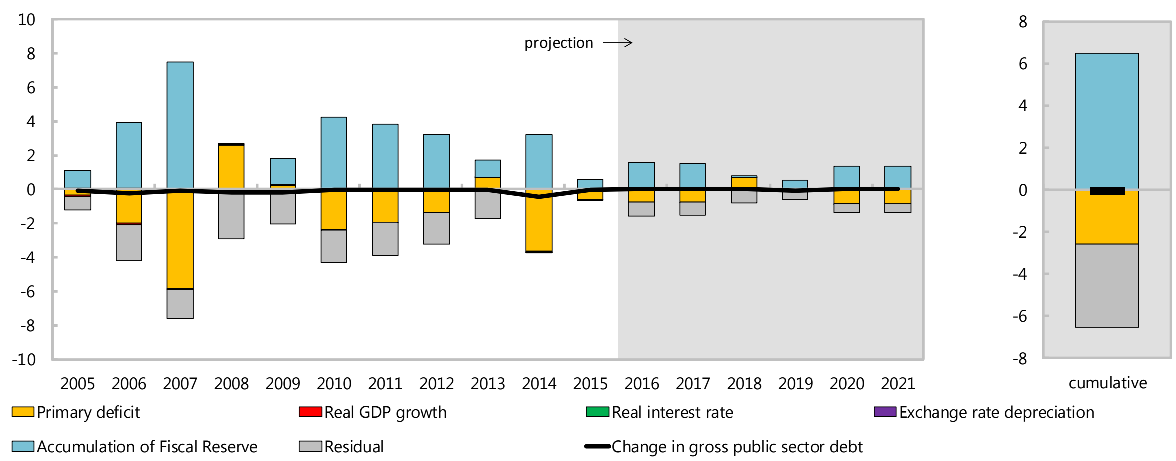
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2005-2013 [2/]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	0.8	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Public gross financing needs	-2.9	-3.2	-0.6	-1.6	-1.5	-0.1	-0.6	-1.4	-1.4
Real GDP growth (in percent)	4.1	2.7	2.4	1.5	1.9	2.4	3.0	3.0	3.1
Inflation (GDP deflator, in percent)	1.4	2.9	3.6	1.8	2.0	2.1	1.4	1.3	1.6
Nominal GDP growth (in percent)	5.6	5.6	6.2	3.4	3.9	4.6	4.4	4.4	4.7
Effective interest rate (in percent) [4/]	4.7	2.9	5.2	5.1	5.1	5.1	5.1	n.a.	n.a.

As of September 20, 2016		
Sovereign Spreads		
EMBIG (bp) 3/		...
5Y CDS (bp)		38
Ratings	Foreign	Local
Moody's	Aa1	Aa1
S&Ps	AAA	AAA
Fitch	AA+	AA+

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	Cumulative	Debt-stabilizing Primary Balance [9/]
Primary deficit	-1.1	-3.7	-0.6	-0.8	-0.8	0.7	0.0	-0.8	-0.9	-2.6	1.4
Primary (noninterest) revenue and grants	18.5	21.2	18.8	20.2	19.7	19.5	19.7	19.7	19.8	118.7	
Primary (noninterest) expenditure	17.3	17.5	18.2	19.5	18.9	20.2	19.7	18.9	18.9	116.1	
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/]	-1.9	0.0	0.0	-0.8	-0.7	-0.8	-0.6	-0.5	-0.5	-4.0	
Change in gross public sector debt	-0.1	-0.5	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	-0.1	
Change of fiscal reserves	2.9	3.2	0.6	1.6	1.5	0.1	0.6	1.4	1.4	6.5	



Source: IMF staff.

1/ Public sector is defined as consolidated public sector.

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 - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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 - π (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).

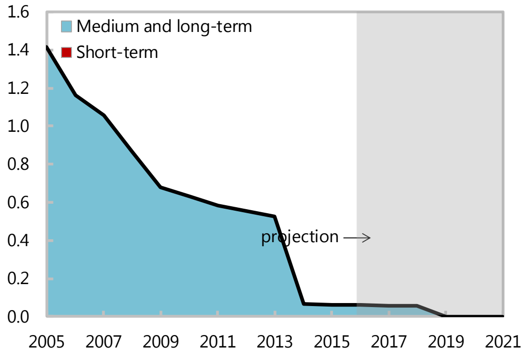
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

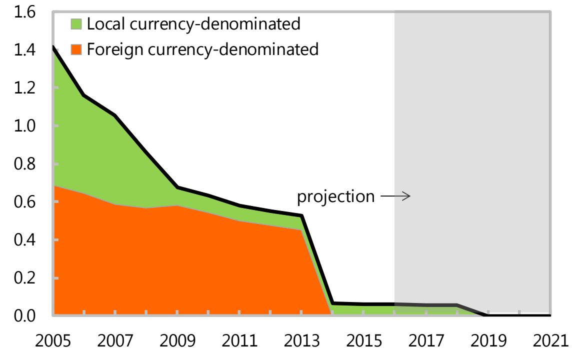
Hong Kong SAR Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(In percent of GDP)



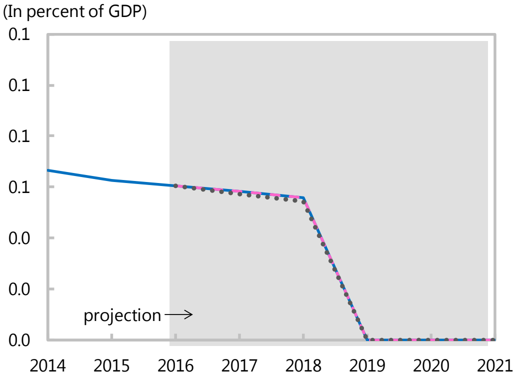
By Currency
(n percent of GDP)



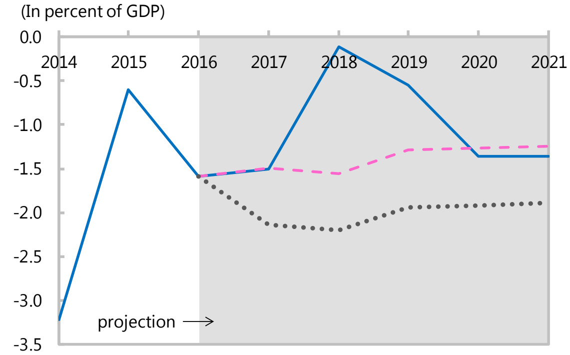
Alternative Scenarios

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	2016	2017	2018	2019	2020	2021
Real GDP growth	1.5	1.9	2.4	3.0	3.0	3.1
Inflation	1.8	2.0	2.1	1.4	1.3	1.6
Primary balance	0.8	0.8	-0.7	0.0	0.8	0.9
Effective interest rate	5.1	5.1	5.1	5.1	n.a.	n.a.
Constant Primary Balance Scenario						
Real GDP growth	1.5	1.9	2.4	3.0	3.0	3.1
Inflation	1.8	2.0	2.1	1.4	1.3	1.6
Primary balance	0.8	0.8	0.8	0.8	0.8	0.8
Effective interest rate	5.1	5.1	5.1	5.1	n.a.	n.a.

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.5	3.5	3.5	3.5	3.5	3.5
Inflation	1.8	2.0	2.1	1.4	1.3	1.6
Primary balance	0.8	1.4	1.4	1.4	1.4	1.4
Effective interest rate	5.1	5.1	5.1	5.1	n.a.	n.a.

Source: IMF staff.

Appendix II. Risk Assessment Matrix 1/

Likelihood	Risk Assessment Matrix Alison to update	Policy Response
	Upside	
	High	
Medium	**1. Steadfast implementation of reforms in mainland China.** Fast progress on enacting structural reform (especially SOE reform), curbing credit growth, and improving overall resource efficiency would lift medium-term growth prospects in mainland China with large spillover benefits for Hong Kong SAR. Growth potential for Hong Kong SAR would improve through close trade and financial links, although growth may remain lower in the near term	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	
Low	**2. Flexible economy allows stronger than expected recovery of growth.** The economy picks up more strongly than expected as flexibility enables a shift into growing sectors.	Continue to use fiscal policy to help support those on lower incomes and ease adjustment to an aging population.
	Downside	
	High	
Medium	**1. Sharp rise in risk premia with flight to safety.** Investors withdraw from specific risk asset classes as they reassess underlying economic and financial risks in large economies, or respond to unanticipated Fed tightening and increases in U.S. term premia. 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 macroprudential measures and provide liquidity through existing facilities.
Low/Medium	**2. Significant China slowdown and its spillovers.** A loss of investor confidence, disorderly corporate defaults, a sharp fall in asset prices, and a quicker fading of the stimulus impact. Weak domestic demand further suppresses commodity prices, roils global financial markets, and reduces global growth (Likelihood: low in short-term, medium thereafter).	Deploy temporary and targeted fiscal stimulus together with continued support for public investment. Target lower income deciles and vulnerable households. Safeguard financial stability through macroprudential 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/Medium	**3. Structurally weak growth in key advanced and emerging economies (medium term).** Weak demand, low productivity growth, and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to lower medium-term path of potential growth. .	As above, plus coordinate closely with home supervisors to address orderly resolution of distressed assets.
Medium	**4. Disorderly correction of house prices:** Higher global market volatility and financing cost 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 macroprudential 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. Ensure adequate supply of land and public housing.

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 III. External Sector Assessment

		Overall Assessment
Foreign asset and liability position and trajectory	**Background.** The net international investment position (NIIP) amounted to around 320 percent of GDP as of end-2015. Both external financial assets (about 1,395 percent of GDP) and liabilities (about 1075 percent of GDP) are high, reflecting Hong Kong SAR's status as a major international financial center with considerable cross-territory investment. The GDP share of the NIIP is projected to decline moderately, driven by the interest-growth differential—as nominal GDP is expected to grow faster than the effective returns on the NIIP. Given the large gross assets and liabilities, annual fluctuations in the NIIP due to valuation changes have been sizable. **Assessment.** Vulnerabilities are low given the size of NIIP and its favorable composition.	**Overall Assessment**: *The external position in 2015 was broadly consistent with medium-term fundamentals and desirable policy settings.* Developments through October 2016 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. The recent REER appreciation is expected to be offset by Hong Kong SAR's strong self-equilibrating economy stemming from flexible goods, factor, and asset markets. 3/ **Potential policy responses**: Macroeconomic policies are broadly appropriate. 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 surplus is estimated to be 3.1 percent of GDP in 2015 (2.5 percent of GDP after cyclical adjustment), which continues to be substantially lower than in the pre-GFC years. 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) accounted for most of the drop in the current account surplus. The favorable terms of trade shock from lower commodity prices improved the current account surplus by about 0.5 percent of GDP in 2015. The current account surplus is projected to be 2.8 percent of GDP in 2016. **Assessment.** The current account is broadly consistent with medium-term fundamentals and desirable policies. Staff's quantitative assessment suggests that the difference between the cyclically-adjusted current account in 2015 and that consistent with fundamentals and desirable policies is between -1½ and 1½ percent of GDP. The large decline of the current account surplus (relative to pre-2010) is mainly driven structural changes related to weaker growth and rebalancing in mainland China as well as the opening of the Mainland capital account. 1/	
Real exchange rate	**Background.** The REER appreciated by about 9 percent in 2015, relative to the average REER in 2014. 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. The appreciation trend continued in 2016: as of October 2016, the REER was about 3 percent stronger than its 2015 average. However, it should be noted that the recent appreciation in REER came after a decade-long REER depreciation (from 1998 to 2011). The current REER level is broadly the same as the level in 2006 (when the current account surplus of Hong Kong SAR reached 13 percent of GDP). **Assessment.** The real exchange rate is broadly consistent with medium-term fundamentals and desirable policies. Based on empirical EBA-type estimates and factoring in the uncertainties and variability of an offshore trading and financial center, the exchange rate is assessed by staff to be from -7 to 7 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 a fully open capital account without capital controls. Although Hong Kong SAR experienced net private inflows in 2015, overall, the capital flow pattern was volatile during the year: a sharp increase in portfolio investment and financial derivatives position (in both the asset and liability side) in the first half of the year and a subsequent sharp decline since Q3. These large movements are likely associated with financial volatility in the Mainland, transmitted through growing cross-border financial linkages. 2/ **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 in the Mainland, 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.	
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 is equivalent to around US$383 billion (about 124 percent of 2015 GDP) as of Oct-2016. **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.	

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 current account is estimated to be about 11 percent of GDP weaker than that consistent with fundamentals and desirable policies. The gap was mainly driven by EBA regression residual (about -12 percent of GDP) and the policy gap is around 1 percent of GDP. The large residual likely reflects a combination of structural factors which are not captured by EBA. Staff found that two structural factors account for some of the difference, including the structural decline in the transport services balance tied to a reduction of re-exporting activity from and to China and the structural reversal of Hong Kong SAR's gold trade balance tied to the opening of the Precious Metals Depository which changed the level of gross imports and exports without a meaningful change in value added accruing to Hong Kong SAR's residents. Two additional EBA-specific factors are also of note. First, EBA's adjustment for financial centers is likely biased upward because of the large current account of the few countries deemed financial centers. Second, EBA's coefficient for NFA to GDP capturing income effects averages out net returns on assets and liabilities across countries, while in fact Hong Kong SAR has systematically lower net returns compared to other economies. Adjusting for all of these factors, staff estimate that the current account gap is close to zero, corresponding to a norm in the range of 1 to 4 percent of GDP. 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 2016: Q2, the banking system claims on mainland banks and nonbank entities amounted to HK$ 6.1 trillion, or about 250 percent of 2015 GDP, although part of the exposure is accounted by foreign banks. 3/ This is reflected in lower inflation rates in 2015 compared to previous years and relatively slower nominal wage growth (from 2011 to 2015, nominal wages increased by 20 percent while nominal GDP increased by about 24 percent).		

Appendix IV. Summary of Macroprudential Measures Introduced Since 2009

Date	Price Range	LTV CAP	Max Loan Amount	Other
Oct 2009	Greater than or equal to HK$20mn Less than HK$20mn	60 percent (previously 70 percent) Remains 70 percent	 HK$12mn	
Apr 2010				Ad valorem stamp duty raised to a range between 3.75 percent and 4.25 percent for properties valued at over HKD 20,000,000.
Aug 2010	Greater than or equal to HK$12mn Less than HK$12mn Not owner-occupied, any price range	60 percent (previously 70 percent for properties valued between HK$12mn and HK$20mn) Remains 70 percent 60 percent (previously 70 percent)	 HK$7.2mn	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
Nov 2010	Greater than or equal to HK$12mn Greater than or equal to HK$8mn and less than HK$12mn Less than HK$8mn Not owner-occupied, any price range	50 percent (previously 60 percent) 60 percent (previously 70 percent) Remains at 70 percent 50 percent (previously 60 percent)	 HK$6mn HK$4.8mn	Special Stamp Duty set at 15 percent for residential properties resold within first six months of purchase, 10 percent if resold between six and 12 months, 5 percent if resold between 12 and 24 months LTV cap for industrial and commercial properties mortgage loans at 50 percent
June 2011	Greater than or equal to HK$10mn Greater than or equal to HK$7mn and less than HK$10mn Less than HK$7mn	50 percent 60 percent (previously 70 percent for properties valued between HK$7mn and HK$8mn) Remains at 70 percent	 HK$5mn HK$4.2mn	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
Sep 2012	Greater than or equal to HK$10mn Greater than or equal to HK$7mn and less than HK$10mn Less than HK$7mn Not owner-occupied, any price range	Remains at 50 percent Remains at 60 percent Remains at 70 percent Remains at 50 percent	 HK$5mn HK$4.2mn	LTV cap lowered by further 20 percentage points for borrowers with main income from outside Hong Kong SAR; LTV cap for net-worth based mortgage loans lowered from 40 percent to 30 percent, irrespective of property value 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 or for replacement were not subject to the DSR limits reduction Maximum tenor of all new property mortgage loans capped at 30 years

Date	Price Range	LTV CAP	Max Loan Amount	Other
Oct 2012				Buyer's Stamp Duty set at 15 percent 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 six and 12 months, 10 percent if resold between 12 and 36 months
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	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 or for replacement were not subject to the DSR limits reduction
	Less than HK$7mn	Remains at 70 percent	HK$4.2mn	
	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 a range of 1.5 percent to 8.5 percent except first-time HK permanent resident buyers and replacement of one-home owner
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	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
	Less than HK$7mn	60 percent (previously 70 percent)	HK$4.2mn	
	Not owner-occupied, any price range	Remains at 50 percent		
Nov 2016				Ad valorem Stamp Duty raised for residential property transactions to a flat rate of 15 percent from a range of 1.5 percent to 8.5 percent except first-time HK permanent resident buyers and replacement of one-home owner

Appendix V. FSAP Recommendations

<table>
<tr><th>Area</th><th>Recommendation</th><th>Progress</th></tr>
<tr><td>Crisis management and resolution</td><td>Establish a fully comprehensive framework for recovery and resolution, in line with emerging international best practices. Establish recovery and resolution plans for all systemic financial institutions, including financial market infrastructures ("FMIs").</td><td>Framework for recovery and resolution
On Track
The Financial Institutions (Resolution) Ordinance ("FIRO") was enacted by the Legislative Council in June 2016. The FIRO provides the statutory backing for a cross-sector resolution regime in Hong Kong 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 FIRO will come into operation on a date to be appointed by the Secretary for Financial Services and the Treasury, which is expected to be subsequent to the coming into force of certain key regulations, primarily those relating to the protection of certain financial arrangements in resolution, to be made as subsidiary legislation under the FIRO.
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). A lead resolution authority may be designated by the Financial Secretary to coordinate and lead resolution planning, and if necessary execution, for a cross-sectoral group, which contains more than one within scope FI from more than one sector (e.g., certain global systemically important bank operations in Hong Kong).
Further work is currently underway to bring the FIRO into force and to make the regime provided for under it, including the transfer and bail-in stabilization options, operational from a resolution policy perspective. At the HKMA, a significant part of this work is to establish a permanent resolution function within the HKMA with dedicated resources and governance. On resolution policy, the work includes the development of key regulations to be made under FIRO such as loss absorbing capacity requirement regulations for within scope FIs (including AIs), the establishment of resolution planning information requirements for AIs (expected to be issued within second half of 2016), and ongoing engagement in international resolution policy development.
Recovery planning for banks [On Track]
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, including the five domestic systemically important banks, have been submitted to the HKMA.
The HKMA plans to publish in second half of 2016 a consultation on amendments to the Banking Ordinance to incorporate new requirements relating to the production of recovery plans and to the submission of such plans to the Monetary Authority. This will create a more explicit legal basis for recovery planning for Hong Kong AIs, primarily to achieve greater certainty and transparency.</td></tr>
</table>

Area	Recommendation	Progress
		FMIs under the purview of SFC **On Track** • The discussion with Hong Kong Exchanges and Clearing Limited ("HKEX") on some aspects of the recovery planning of three of the four existing recognised clearing houses ("RCH") in HKEX Group namely, Hong Kong Securities Clearing Company Limited ("HKSCC"), HKFE Clearing Corporation Limited ("HKCC"), The SEHK Options Clearing House Limited ("SEOCH"), has been ongoing. HKEX has undertaken to submit a proposal on its approach to develop a recovery plan for these three RCHs and a draft recovery plan for each of them by end of 2016. The recovery plan will take into consideration (i) the guidance on development of recovery plans for FMIs; and (ii) the consultation report on "Resilience and recovery of central counterparties ("CCPs"): Further guidance on the Principles for Financial Market Infrastructures ("PFMI")" ("Further PFMI Guidance 2016") jointly published by the Committee on Payments and Market Infrastructures and the International Organisation of Securities Commissions ("CPMI-IOSCO") in October 2014 and August 2016 respectively. HKEX was asked to review the recovery plan for its fourth RCH, OTC Clearing Hong Kong Limited, to identify any areas for improvements in light of the Further PFMI Guidance 2016. • The SFC will work with the four RCHs in developing their respective resolution plans in due course. **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 as mentioned above has developed its own recovery plan based on PFMI requirements. The recovery plans, which will be updated annually, have been 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, 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.
Insurance sector	The authorities should ensure implementation of the independent Insurance Authority ("IIA") as scheduled in 2015.	**On Track** • The Insurance Companies (Amendment) Ordinance 2015 ("Amendment Ordinance"), the enabling legislation for the establishment of IIA, was enacted on 10 July 2015. It provides that, among other things, IIA should be independent of the Government and the industry. Members of IIA were appointed and took office in December 2015. Under the Amendment Ordinance, IIA is automatically renamed as the Provisional Insurance Authority, which has administrative power but not regulatory power. It is undertaking essential preparatory work to take over the regulatory functions of the existing Insurance Authority ("IA") in early 2017.

Area	Recommendation	Progress
	In addition, the legal and regulatory framework should be strengthened	**On Track** • Under the Amendment Ordinance, the appointment of certain individuals by an insurer, including controllers, directors, key persons in control functions and appointed actuaries, is subject to the prior approval of IIA. Control functions currently include risk management; financial control; compliance; internal audit; actuarial and intermediary management functions. To provide flexibility to update the regulatory regime in light of future developments, the Financial Secretary may specify other control functions through subsidiary legislation. IIA is also empowered under the Amendment Ordinance to revoke the appointment of such person on fitness and propriety grounds. • Besides, shareholder controllers will be required to report to the IA the acquisition or disposal of their shareholding interests for their appointment or cessation as controllers of insurers. The IA has revised the existing Guidance Note ("GN") on Corporate Governance which will, among other things, enhance the requirements for insurers to implement contingency plans in their risk management process. The revised GN has been issued in October 2016 and will take effect from 1 January 2017.
	(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 (ii) below).
	(ii) implement an RBC regime and	**On Track** • A consultation on the proposed RBC framework was conducted at the end of 2014. 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 the development of detailed rules for quantitative requirements (i.e., Pillar 1 requirements under the RBC framework). After that, quantitative impact studies will be carried out. • 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 will review the relevant GNs and make revisions ahead of the legislative process as necessary.

Area	Recommendation	Progress
	(iii) strengthen supervision of intermediaries.	**On Track** • The Amendment Ordinance provides for the establishment of a statutory licensing regime for insurance intermediaries and provides IIA 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. IIA will also be 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. • As regards the conduct of business requirements for insurers, the IA has issued two GNs 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 GNs 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 Clearing Hong Kong Limited 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"). (ii) HKEX agrees on the need to strengthen its compliance function and has set up a Regulatory Compliance Unit. (iii) The SFC completed an on-site inspection on HKEX's cash trading operations and activities in September 2015. HKEX accepted all the recommendations of SFC. In this regard, HKEX has completed actions (deliverables) to address most of the recommendations from the SFC's findings, and has indicated a target delivery time that will be no later than 31 December 2016 for the deliverables on the remaining recommendations.

Area	Recommendation	Progress
		An inspection report incorporating SFC's findings and recommendations was sent to HKEX on 4 March 2016. HKEX provided its formal response on 10 May 2016. SFC is monitoring HKEX's implementation of the proposals to address the recommendations in the inspection report. • 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 recognized 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 "SFO") and guide potential applicants who wish to operate a futures market in Hong Kong.
	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. (http://www.fstb.gov.hk/fsb/ppr/consult/doc/conclu_rpirrlea_e.pdf). • 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 in 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 in the 2016-17 legislative session. • 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.

<table>
<tr><th>Area</th><th>Recommendation</th><th>Progress</th></tr>
<tr><td></td><td>Strengthen enforcement</td><td>Implemented
Since the SFO came into operation in 2003, the enforcement approach (including imposition of punitive, deterrent sanctions and remediation to victims) of the SFC has been proven to be effective in ensuring that the markets that the SFC regulates are safe, fair and efficient. In view of the ever-evolving market situation, FSTB will continue to work with SFC for continual improvement to minimise financial crimes and market misconduct, uphold market integrity and inspire confidence of investors.
A Memorandum of Understanding ("MOU") was entered between SFC and Department of Justice in March 2016 to formalise and further strengthen cooperation in the handling of criminal cases under the SFO and other relevant legislation.</td></tr>
<tr><td>Financial market infrastructure("FMI")</td><td>Develop a clear timetable for each FMI for compliance with the Principles for FMIs ("PFMIs").</td><td>FMI under SFC purview
On Track
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. Most of the areas identified have been addressed in 2015, while a few will require legislative amendments or further study for implementation.
OTC Clearing Hong Kong Limited ("OTC Clear") has completed a self-assessment against the PFMIs in respect of the proposed cross currency swap clearing service and concluded that it is in compliance with the PFMIs. The SFC has reviewed the self-assessment report and has no particular concern about its analysis or the conclusion reached. However, in light of the Further PFMI Guidance 2016, the SFC has asked HKEX to review their self-assessment on OTC Clear and all other recognised clearing houses in the HKEX Group to consider if there are any further areas for improvement.[1]
FMI under HKMA purview
Implemented
The HKMA required the FMIs under its purview to have made changes to conform with relevant requirements in the PFMI, 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]
As of end-August 2016, the HKMA has completed PFMI assessments on all the FMIs under its purview, with the assessment summaries published on the HKMA website.[3] The only exception is USD CHATS, for which the assessment will be finalised by Q3/Q4 2016. All FMIs under the purview of the HKMA are considered to be generally observant of the PFMI.</td></tr>
<tr><td colspan="3">1/ The proposed guidance outlined in this consultative report provides further clarity and granularity on several key aspects of the PFMI to further improve central counterparty ("CCP") resilience. These are: governance, credit and liquidity stress testing, margin, a CCP's contribution of its financial resources to losses, and its coverage of credit and liquidity resource requirements. The report also proposes guidance that is intended to facilitate a CCP's development of its recovery plan.
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.</td></tr>
</table>

<table>
<tr><th>Area</th><th>Recommendation</th><th>Progress</th></tr>
<tr><td></td><td></td><td>The Central Moneymarkets Unit ("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 them 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.
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.
Life insurers are required to conduct periodic industry-wide standardized 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.</td></tr>
</table>

Area	Recommendation	Progress
		• 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 for cross-border banking groups including a number of Globally Systemically Important Banks to discuss the risk profiles, business strategies, and developments of banking groups, as well as other supervisory concerns and priorities. It also continues to participate in the Crisis Management Groups of GSIBs to discuss and oversee the development of recovery and resolution plans for each banking group in accordance with the Key Attributes established by FSB. • Reflecting the enactment of the FIRO in June 2016, the HKMA's new permanent resolution authority function will lead resolution planning and actively coordinate with banking supervision in cross-border resolution planning.
	Strong cooperation with regulatory counterparts in mainland China	**Implemented** • The HKMA has been maintaining close dialogue with the China Banking Regulatory Commission ("CBRC") on supervisory matters relating to the mainland bank subsidiaries and branches of Hong Kong 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 program 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 to prepare for the launch of the Shenzhen-Hong Kong Stock Connect which was announced in August 2016. • The Insurance Authority ("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.

Area	Recommendation	Progress
	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 the first phase of mandatory reporting and mandatory clearing as follows: (i) the first phase of mandatory reporting was implemented on 10 July 2015, which requires the reporting of certain interest rate swaps and non-deliverable forwards to the Hong Kong Monetary Authority'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. Legislation has also been enacted for the next phase of mandatory reporting, which covers the five main asset classes (namely interest rate derivatives, foreign exchange derivatives, equity derivatives, credit derivatives and commodity derivatives) and will commence operation in July 2017. • 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 and the US. 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 recognising 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.

INTERNATIONAL MONETARY FUND

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

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION DISCUSSIONS—INFORMATIONAL ANNEX

December 19, 2016

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 7, 2016)

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, expenditure and income 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 and 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 7, 2016)

	Date of Latest Observation	Date Received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of Publication[5]
Exchange rates	Nov. 2016	Nov. 2016	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	Oct 2016	Nov 2016	M	M	M
Reserve/base money	Oct. 2016	Nov. 2016	M	M	M
Broad money	Oct. 2016	Nov. 2016	M	M	M
Central bank balance sheet	Oct. 2016	Nov. 2016	M	M	M
Consolidated balance sheet of the banking system	Sep. 2016	Nov. 2016	M	M	M
Interest rates[2]	Nov. 2016	Nov. 2016	D	D	D
Consumer price index	Oct 2016	Nov. 2016	M	M	M
Revenue, expenditure, balance and composition of financing[3]–central government	Oct. 2016	Nov. 2016	M	M	M
Stocks of central government and central government-guaranteed debt[4]	Oct. 2016	Nov. 2016	M	M	M
External current account balance	Q2/16	Sep. 2016	Q	Q	Q
Exports and imports of goods and services	Q2/16	Sep. 2016	Q	Q	Q
GDP/GNP	Q3/16	Nov. 2016	Q	Q	Q
Gross external debt	Q2/16	Sep. 2016	Q	Q	Q
International investment position	Q2/16	Sep. 2016	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).