



# PEOPLE'S REPUBLIC OF CHINA—HONG KONG SPECIAL ADMINISTRATIVE REGION—STAFF REPORT; PRESS RELEASE AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE PEOPLE'S REPUBLIC OF CHINA—HONG KONG SPECIAL ADMINISTRATIVE REGION

May 2014

## 2014 ARTICLE IV CONSULTATION DISCUSSIONS

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 2014 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:

- **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 9, 2014, following discussions that ended on March 12, 2014, with the officials of the People's Republic of China—Hong Kong SAR on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 23, 2014.
- **Informational Annex** prepared by the IMF.
- **Press Release** summarizing the views of the Executive Board as expressed during its May 9, 2014 discussion of the staff report that concluded the Article IV consultation with the People's Republic of China—Hong Kong Special Administrative Region.
- **Statement by the Executive Director** for People's Republic of China—Hong Kong Special Administrative Region

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

April 23, 2014

## STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION DISCUSSIONS

### KEY ISSUES

**Outlook and risks.** The macroeconomic outlook is favorable. Growth has firmed, inflation has eased, and unemployment has remained low—trends that are expected to continue. The main risks relate to the impact of the Fed's tapering, the outlook for the Mainland, and a possible correction in property prices.

**Financial.** The Financial Sector Assessment Program (FSAP) conducted in 2013–14 concluded that the financial system is well regulated and supervised and the banking system is resilient to shocks. The main areas for improvement are the financial sector resolution regime and insurance sector regulation and supervision. The large and growing exposure to the Mainland warrants continued close monitoring.

**Property.** After a prolonged rise, property prices have stabilized. Counter-cyclical prudential and fiscal measures deployed during the upswing provide buffers that can be used to facilitate an orderly adjustment in the market while safeguarding financial stability. A long-run solution to housing hinges on ensuring adequate supply.

**Fiscal policy.** Hong Kong SAR has a track record of fiscal discipline. Casting fiscal policy in a long-term framework will help strike a balance between spending to address aging and inequality, preserving low taxes, and maintaining fiscal prudence.

**External assessment.** Hong Kong SAR's external position is consistent with medium-term fundamentals and desirable policies. The Linked Exchange Rate System remains the best arrangement for Hong Kong SAR.

Approved By  
**Changyong Rhee and  
 Kalpana Kochhar**

Discussion took place in Hong Kong SAR during March 4–12, 2014. The staff team comprised Steven Barnett (head), Mali Chivakul, Waikeli Lam (all APD), and Shaun Roache (Resident Representative). Carlos Medeiros (MCM) and Markus Rodlauer (APD) attended the final discussions. Sun Ping and Michael Cheng (both OED) participated in policy meetings. Wei Liao, Alla Myrvoda, and Lesa Yee supported the team.

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## OUTLOOK AND RISKS

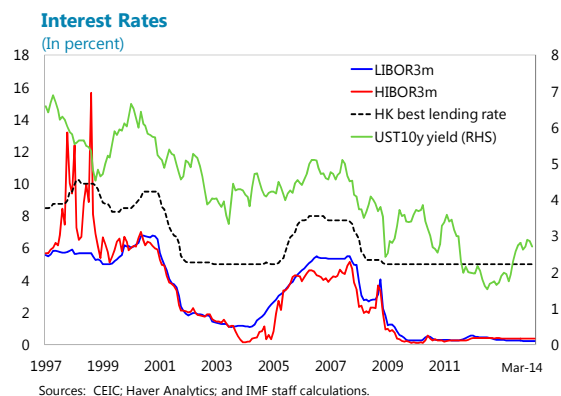
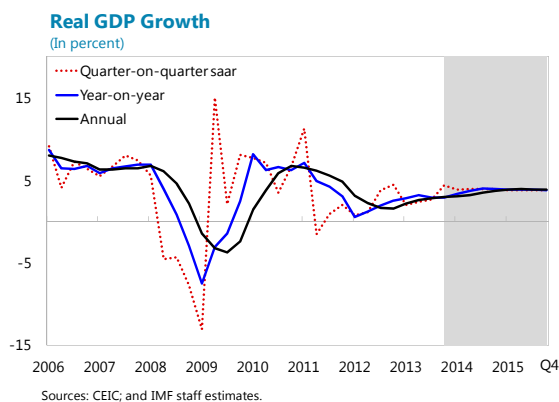
**1. Political context.** The leadership assumed office in July 2012 amid public concerns over the high cost of housing, inequality, and immigration. In his annual Policy Address at the beginning of 2014, the Chief Executive committed to provide additional assistance to low-income households, increase housing supply, and improve competitiveness.

**2. Developments and outlook.** After a slowdown in 2012 amidst weak global conditions, Hong Kong SAR's growth recovered to 2.9 percent in 2013 as resilient domestic demand helped offset the continued drag from net exports (Figure 1). As the global recovery takes hold, external demand is forecast to improve and lift growth to around 3¾ percent in 2014, while domestic demand remains solid. Inflation is expected to remain at around 4 percent, given the slow pass-through of housing costs. The labor market has remained strong, with unemployment slightly above 3 percent. The current account is projected to improve gradually in line with the global recovery.

**3. Financial developments.** Credit continued to grow rapidly, especially lending for use outside of Hong Kong SAR. Credit growth picked up through 2013 (16 percent y/y), though it started to moderate towards year's end (Figure 2). The main driver of growth was strong demand for credit for use outside of Hong Kong SAR. Such lending was generally in foreign currency and mainly represents Mainland-related lending. Regarding loans for use in Hong Kong SAR (excluding trade finance), growth picked up slightly to 11 percent y/y and the composition shifted away from real estate. Both residential and commercial property prices have leveled off, albeit at an elevated level (Figure 3). Housing transactions in the secondary market are, however, at a record low. IPO activity and debt issuance has picked up, while the Hang Seng index has remained subdued.

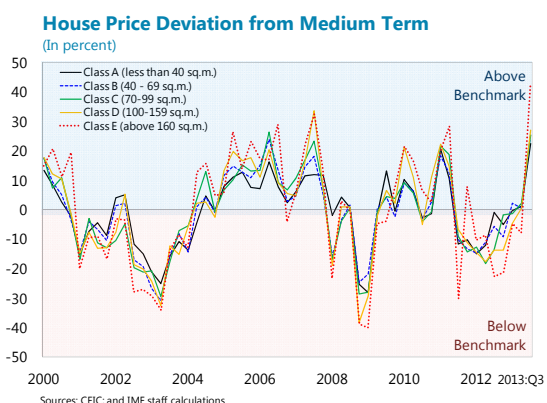
**4. Risks.** Hong Kong SAR is a small and highly open economy and, as such, is heavily influenced by global developments (see attached risk matrix). The main external risks are from Fed tapering and the implications of economic transformation in the Mainland (including slower Mainland growth). On the domestic front, a disorderly correction in property prices continues to be the main risk.

- **Spillovers from Fed tapering.** Hong Kong SAR is likely to benefit from Fed tapering, assuming it is associated with a recovery in U.S. demand (Box 1). Hong Kong SAR is directly affected by U.S. interest rates, since as a result of the Linked Exchange Rate System (LERS), it imports U.S. monetary policy (Figure 4). The direct effect of tapering (rising term



spread) on the Hong Kong SAR economy is fairly muted as most borrowing costs are closely linked to short-term interest rates, which move in tandem with the U.S. short-term rates. An orderly exit from unconventional monetary policy in the U.S. would tighten domestic liquidity conditions, but any negative effects would likely be outweighed by the benefit of a stronger U.S. economy. However, negative spillovers could prevail if exit is associated with increased volatility in global capital flows and financial markets. Higher interest rates, especially short-term rates, would also affect property prices with implications for bank and household balance sheets.

- Reforms in the Mainland.** Hong Kong SAR has become increasingly integrated with the Mainland through goods and services trade as well as financial linkages. Hong Kong SAR is also the main offshore RMB center and has benefited from Mainland companies' fund raising activities. Empirical evidence suggests that permanent shocks from the Mainland explain a large part of Hong Kong SAR's trend output volatility.<sup>1</sup> This close integration presents both downside and upside risks, depending mainly on growth and reform implementation in the Mainland. Full implementation of reforms in the Mainland could lift GDP growth in Hong Kong SAR about 0.3 percentage points in the medium term (Box 2). In the near term, however, growth could slow by  $\frac{1}{4}$ – $\frac{1}{2}$  percentage points depending on the extent that reforms slow growth in the Mainland. Further financial and exchange rate reforms, together with the liberalization of the capital account would create more cross-border opportunities for Hong Kong SAR's financial sector. Conversely, a sharp slowdown in the mainland would have a significant negative impact on Hong Kong SAR's growth with implications on the financial sector.<sup>2</sup>
- Property price correction.** Property prices have increased some 300 percent from their trough in 2003. While prices have leveled off more recently, estimates from staff models suggest they could be higher than suggested by fundamentals. Specifically, a user cost of property model, which suggests that property prices should have adjusted more to the increase in long-term interest rates (the opportunity cost of holding real estate) following Fed tapering<sup>3</sup> and a regression-based model were both updated.<sup>4</sup> Thus, a disorderly correction,



<sup>1</sup> Based on He, Liao, and Wu (forthcoming) "Hong Kong's Business Cycle Synchronization: A Trend and Cycle Analysis." This is joint work by IMF and HKMA staff.

<sup>2</sup> This scenario was explored in previous staff reports and in N'Diaye and Ahuja (2012). Hong Kong SAR's output could fall by about  $\frac{3}{4}$  of a percentage point for each 1 percentage point reduction in Mainland output.

<sup>3</sup> Staff re-estimated the model from Ahuja and Porter (2011) "Are House Prices Rising Too Fast in Hong Kong SAR?" IMF Working Paper WP/10/273 using the actual (rather than filtered) risk free rate to capture the rise in interest rates.

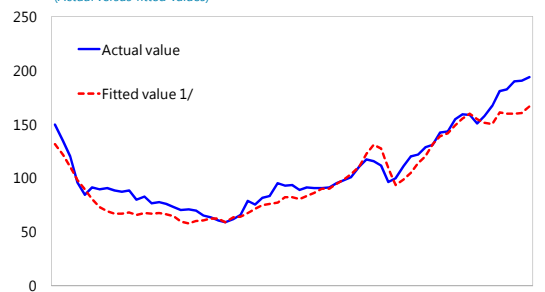
<sup>4</sup> Staff re-estimated the model from Craig and Hua (2011) "Determinants of Property Prices in Hong Kong SAR: Implications for Policy" IMF Working Paper 11/277 to include latest observations up to 2013:Q3.

resulting from, for example, global market volatility or domestic shock, remains a key risk as an abrupt downturn in prices could trigger an adverse feedback loop between economic activity, bank lending, household balance sheets, and the property market.

**5. Authorities' view.** The authorities broadly concurred with the staff's projections of better growth outlook for 2014 as long as the global recovery takes hold. On risks, they agreed that an orderly exit of unconventional monetary policy in the United States would benefit Hong Kong SAR if it reflected improved global growth prospects. However, they noted that exit could also entail higher financial market and capital flow volatility. Therefore, they had been proactive in preparing for exit since 2010, including implementing six rounds of

counter-cyclical prudential measures to bolster the resilience of the financial sector. Regarding spillovers from the Mainland, the authorities were aware of both the benefits from continued closer integration as well as the potential risks. In particular, they had been closely monitoring cross-border lending. They considered the current swap/liquidity arrangement with the People's Bank of China (PBC) as sufficient to guard against liquidity problems in the offshore renminbi market. They were confident that Hong Kong SAR would continue to benefit from further financial liberalization and reforms in the Mainland, especially given Hong Kong SAR's close ties and strong institutions. Growth in other offshore renminbi markets and further opening in Mainland presented, in their view, opportunities for expansion, such as providing wholesale renminbi services to other financial centers.

**Hong Kong SAR: Real Residential Property Price Index**  
(Actual versus fitted values)



Sources: IMF staff estimates.

<sup>1</sup> Co-integration equation is estimated on the sample 1998:Q1-2013:Q3.

## EXTERNAL ASSESSMENT

**6. External assessment.** The real exchange has appreciated modestly over the last year, official reserves of over 100 percent of GDP provide a sizable buffer, vulnerabilities in the international investment positions are low given the strong net external asset position, and there has been no foreign exchange purchase since early 2013 (Figure 4). Empirical results in assessing equilibrium exchange rate and considerations on external stance suggest that the external position is consistent with medium-term fundamentals and desirable policies (Box 3).

**7. Exchange rate regime.** The LERS is a transparent, credible, and effective exchange rate regime and warrants continued support as the best arrangement for Hong Kong SAR. This is reinforced by recent research, done jointly with the Hong Kong Monetary Authority (HKMA), which concludes that the United States remains the biggest driving force behind Hong Kong SAR's business cycle fluctuations.<sup>5</sup> More broadly, the success of the LERS over the past 30 years reflects Hong Kong SAR's strong fiscal position, robust and well-supervised financial system, and flexible markets.

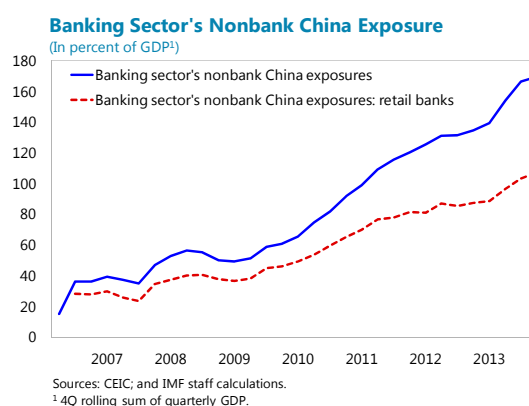
<sup>5</sup> Based on He, Liao, and Wu (forthcoming) "Hong Kong's Business Cycle Synchronization: A Trend and Cycle Analysis." This is a joint work with the HKMA.

8. **Authorities' views.** The authorities concurred with the staff's assessment that the external position and real exchange rate are broadly in line with fundamentals. They remain firmly committed to the Linked Exchange Rate System (LERS) and considered it as the most appropriate exchange rate arrangement for Hong Kong SAR.

## FINANCIAL SECTOR

9. **Risks.** Credit growth has been rapid since 2010. Low interest rates have fueled both corporate and household borrowing. As a result, corporate and household debt is at a record high. Corporate debt to GDP is among the highest in the region, but household debt is still low compared to international peers. Among the listed firms, the distribution of leverage appears to be broad-based with no large pocket of highly leveraged companies, and firms are profitable and liquid. Credit growth has been mainly driven by lending for use outside Hong Kong SAR, including Mainland China.

10. **Mainland exposure.** Financial integration with the Mainland is expected to continue to deepen, which underscores the importance of continued close monitoring of the financial system's rising Mainland exposure. Hong Kong SAR's financial sector external claims on the Mainland are now about 160 percent of GDP, of which about 120 percent of GDP are claims on banks (they largely represent RMB placement) and 40 percent of GDP are claims on nonbank. The Mainland has become the most systemically important exposure for Hong Kong SAR in terms of a potential shock to interbank markets.<sup>6</sup> A broader concept of nonbank exposure—Nonbank Mainland China exposure (NBMCE)—has risen to about 170 percent of GDP or 19 percent of total assets. NBMCE includes exposure to resident Mainland affiliates for use outside of Hong Kong SAR (including the Mainland and elsewhere), lending of Hong Kong SAR bank subsidiaries in Mainland China, and borrowing by foreign companies for use in the Mainland. While these exposures could generate significant spillover risks, there are also a number of mitigating factors. For example, foreign bank branches account for 43 percent of the exposures with credit risk ultimately born by head offices. On the borrower side, Mainland large and well-known SOEs account for half of the lending with the rest split between Mainland private entities (19 percent) and other international and Hong Kong SAR corporations (31 percent). For the latter, repayment ability is based on group financials rather than their Mainland operations. Also more than half of the exposures are collateralized. The HKMA has recently enhanced reporting requirements on Mainland exposures. In addition, since 2012, the HKMA has introduced specific RMB risk management



<sup>6</sup> As suggested by staff's network analysis (see the 2014 FSSA and Box 3 in IMF Country Report No. 13/11).



and net open position limits. Surveillance and supervision of Mainland exposures should remain a key supervisory priority for the HKMA, including effective cooperation with Mainland supervisors.

**11. Stress tests.** The FSAP stress tests conclude that the banking system is well positioned to absorb losses. In adverse scenarios, which combine lower global growth, including in China, with higher U.S. interest rates and asset price shocks, there is no aggregate capital shortfall, but a few smaller banks might be slightly more vulnerable under a severe economic scenario. The banking system is highly capitalized (Tier 1 capital ratio is just over 13 percent) and NPLs are low at 0.5 percent. The banking system is also found to be resilient to changes in liquidity conditions, with foreign branches being more vulnerable as some rely on their parents for funding.

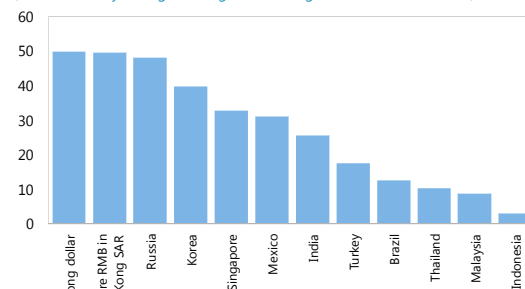
Stress Test Scenarios			
	Baseline	Slow Growth	Severe Adverse
	(Percent)		
<i>Average 2014–18</i>			
Real GDP growth	4.4	2.6	2.0
<i>End-2018</i>			
Unemployment	3.8	6.8	7.7
3m HIBOR	0.8	4.5	4.5
Best lending rate	5.4	6.7	6.3
<i>Cumulative change 2014–18</i>			
Residential house price	-3.0	-30.0	-40.0
Hang Seng Index	40.0	-50.0	-65.0

Source: IMF staff estimates.

**12. Supervision and regulation.** The FSAP finds that Hong Kong SAR’s financial system is well regulated and supervised—at the global forefront in many areas—in line with the needs of a major global financial center. Main areas for improvement include the financial sector resolution regime and insurance sector regulation and supervision (see Box 4). As a financial center, it is also important for the authorities to maintain their active international engagement to effectively manage cross-border challenges and comply with evolving international standards including with regard to AML/CFT. Continued market infrastructure development while maintaining a high standard of regulation and supervision will also help sustain Hong Kong SAR’s competitiveness in the growing offshore RMB business.

**13. RMB internationalization.** With larger pool of offshore RMB in Hong Kong SAR and more varieties of RMB-denominated assets, the market has become active and liquid (Box 5). Firms, both from the Mainland and elsewhere, have taken advantage of low funding cost to raise funds through the offshore RMB market. Offshore RMB in Hong Kong SAR has already become one of the most traded emerging market currencies, with daily average turnover similar to that of the Hong Kong dollar. The Hong Kong SAR authorities’ continued effort to improve market infrastructure has helped market development. The latest initiative is to introduce a mutual recognition program with the Mainland for asset management funds. Through the program, Mainland investors will be able to invest in Hong Kong SAR-domiciled funds and vice versa.

**Local Currency OTC Foreign Exchange Turnover: April 2013**  
(In USD bn, daily averages; 'net-gross' basis; against all other currencies)



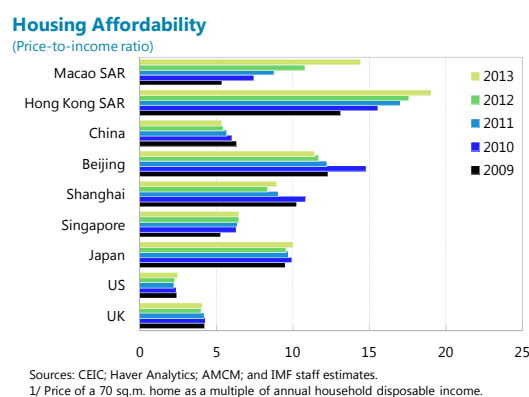
Sources: BIS; and IMF staff calculations.

**14. Authorities’ view.** The authorities appreciated the work of the FSAP team and broadly concurred with the main findings, which are consistent with ongoing reforms. They emphasized that high-quality supervision and regulation combined with a sound financial infrastructure were critical for consolidating Hong Kong SAR’s position as a global financial center. They added that it was

natural for Hong Kong SAR to become a financial hub for the Mainland corporate sector's offshore funding. Exposure to the Mainland could therefore rise further, especially as the Mainland continues to open up. The HKMA would continue to closely monitor these exposures, and, as required, take steps to manage risks. They noted their active financial sector policy agenda, which includes implementing Basel III, introducing a new resolution regime for financial institutions, and reforming OTC derivative and insurance regulation and supervision. They were also working on reviewing the legal framework for market development, including the tax regime for the asset management industry. Regarding AML/CFT, the authorities noted that Hong Kong SAR had made significant progress in addressing the issues identified in the 2008 FATF mutual evaluation, and thus was removed from its "follow-up process" in October 2012.

## PROPERTY SECTOR

**15. *Background.*** In light of the rapid rise in property prices, the authorities' have proactively implemented measures to safeguard financial stability and stabilize the property market. These include tightening required loan-to-value (LTV) ratios (average LTV is now around 55 percent) and debt service ratios (now about 35 percent), which provide some buffer despite higher overall debt than in the past. Fiscal measures include increasing stamp duties on speculative transactions and buyers who are not permanent residents. Supply-side measures have also been proposed with more land supply and a new 10-year housing target. Despite the recent price stabilization, housing affordability remains a concern with the highest price-to-income ratio among regional peers.



**16. *Property-related policies.*** A long-run solution to housing hinges on ensuring adequate supply. The recently announced plan to increase housing supply, including a refocus on public housing, will help address concerns on elevated house prices and rising inequality. However, this will take years and, in the mean time, the counter-cyclical prudential and fiscal measures deployed during the upswing can facilitate an orderly adjustment in the market. In unwinding the counter-cyclical prudential measures, priority should be placed on safeguarding financial stability. For example, if growth in residential mortgage lending was expected to slow excessively—as could happen during a market correction—then some of the cyclical tightening of LTVs could be safely unwound. However, under such circumstances (weak credit demand) the impact on the housing market may also be fairly limited. The fiscal measures (stamp duties) more directly affect prices and thus are likely to have a stronger impact on the housing market. These could be eased as the market normalizes, with a faster reduction in the event of a sharp correction.

**17. *Authorities' view.*** The authorities noted that the current property cycle, starting from the trough in 2003, has been long, partly due to the low global interest rate environment in recent years. While recognizing the risk of a possible abrupt downturn, they noted that Hong Kong SAR households have proved resilient to large swings in property prices in the past. Moreover, the relatively low LTV ratios and household debt service ratios would provide an important cushion. They agreed with staff that the

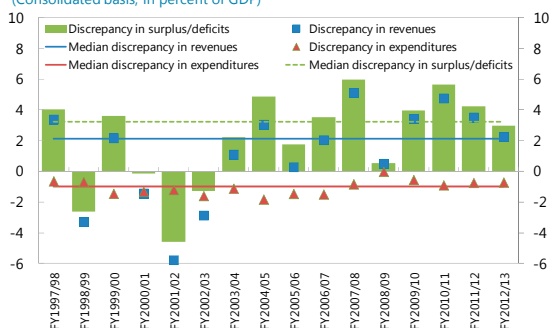
objective of maintaining financial stability must prevail in considering unwinding counter-cyclical prudential measures and stressed the importance of being forward looking. They also pointed out that the impact of unwinding counter-cyclical prudential measures on the market during a down cycle may be uncertain because, at that time, credit demand would be weak and banks would likely be more conservative in their lending decision. On housing supply, the authorities are committed to increase public housing (a new target of about 280,000 units, compared to about 151,000 units completed in the last 10 years) and land supply in the coming decade.

## FISCAL POLICY

**18. *Background.*** The authorities have maintained a prudent and counter-cyclical fiscal policy. They place a premium on sound fiscal management and small government, executed through balancing the budget over the business cycle and maintaining a low tax environment that makes Hong Kong SAR attractive as a global financial center. Reflecting this prudence, fiscal reserves now exceed 35 percent of GDP and the fiscal outturn has consistently overperformed the budget (by about 3 percent of GDP on average over the past 15 years). Meanwhile, rising inequality and population aging are adding to spending pressures, which has often led to ad-hoc or one-off initiatives, including waiving rates (annual fee paid by most property owners or occupiers), paying rents for public housing tenants, one-off tax relief, subsidies for electricity, transfers to the poor and elderly, and higher capital spending. A Commission on Poverty was established in December 2012 and published the first official poverty line last September, which will be used to facilitate policy formulation and assess policy effectiveness. A statutory minimum wage was introduced in 2011 and increased by 7.1 percent in May 2013.

**Discrepancy of Fiscal Outturn and Budget**

(Consolidated basis; in percent of GDP)

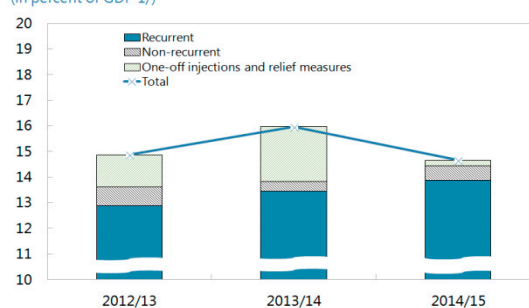


Sources: Government budget statements; and IMF staff estimates.

**19. *Consistent budget overperformance.*** The overperformance has in part been driven by an underestimation of consolidated fiscal revenues by around 2 percent of GDP on average, while consolidated spending averaged about 1 percent lower than budgeted.<sup>7</sup> Excluding the capital account—consisting of volatile land premium and capital works spending—the operating surpluses also have outperformed the budget estimate by nearly

**Government Expenditures**

(in percent of GDP 1/)



Sources: Budget Speech FY2014/15. Numbers for 2014/15 is based on authorities' projection of GDP.

<sup>7</sup> The bias is estimated based on the initial budget forecast and the actual outturn of a fiscal year ending in March. The government also announces a revised budget estimate in the interim of a fiscal year, often at the budget announcement for the upcoming fiscal year, of which the bias is smaller. Some one-off items, such as bond issuance in FY2004/05 and subsequent redemption may affect the magnitude of bias.

2 percent of GDP. The budget over-performance is similar to some other advanced economies.<sup>8</sup>

**20. 2014/15 Budget and fiscal policy framework.** In line with the improved economic outlook, the 2014/15 budget has an appropriate unwinding of stimulus, including a reduction in one-off injection and relief measures of about 1.9 percent of GDP. There is an increase of 7.8 percent in recurrent spending for 2014–15 over the revised estimate for 2013–14. Near 60 percent of recurrent expenditure for FY2014/15 is allocated to education, health and social welfare, an increase of 6.7 percent from last year. In this context, there may be scope to strengthen social programs through a reprioritization of spending and efficiency gains in existing programs. The recent report of the Working Group on Long-Term Fiscal Planning casts fiscal policy in a long-term framework. This will help anchor the discussion about how to balance spending to address aging and inequality with the authorities' commitment (enshrined in the Basic Law) to preserving low taxes and maintaining fiscal prudence. The report showed an emergence of structural deficits over the next decades given increased spending due to aging. It also proposed, for further public consideration, some recommendations as inputs to help frame the discussion about long-term fiscal policy.

**21. Authorities' view.** With the recovery taking hold, this year's budget unwinds most of the temporary relief measures included in recent budgets. Budget overperformance underscores strong fiscal discipline and a cautious approach to budgeting. The authorities also noted that existing social programs have contributed to containing rising inequality, and that the Gini coefficient after redistributive taxes and transfers has stayed broadly unchanged in recent years. They added that the recently-established official poverty line will provide a useful tool for designing and assessing social programs aimed at improving welfare of lower-income families. The authorities noted that the report of the Working Group on Long-term Fiscal Planning could help anchor public debate, and they intended to develop long-term policies on the basis of the recommendations in the report. While recognizing the long-term fiscal needs, the authorities stressed that preserving fiscal discipline was of paramount importance and critical for fostering macroeconomic and monetary stability.

## STAFF APPRAISAL

**22. Macroeconomic context.** Hong Kong SAR is recovering from a slowdown in 2012. Stronger external demand as well as continued resilient domestic demand should help propel the economy this year. Growth this year is expected to rise to 3¾ percent with low unemployment and stable inflation. The main domestic risk continues to be an abrupt property price correction. As a small and highly open economy, Hong Kong SAR is susceptible to external shocks and could be affected by Fed's tapering and developments in the Mainland.

**23. External assessment.** Hong Kong SAR's external position is assessed to be consistent with medium-term fundamentals and desirable policies. This finding is supported by empirical estimates, analysis of the balance of payments and the net foreign assets position, and consideration of Hong Kong SAR's status as a global trading and financial center. Robust and proactive financial supervision and regulation, prudent fiscal management, flexible markets, and the Linked Exchange

<sup>8</sup> See for example Mühleisen and others (2005), "How Do Canadian Budget Forecasts Compare with Those of Other Industrial Countries?"

Rate System have worked well to keep the external position broadly in balance. The LERS is a transparent, credible, and effective exchange rate regime.

**24. *Financial sector.*** The FSAP finds that Hong Kong SAR's financial system is well regulated and supervised, displaying a high level of compliance with international standards. The priorities for improvement are in the area of the financial sector resolution regime and insurance sector regulation and supervision. The FSAP stress tests also suggest that the financial sector has the capacity to withstand a diversity of large and global shocks. Deepening ties with the Mainland suggest that financial linkages, including through the offshore RMB market, will continue to grow, especially as the Mainland further liberalizes its capital account and financial sector. However, the large and rapidly growing exposure to the Mainland and the potential for higher RMB volatility to impact the offshore market requires close monitoring and cooperation with Mainland supervisors.

**25. *Property sector.*** The authorities' target to increase housing supply is a welcome step in improving affordability and addressing the medium-term challenges in the property market. Counter-cyclical prudential policies that have been implemented over recent years should provide buffers to the financial system in the event of a property price correction. Fiscal measures deployed during the upswing could facilitate an orderly adjustment in the market while safeguarding financial stability. The unwinding of the counter-cyclical prudential measures should be linked to the dissipation of systemic financial sector risks. The fiscal measures (extra stamp duties) could be eased in line with the normalization of the market, with a faster reduction in the event of a sharp correction.

**26. *Fiscal policy.*** The authorities continue to maintain a prudent, counter-cyclical fiscal policy that provides a solid foundation for the LERS. This year's budget has an appropriate unwinding of stimulus as the economic recovery takes hold. The effort to cast fiscal policy in a long-term framework, as proposed recently by the Working Group on Long-Term Fiscal Planning, is welcome. Fiscal policy planning will need to strike a balance between addressing aging and inequality related needs while fulfilling the authorities' commitment to low taxes and fiscal prudence. In this context, there may be scope for a reprioritization of spending and efficiency gains in existing social programs. Beyond that, public discussion should continue on policies to address long-term spending pressures while preserving fiscal prudence.

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

### Box 1. Fed's Tapering and Implications on Hong Kong SAR

*This box examines how U.S. Fed tapering could impact Hong Kong SAR's economy. Evidence from past episodes suggests that Hong Kong SAR growth and exports are likely to rise. This implies that any drag from higher interest rates has been offset by the benefit of stronger U.S. growth. The impact on Hong Kong SAR financial conditions is less clear. Moreover, some caution is warranted in extrapolating from past episodes to the current one, as many factors are at a play that could influence how Hong Kong SAR is impacted this time.*

**With the LERS, Hong Kong SAR imports U.S. monetary policy.** Therefore, since 2009, it has been in a high-liquidity low-interest rate environment, which has fueled growth in credit and property prices. Hong Kong SAR can be affected by Fed's tapering (or rise in the term spread) through:

- **Asset prices.** Property prices could correct with the rise in the opportunity cost of funds (long-term interest rates), which would have negative wealth effects and dampen household consumption.
- **Credit.** While credit in Hong Kong SAR is mostly based on short-term rates, the higher-term spread could affect borrowing costs (such as in the bond market).
- **Risk sentiment.** Cross-border flows would be impacted by portfolio shifts as investors reevaluate risk and return, as evidenced by the bouts of global capital market volatility since the Fed's announcement of tapering in May 2013. Staff analysis suggests that U.S. interest rates do not significantly impact non-FDI capital flows into Hong Kong SAR. However, such flows have increased noticeably during the period of U.S. unconventional monetary policy—pointing to the possibility that global capital market volatility could spillover into Hong Kong SAR.

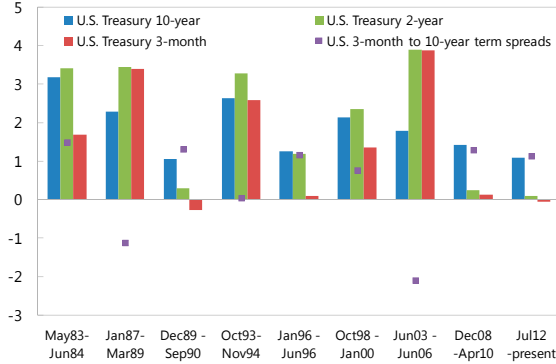
**Rising U.S. long-term interest rates tend to be associated with a pick-up of growth in both the U.S. and Hong Kong SAR.** The performance of Hong Kong SAR's economy is examined around peaks and troughs of U.S. financial cycles (see figure). Since the early 1990s, in all but one episode growth in Hong Kong SAR rose following increasing U.S. yields. The exception is 1994, which was followed by deteriorating conditions in emerging markets. Hong Kong SAR exports also tended to rise, as import demand from the U.S. picked up with the increase in U.S. growth. However, the impact on general financial conditions is not conclusive. Staff's formal examination of the relationship through a structural vector autoregression (SVAR) model also finds that an increase in U.S. term spreads is associated with an increase in output in Hong Kong SAR.<sup>1</sup> Negative effects from U.S. yield curve steepening were generally offset by stronger U.S. growth. However, it is not conclusive to what extent the current episode will follow these past patterns, especially if it is associated with rising global capital flow volatility or other shocks.

<sup>1</sup>The model includes the United States, the Mainland, and Hong Kong SAR.

### Box 1 Figures: Fed's Tapering and Implications on Hong Kong SAR

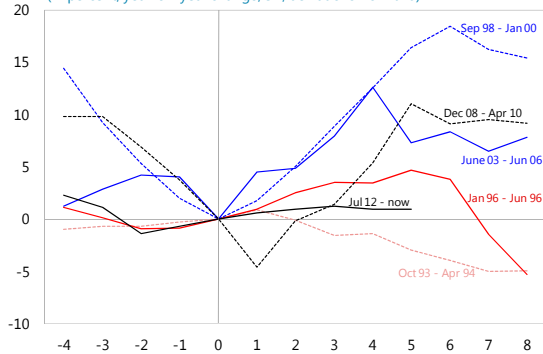
The size of the current episode's increase in U.S. long-term yields and term spreads is in line with past episodes'.

**Rising US Long-Term Interest Rate Episodes**  
(Percent change from troughs to peaks)



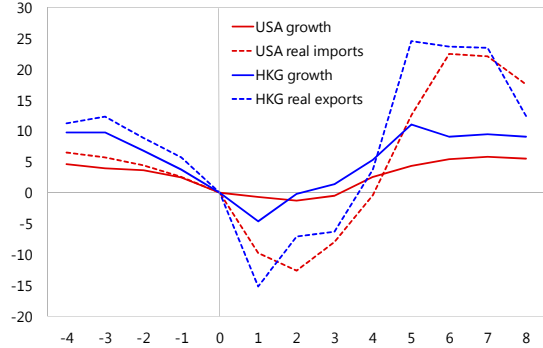
Hong Kong growth responses were positive in most episodes except in 1994...

**Hong Kong SAR Growth: All Rising US Yield Episodes**  
(In percent, year-on-year change; SA; deviations from t=0)



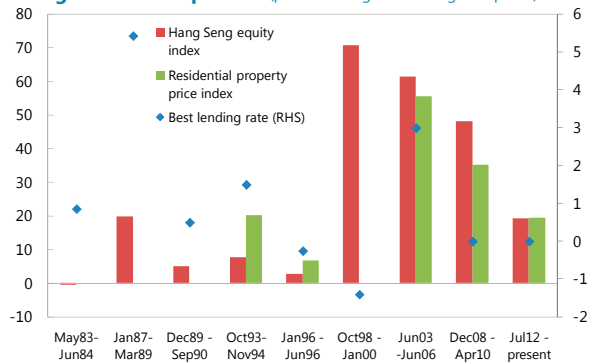
...and the 2008 episode.

**2008-10 Episode: U.S. and Hong Kong SAR Growth**  
(y/y percent change; SA; deviations from t=0, 2008:Q4)



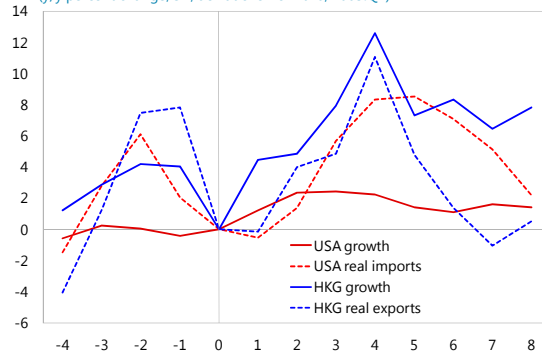
Change in financial conditions varied in these episodes.

**Hong Kong SAR Financial Conditions During Rising U.S. Long-Term Rate episodes**  
(percent change from troughs to peaks)



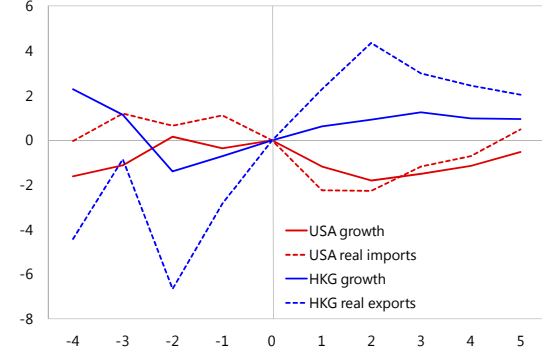
Rising U.S. yields usually coincided with a pick-up in U.S. growth and imports, lifting Hong Kong SAR exports, most recently in the 2003 episode...

**2003-06 Episode: US and Hong Kong SAR Growth**  
(y/y percent change; SA; deviations from t=0, 2003:Q2)



There is not yet a clear pattern of correlated trade pick-up in the current episode.

**Current Episode: US and Hong Kong SAR Growth**  
(y/y percent change; SA; deviations from t=0, 2012:Q3)



Sources: CEIC; Haver Analytics; IMF, WEO, and IMF staff calculations.



## Box 2. Impact of China's Economic Transition Under the Third-Plenum Reform Blueprint

*Successful implementation of reforms in the Mainland would be good for the Mainland, World, and Hong Kong SAR economies. Implementation could initially slow Mainland growth, with knock-on effects to Hong Kong SAR. However, over time, Mainland growth would be more inclusive and sustainable with much higher per capita income and consumption, providing significant benefits to the Hong Kong SAR economy.*

**China has put forward a comprehensive and ambitious reform blueprint.** If successfully implemented, it would move the economy to a more inclusive, green, and sustainable growth path. By giving markets 'decisive' role, reforms would guide better resource allocation, expand the service sector, and fuel productivity gains. This move to a slower but higher-quality and more sustainable growth path will have global spillovers. A structural general equilibrium model is used to assess the impact of reforms, with a focus on the Mainland and Hong Kong SAR.<sup>1</sup> Translating the blueprint to a structural model requires making assumptions about the timing and sequencing of implementation.<sup>2</sup> The World Economic Outlook baseline, which assumes a full but gradual implementation of reforms, is compared to two alternative scenarios. One with faster implementation ("fast implementation") and another with little progress ("No implementation").

**In the "fast implementation" scenario Mainland growth slows in the near-term, but in the long-run income is much higher.** The simulation suggests that near-term growth could slow by  $\frac{1}{2}$ – $\frac{3}{4}$  percentage points relative to the WEO baseline (text figures). Over time, however, the reform dividends would kick-in and by 2020 income would be higher than in the baseline. Moreover, private consumption would grow faster than output and converge to the GDP share in comparable economies. By 2030, income per capita would rise from 25 percent of the U.S. level (PPP terms) to 40 percent and consumption per capita would nearly double (to 25 percent of the U.S. level). The global economy would benefit from China's rise in per capita income and consumption. The gradual move towards higher value-added exports in China would give room for labor-intensive industries in other emerging economies to gain ground. After an initial slowdown, global growth could increase by 0.2 percentage points per annum over the medium term.

**Hong Kong SAR would benefit significantly in the long run.** The simulation suggests that growth in Hong Kong SAR, relative to the baseline, would slow modestly (about  $\frac{1}{4}$  percentage points) for two years. The benefits, however, will emerge over time as Hong Kong SAR gains from higher per capita income. Growth would be  $\frac{1}{4}$  percentage points higher over the medium term (text figures) and, by 2030, income per person in Hong Kong SAR is  $3\frac{1}{2}$ –5 percent higher than under the baseline.

- *Trade channel.* The Mainland is Hong Kong SAR's largest trading partner and accounts for more than half of Hong Kong SAR's external trade (at about 180 percent of GDP). In the simulation, RMB appreciation and a loss of competitiveness from rising labor and resource costs dampen re-exports from Mainland in the near term. However, over time, Hong Kong SAR would benefit from higher value-added exports as the Mainland moves up the quality ladder in supply chains and household income improves. In addition, Hong Kong SAR also provides a host of services, including logistics, financial, and business services while tourism is an important source of employment. By continuing to upgrade its infrastructure and human capital, Hong Kong SAR would best be able to benefit from rising Mainland demand.

<sup>1</sup> This note uses the Flexible System of Global Models (FSGM) to assess the spillover impact. The model is also used in Spillover Reports by the International Monetary Fund.

<sup>2</sup> The parameters used in the model are based on previous empirical research and cross-country comparisons, where applicable, which would generate endogenous impact on key macroeconomic variables. For details, see forthcoming working paper.



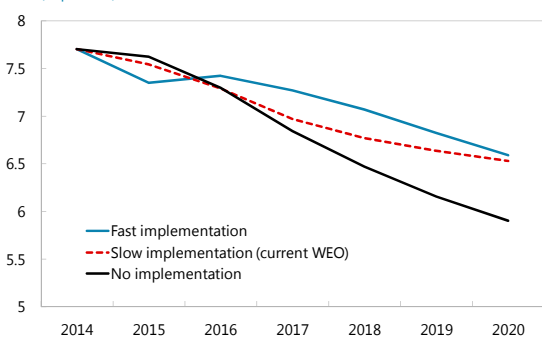
- Financial channels.** Reforms in Mainland would provide a ‘first-mover’ advantage for Hong Kong SAR as a leading offshore RMB center. Hong Kong SAR has the largest pool of RMB deposits, is the main hub for RMB payments, and has asset markets poised to expand as the Mainland undertakes financial and exchange rate reforms. As reforms progress, gross capital flows are likely to increase significantly and financial activity in Hong Kong SAR could rise accordingly, including initial public offerings, offshore bond issuance, and syndicated loan markets. Activity has already picked up in the first quarter of 2014, with new listings reaching US\$5.8 billion, a fivefold increase from last year, while RMB bond issuance (not including RMB certificates of deposit) amounted to about US\$9.5 billion.

However, in the “no-implementation” scenario, the Mainland and global economies would be worse off, with knock-on effects to Hong Kong SAR. This becomes clear over time, as the convergence of Mainland income to advanced economy levels stalls. This maps into slower growth that adversely impacts the global economy and Hong Kong SAR. The “no-implementation” simulation suggests that by 2030, Hong Kong SAR income per capita would be 4–7 percent lower than in the baseline and about 7–12 percent lower than in the “fast-implementation” scenario.

### Box 2 Figures: Impact of China’s Third-Plenum Reform Blueprint

*Steadfast implementation of China’s reform blueprint would slow growth in the near term, but help achieve more inclusive and sustainable growth in the long run...*

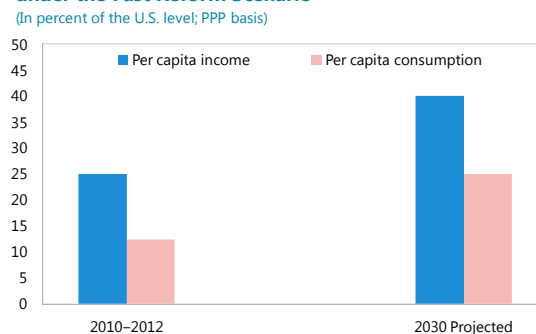
**China: GDP Growth under Various Reform Scenarios**  
(In percent)



Sources: Staff estimates and simulations.

*... with per capita income and consumption in China rising significantly.*

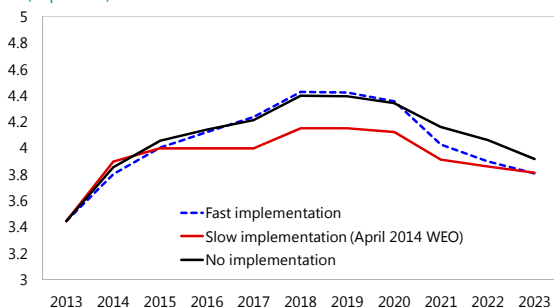
**Convergence of Per Capita Income and Consumption under the Fast Reform Scenario**  
(In percent of the U.S. level; PPP basis)



Sources: IMF (2012), staff estimates based on FSGM-G20MoD.

*A moderate near-term growth slowdown in China would have knock-on effect on Hong Kong SAR, but the long-run benefits are significant...*

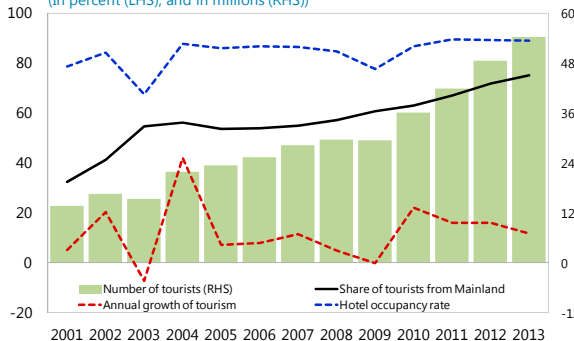
**Hong Kong SAR: Private Consumption Growth under Various Reform Scenarios in Mainland China**  
(In percent)



Sources: Staff estimates and simulations.

*... driven by close integration in China through trade and financial channels.*

**Hong Kong SAR: Tourism**  
(In percent (LHS); and in millions (RHS))



Sources: Haver Analytics; and IMF staff calculations.

### Box 3. Hong Kong SAR: External Sector Assessment

Staff assesses Hong Kong SAR's external position to be consistent with medium-term fundamentals and desirable policies. This finding is supported by empirical estimates, analysis of the balance of payments and net foreign assets position, and consideration of Hong Kong SAR's status as a global trading and financial center.

**Empirical estimates.** Three techniques—the Macrobalance (MB), Equilibrium Real Exchange Rate (ERER), and External Sustainability (ES)—are used to assess the real exchange rate. The estimation on MB and ERER is based on a sample of 55 developed and emerging economies, and a separate sample of six international financial centers (Belgium, Hong Kong SAR, Luxembourg, Singapore, Netherlands, and Switzerland). The results are broadly unchanged from last year. As a global trading and financial center, gross exports of goods and services and gross external assets are considerably larger than for other economies (Figure 1). As a result, net foreign assets and the current account balance are likely to be more variable, making quantitative estimates subject to more uncertainty than other economies.<sup>1</sup>

**External developments and outlook.** Net foreign assets increased significantly after the global financial crisis, to over 250 percent of GDP, reflecting a pickup in capital inflows as result of monetary easing in advanced economies and valuation changes. As a regional financial center, gross capital flows are large relative to the economy (over 100 percent of GDP). Hong Kong SAR's strong financial institutions, buttressed by robust regulation and supervision and experience as a financial center, help contain the risks from volatile capital flows. As such, Hong Kong SAR has been able to maintain external stability with a fully open capital account and the Linked Exchange Rate System. Foreign exchange reserves are 110 percent of GDP, and are adequate for precautionary purposes and ensuring the smooth functioning of the Linked Exchange Rate System. In addition, the government has fiscal reserves of about 35 percent of GDP, sufficient to cover 20 months of public spending. The current account surplus fell substantially following the global financial crisis, but is expected to improve in line with the global recovery. From a low of 2¾ percent of GDP in 2012, the surplus is projected to rise to 5 percent of GDP over the medium term in line with the global recovery, driven mainly by a pickup in the income balance.<sup>2</sup>

**Overall assessment.** The external position is broadly consistent with medium-term fundamentals and desirable policy settings. In quantitative terms, the gap relative to the level consistent with medium-term fundamentals and desirable policies is -3 to 3 percent of GDP for the current account and -10 to 10 percent for the REER. This judgment is based on the quantitative estimates, staff's assessment that macroeconomic policies are appropriate, and the outlook for the external position. Staff does not perceive distortions substantially affecting saving and investment rates and balances. The relatively wide ranges reflect the uncertainty in such assessments for a global trading and financial center. 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.

<sup>1</sup>Hong Kong SAR is not included in the External Balance Assessment (EBA), in part because these techniques are not well-suited for offshore financial centers. As in other financial centers, the external sustainability (ES) approach, in assuming a stabilizing net foreign asset to GDP ratio at high levels, may not be indicative of Hong Kong SAR's external stability.

<sup>2</sup>Current account balance and its projection measured in the format of Balance of Payments Manual 5 (BPM5).

#### Exchange Rate Assessment: 2012 and 2013 (Misalignment from medium-term fundamentals; in percent)

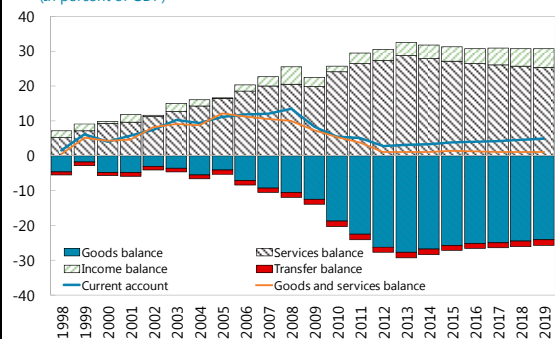
Approach	Coverage	2012	2013
MB	Six financial center	1.4	0.4
	55 economies	3.8	2.8
	Authorities' estimates 1/		0.0 – 1.5
ERER	Six financial center	-10.5	-11.0
	55 economies	-6.5	-7.1
	Authorities' estimates 1/		-2.9 – 3.5
ES	Staff estimates based on CGER-type model	6.5	7.2
	Authoritie's estimates 1/		6.1

Sources: Authorities' and IMF staff estimates.  
1/ Latest assessment as of March 4, 2014.

### Box 3 Figures: Hong Kong SAR: External Sector Assessment

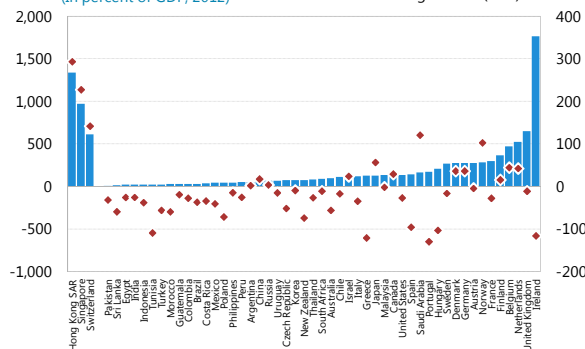
In line with the global recovery and continued closer integration with the Mainland, the current account surplus is forecast to rebound somewhat over the medium term.

**Current Account Balance for Hong Kong SAR**  
(In percent of GDP)



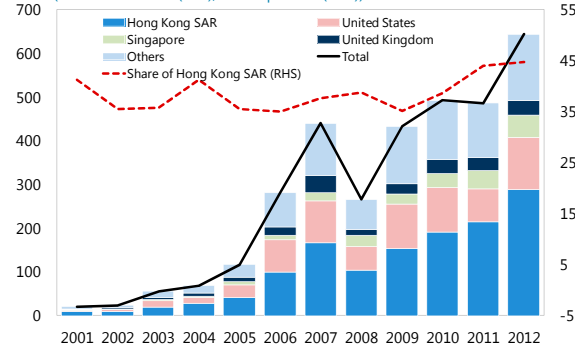
Likewise, as a financial center, gross external assets are larger in percent of GDP than other economies.

**External Assets**  
(In percent of GDP, 2012)



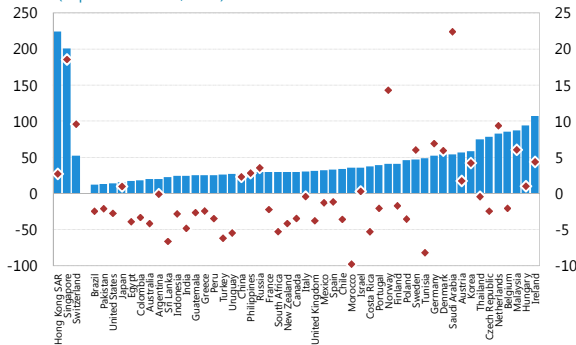
The large and rising gross flows are in part driven by increasing portfolio investment with Mainland China.

**Sources of Portfolio Investment in Mainland China**  
(In billions of USD (LHS); and in percent (RHS))



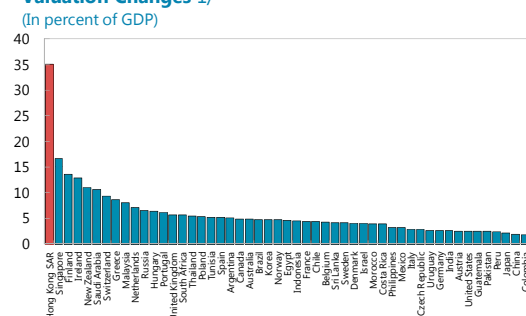
As a regional trading hub, exports of goods and services exceed 200 percent of GDP, much higher than in other economies.

**Current Account Balance**  
(In percent of GDP; 2012)



Valuation changes, therefore, are also likely to have a stronger impact on net foreign assets.

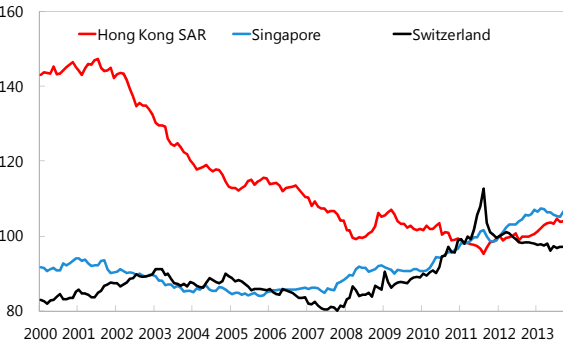
**Average Volatility in Net Foreign Assets Driven by Valuation Changes 1/**  
(In percent of GDP)



1/ Average between 1986 and 2012, where data are available.

The real effective exchange rate has appreciated by about 5 percent in 2013.

**Real Effective Exchange Rate**  
(Index, Jan 2012 = 100)



Sources: Lane and Milesi-Ferretti (2007) dataset; IMF, CPIS; IMF, Information Notice System; IMF, WEO; and IMF staff calculations.

#### Box 4. Main FSAP Recommendations

Overall, the FSAP finds Hong Kong SAR's regulation and supervision framework of the financial sector to be robust. Key recommendations are as follows:

- **Crisis management and resolution.** The authorities are encouraged to push forward their plans to establish a fully comprehensive framework for recovery and resolution, in line with emerging international good practices. This is especially important given the role the globally systemically important institutions (G-SIFIs) play in Hong Kong SARs, but also for the resilience of the financial market infrastructures (FMIs).
- **Insurance sector.** The authorities should ensure implementation of the independent Insurance Agency (IIA) as scheduled in 2015. In addition, the legal and regulatory framework should be strengthened in a number of areas, including by establishing a regulatory regime for insurance groups, implementing a risk-based capital regime and strengthening supervision of intermediaries.
- **Securities market.** As the authorities have already identified, it is important to strengthen the oversight regime of the Hong Kong Exchanges and Clearing Limited, especially as its business model evolves. In addition, oversight of external auditors should be improved, and the enforcement regime strengthened in a few areas.
- **Banking sector.** Hong Kong SAR has a very high level of compliance with the strengthened Basel Core Principles for Effective Banking Supervision (BCPs).
- **Financial market infrastructure (FMIs).** Further enhancements will be needed by the clearing houses to comply fully with new international standards and support Hong Kong SAR's position as an international financial center.
- **Macprudential oversight.** Strengthening the capacity for systemic risk analysis at the SFC and the IA would help ensure that cross-sectoral interconnections are adequately captured and brought to the attention of the Financial Stability Committee.
- **Cross-border regulatory coordination.** Continued active participation in the supervisory colleges and crisis management groups of GSIFIs is essential in managing risk in the financial system. Similarly, strong cooperation with regulatory counterparts in China is essential to manage the risks associated with increased integration. Continued active participation in international regulatory fora is also needed to mitigate potential effects from global regulatory developments.

### Box 5. Update on RMB Internationalization

*The use of offshore RMB has continued to expand rapidly. This is true in terms of use for trade and FDI, number of offshore financial centers, depth of assets markets, and daily turnover.*

**Trade and investment.** By end-2013, trade settlement in RMB had increased to about 14 percent of the Mainland's total current account transactions trade, double the ratio share in 2011. The share of FDI settled in RMB increased from 4 percent in 2011 to 20 percent. About 9 percent of outward direct investment (ODI) it settled in RMB.

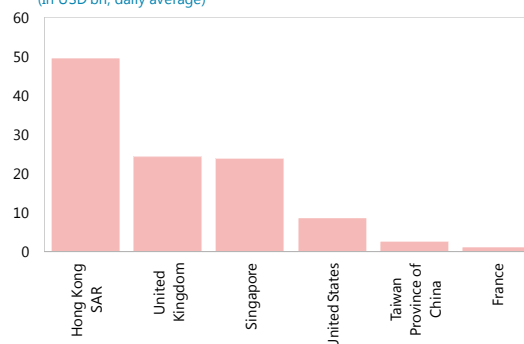
**Offshore financial centers.** RMB business has expanded to other financial centers. In 2013, RMB clearing banks were established in Singapore and Taiwan Province of China. The United Kingdom and Germany are also expected to establish RMB clearing banks soon. Singapore, France, and the United Kingdom were also granted Offshore RMB Qualified Foreign Institutional Investors (RQFII) quota (RMB 50-80 billion each, compared to RMB 270 billion for Hong Kong SAR). However, Hong Kong SAR remains the leading offshore RMB center. It has the largest pool of RMB deposits and is the main hub for RMB payment through HKMA's Real Time Gross Settlement (RTGS) infrastructure. RMB deposits in Hong Kong SAR grew strongly in 2013 (43 percent y/y), and at end-2013 totaled RMB 860 billion. This is about 12 percent of total deposits in Hong Kong SAR, but only about 1 percent of Mainland deposits. Singapore and Taiwan Province of China hold, respectively, about RMB 200 billion and RMB 180 billion of RMB deposits. According to SWIFT payment data, Hong Kong SAR is a leading hub for RMB payment with a market share of 73 percent. For comparison, Singapore and the UK each have a share of about 6 percent.

**Offshore RMB assets.** Issuance of dim sum (offshore RMB) bonds remained active and the outstanding amount reached RMB 310 billion at end-2013. A variety of Mainland and international entities have issued bonds, seeking to establish a footprint in the RMB market and take advantage of low funding costs—analysts reported that some issuers could lower funding costs by around 50 basis points by issuing in RMB and swapping into U.S. dollars. The market has deepened further with the emergence of new types of RMB-denominated assets, including (as of March 2014) 17 ETFs, 1 REIT, and derivative warrants. Average daily trading of these listed RMB securities in Hong Kong SAR reached RMB 95 million in 2013 (over 90 percent of the trading was in ETFs). The outstanding amount of RMB bank loans rose to RMB 116 billion in 2013.

**Offshore RMB trading volume.** From 2010 to 2013, total RMB foreign exchange transactions in Hong Kong SAR increased almost five-fold (including spot, outright forwards, foreign exchange swaps, and other products). The biggest increase was in swap transactions, which accounted for about half of the total. Average daily RMB turnover in Hong Kong SAR was about USD 50 billion, one of the highest among EM currencies, and more than onshore RMB turnover.

**Market development.** The Hong Kong SAR authorities have continued to foster market development. In June 2013, the Treasury Markets Association launched an interbank reference rate for the offshore RMB market (CNH HIBOR fixing), which provides a benchmark for loan facilities and helps market participants manage interest rate risk. The HKMA also enhanced the RMB liquidity facilities available to participating banks in Hong Kong SAR by using (i) the PBC swap agreement (RMB 400 billion) to make one-day funds available on the next day (T+1 basis); and (ii) the HKMA's own RMB facility to make overnight funds available on the same day (T+0 basis).

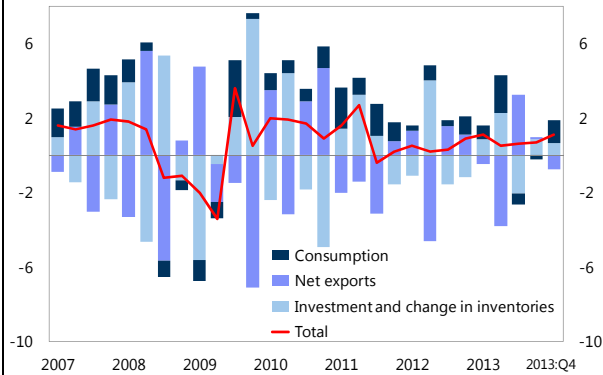
**RMB OTC Foreign Exchange Turnover: April 2013**  
(In USD bn, daily average)



**Figure 1. Macroeconomic Developments**

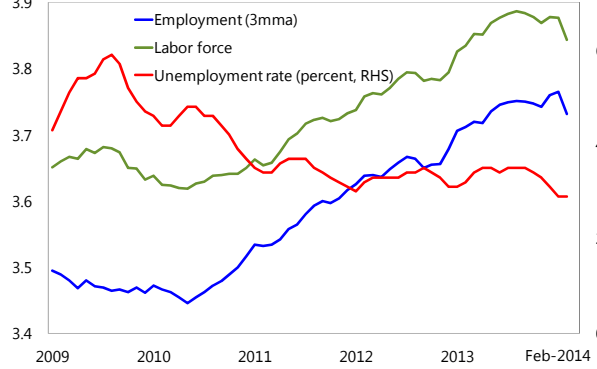
Growth in 2013 has been supported by improved net exports...

**Contribution to Growth**  
(In percent, quarter-on-quarter, sa)



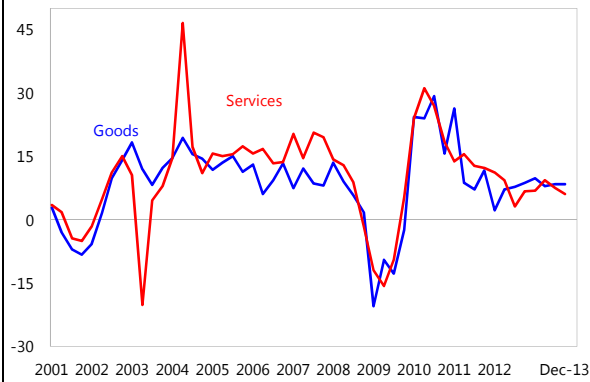
...and strong labor market.

**Labor Market Indicators**  
(In million)



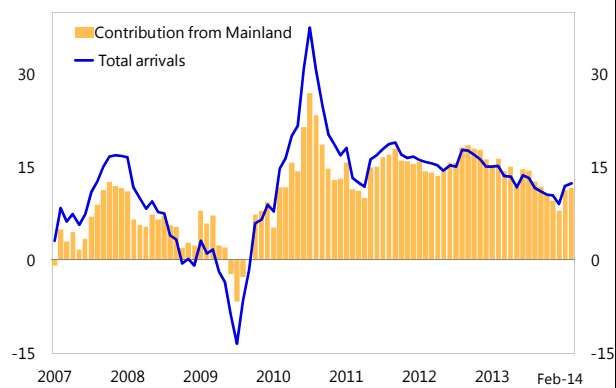
Export growth has picked up from its trough in 2012...

**Current Account: Exports of Goods and Services**  
(In percent, year-on-year)



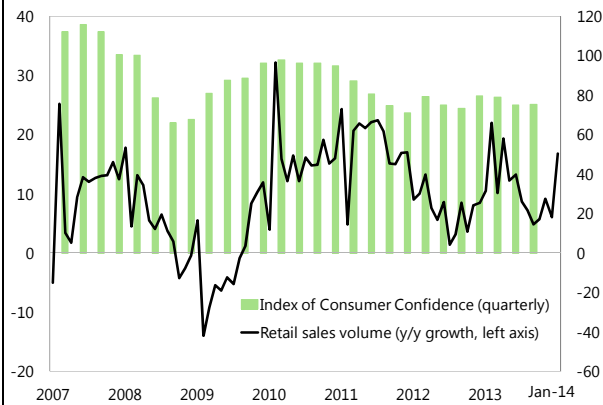
...driven by continued robust tourism receipts from Mainland China.

**Tourist Arrivals**  
(In percent, year-on-year, 3mma)



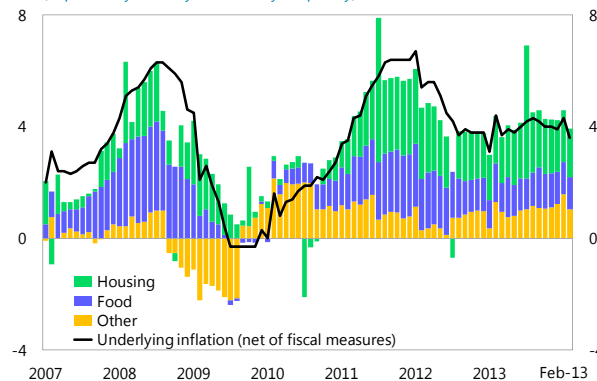
Retail sales have slowed after a strong 2013:H1, but remain healthy and in line with continued consumer confidence.

**Consumer Confidence and Retail Sales**



Inflation has stabilized around 4 percent, reflecting the persistence of housing (which tracks the 24-month moving average of rent).

**Contributions to Inflation**  
(In percent, year-on-year, monthly frequency)



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

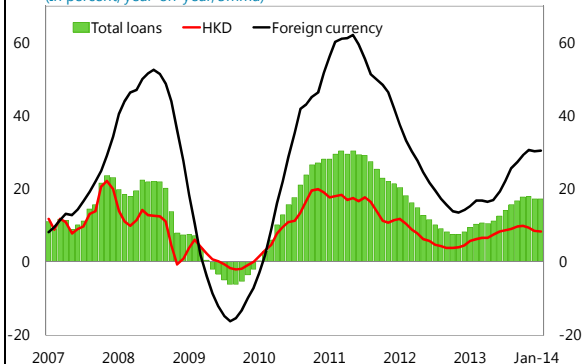
**Figure 2. Credit Development**

Credit growth has picked up in foreign currency loans that are mostly driven by lending for use outside Hong Kong SAR, including Mainland China.

As a result, exposure to the Mainland nonfinancial corporate sector has increased. Claims on Mainland banks track the rise in RMB deposits.

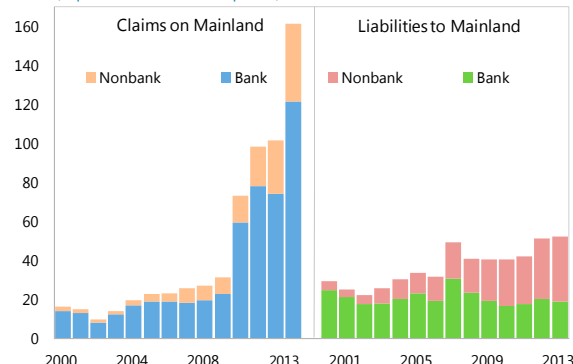
**Credit Growth**

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



**Hong Kong SAR Exposure to Mainland**

(In percent of GDP, end of period)

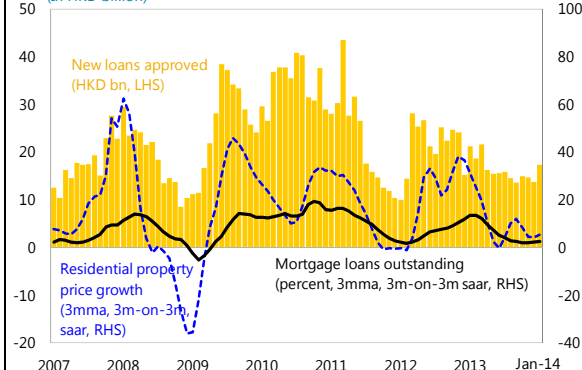


Mortgage lending has slowed.

The share of lending related to real estate has declined over the past year, with more loans going wholesale/retail trade and manufacturing.

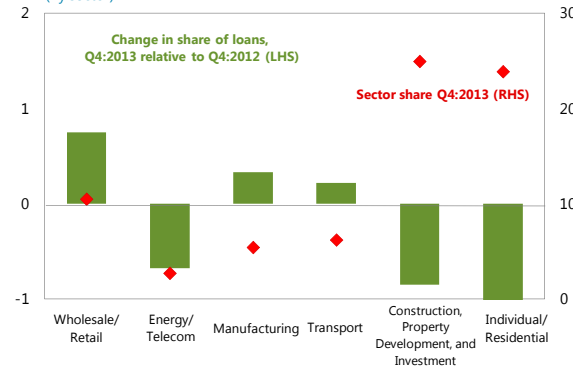
**New Loans Approved**

(In HKD billion)



**Loans Outstanding for Use in Hong Kong SAR**

(By sector)

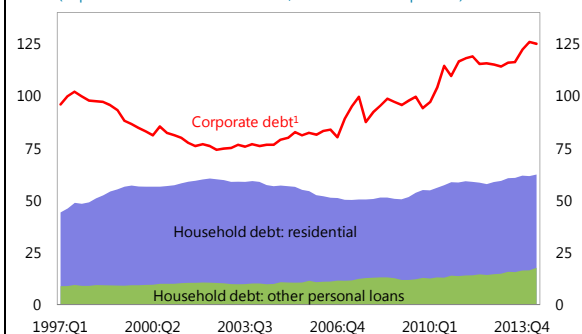


Strong lending growth in recent years has pushed household and corporate debt to GDP to a record high level...

...although most firms do not have high leverage.

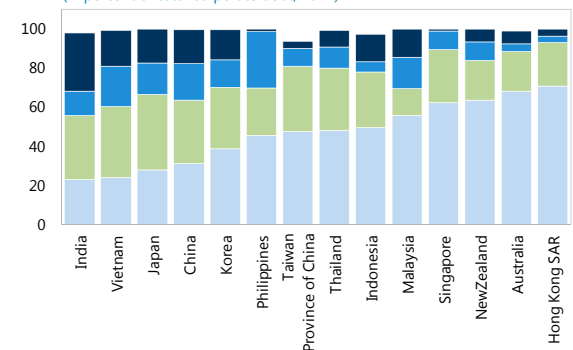
**Household and Corporate Debt**

(In percent of annual nominal GDP, sum of last four quarters)



**Corporate Debt by Leverage Ratio 1/**

(In percent of total corporate debt, 2012)



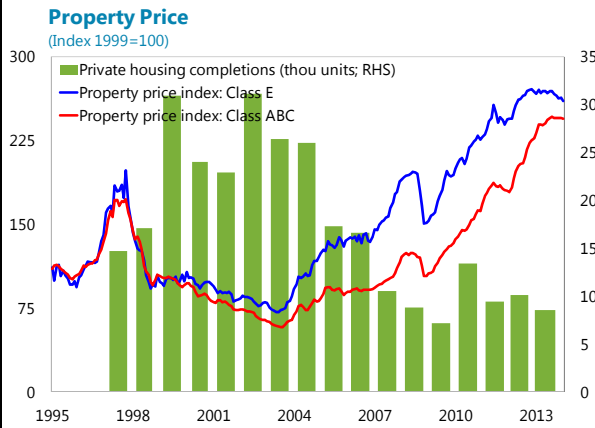
<sup>1</sup> Corporate debt defined as loans of all authorized institutions—loans to professional and private individuals—loans to professional and private individuals for other business purposes.

1/ Leverage ratio is measure by total debt/common equity.

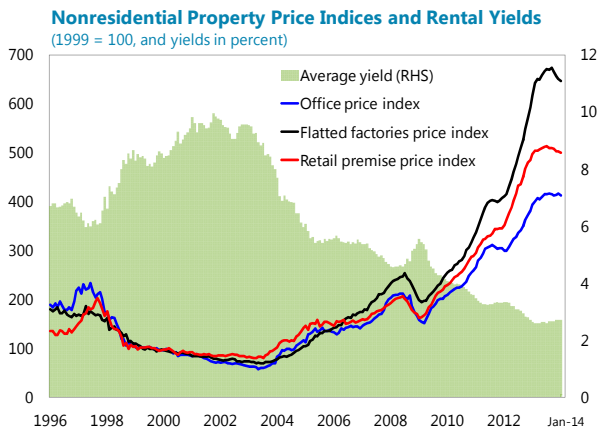
Sources: CEIC; HKMA; Haver Analytics; World Scope; IMF, April 2014 Asia and Pacific *Regional Economic Outlook*; and IMF staff calculations.

**Figure 3. The Property Market**

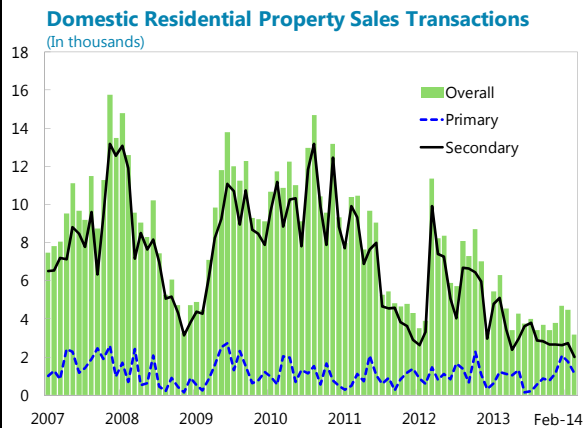
Residential property prices have started to stabilize at a high level amidst low supply.



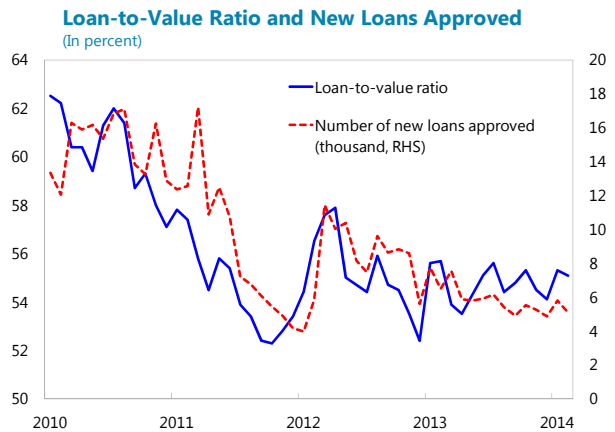
Nonresidential property prices have also stabilized.



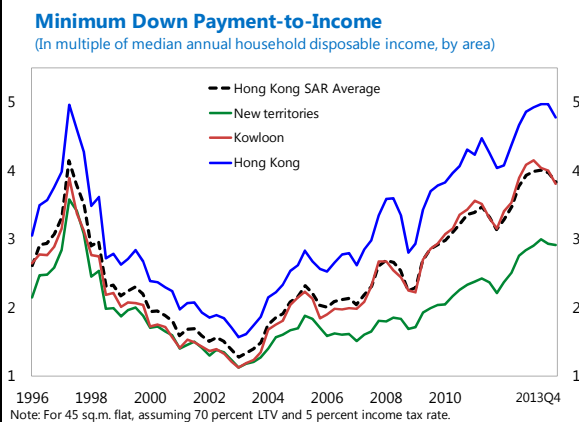
Transaction volume, especially in the secondary market, has been at low levels throughout 2013.



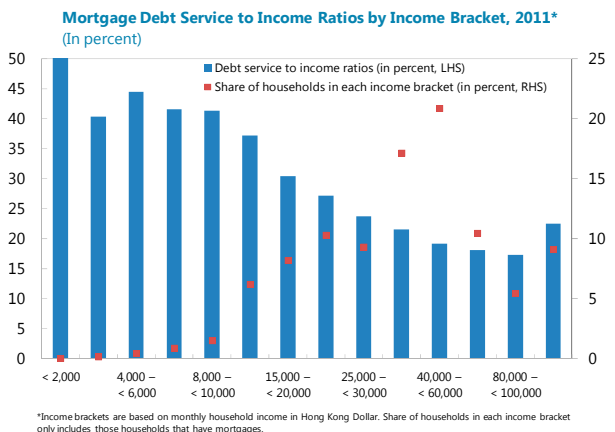
Loan-to-value ratios and the number of new loans have declined.



With price stabilizing, minimum down payment to income has stabilized at a high level, underscoring concerns about affordability.



Debt service ratios remain low for most households and when compared to the past.

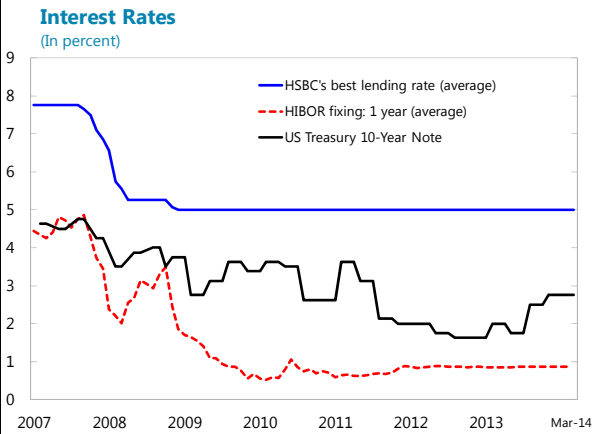


Sources: CEIC; Haver Analytics; Transport and Housing Bureau, Government of Hong Kong SAR; HKMA; and IMF staff estimates.

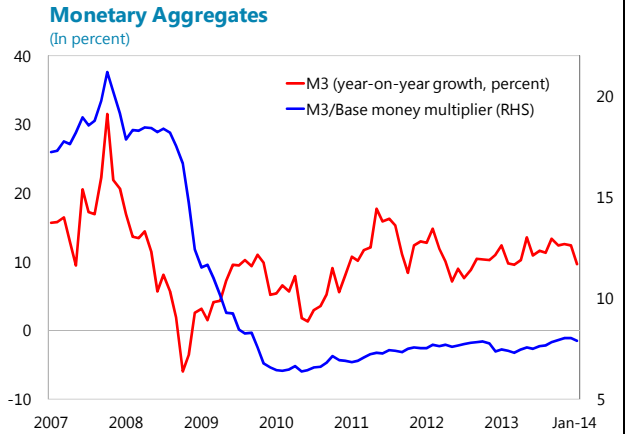


**Figure 4. Financial Conditions**

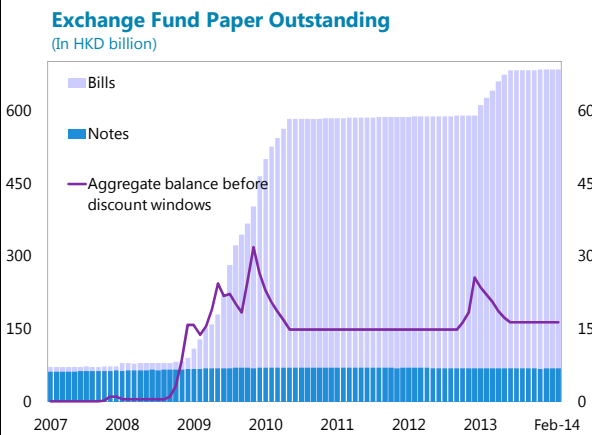
Short-term rates and bank lending rates remain low and stable despite the uptick of U.S. long-term rates.



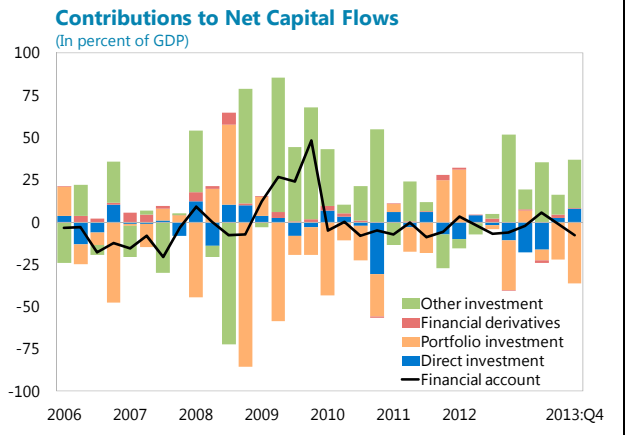
Low interest rates have fueled money growth.



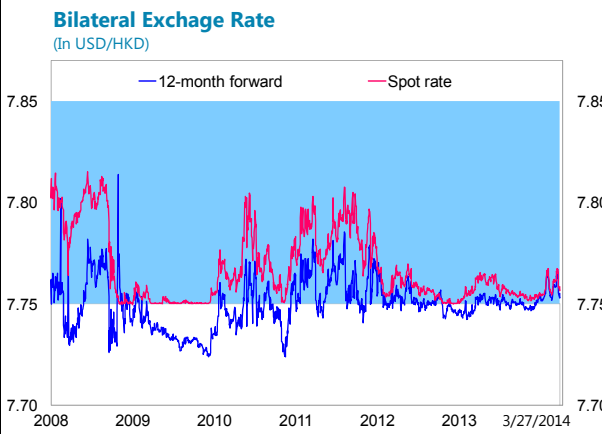
The issuance of exchange fund papers was increased in 2013 to help limit monetary expansion



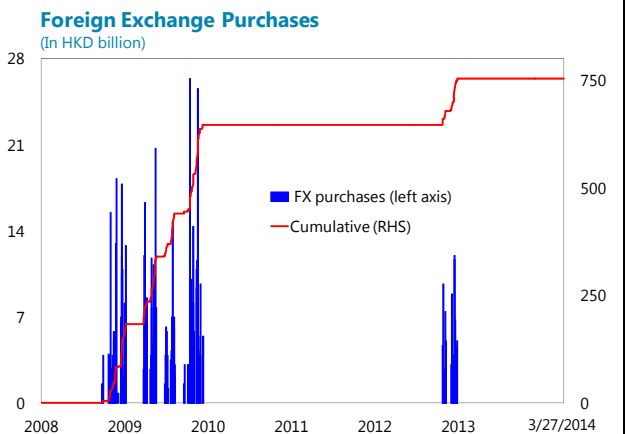
Capital inflows rebounded in 2013 but were mostly offset by outflows.



Bilateral exchange rate has been leaning on the strong side of the band...



...but the HKMA has not purchased foreign exchange since the beginning of 2013.

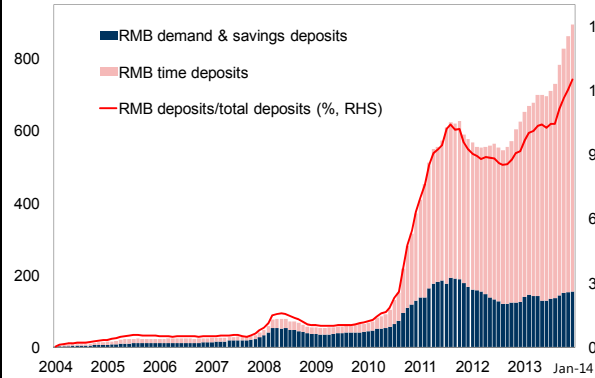


Sources: Bloomberg; CEIC; Haver Analytics; and IMF staff estimates.

**Figure 5. Offshore RMB Market**

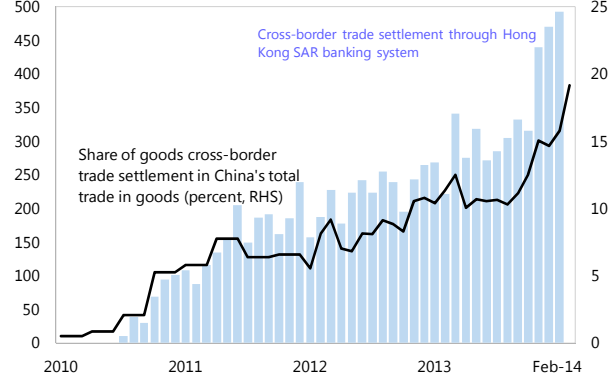
RMB deposit growth has accelerated...

**Renminbi Deposits in Hong Kong SAR**  
(In RMB billion)



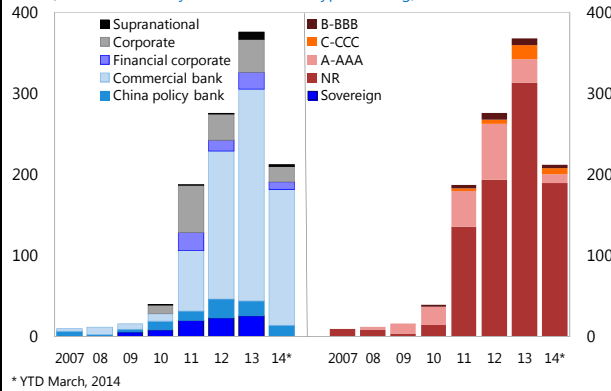
...with continued increase in trade settlement volume.

**Cross-Border Trade Settlement**  
(In RMB bn)



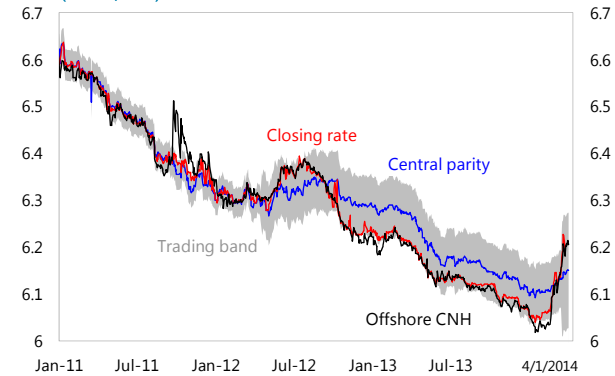
Bond issuances have picked up with strong increase from commercial banks.

**CNH Bonds: New Issuance**  
(In billions RMB; by issuer sector and type of rating)



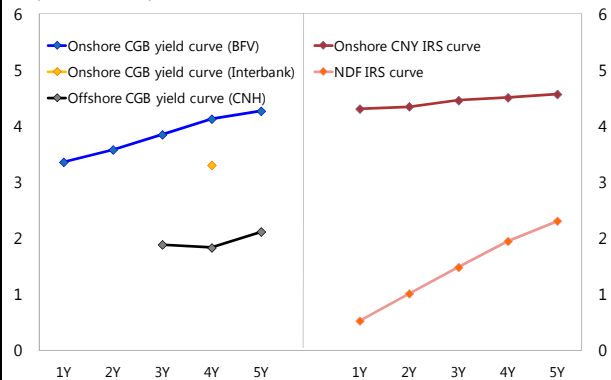
CNH closing prices have broadly tracked moves in CNY.

**Spot Exchange Rate**  
(In USD/RMB)



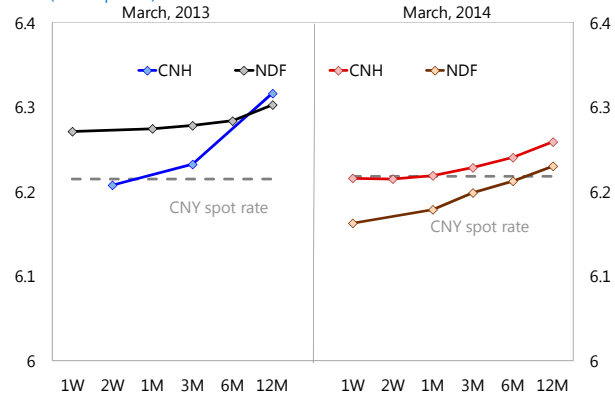
Cost of funding has picked up but still remained lower to that on the Mainland.

**Yield Curve**  
(March 27, 2014)



The forward curves have generally shifted somewhat lower (pricing in less depreciation) compared to a year ago.

**Exchange Rate Forwards: RMB/USD**  
(End of period)



Sources: Bloomberg; CEIC; Haver Analytics; and IMF staff calculations.

**Table 1. Hong Kong SAR: Selected Economic and Financial Indicators, 2009–15**

	2009	2010	2011	2012	2013	Staff projections	
						2014	2015
Real GDP (percent change)	-2.5	6.8	4.8	1.5	2.9	3.7	3.8
Contribution							
Domestic demand	0.5	6.7	5.9	3.8	3.9	3.6	3.8
Private consumption	0.1	3.8	5.1	2.6	2.7	2.6	2.6
Government consumption	0.2	0.3	0.2	0.3	0.2	0.2	0.3
Gross fixed capital formation	-0.8	1.7	2.3	1.6	0.8	0.8	0.9
Inventories	1.0	0.9	-1.7	-0.8	0.1	0.0	0.0
Net exports	-2.9	-0.2	-1.4	-2.2	-0.9	0.1	0.0
Inflation (percent change)							
Consumer prices	0.5	2.4	5.3	4.1	4.3	4.0	3.8
GDP deflator	-0.4	0.3	3.9	3.7	1.2	3.5	3.4
Employment (percent change)	-1.1	0.0	2.9	2.2	1.8	1.1	1.0
Unemployment rate (percent, period average)	5.4	4.4	3.4	3.3	3.1	3.1	3.1
Real wages	-1.5	-0.4	2.7	1.6	1.0	...	...
Government budget (percent of GDP)							
Revenue	19.2	21.2	22.6	21.7	21.3	21.2	21.4
Expenditure 1/	17.4	17.0	18.8	18.5	20.5	18.5	21.0
Consolidated budget balance 1/	1.6	4.2	3.8	3.2	0.8	2.6	0.5
Fiscal reserves as of March 31	31.4	33.5	34.6	36.0	35.3	35.1	33.2
Money and credit (percent change, end-period)							
Narrow money (M1)	39.6	12.8	10.8	22.2	9.7	...	...
Broad money (M3)	5.2	8.0	12.9	11.0	12.4	...	...
Loans for use in Hong Kong SAR (not including trade financing)	-2.1	20.9	12.5	7.0	10.6	...	...
Interest rates (percent, end-period)							
Best lending rate	5.0	5.0	5.0	5.0	5.0	...	...
Three-month HIBOR	0.1	0.3	0.4	0.4	0.4	...	...
Asset prices							
Hang Seng stock index (end of period, 1964=100)	21,873	23,035	18,434	22,657	23,306	...	...
Hang Seng stock index (percent change)	52.0	5.3	-20.0	22.9	2.9	...	...
Residential property prices (end of period, percent change)	28.5	21.0	11.1	25.7	7.7	...	...
Merchandise trade (percent change)							
Export volume	-12.5	17.3	3.4	1.8	6.7	8.4	8.4
Import volume	-9.5	18.1	4.7	3.0	7.6	8.0	8.1
Current account 2/	9.9	7.0	5.6	1.6	2.1	3.5	4.1
Foreign exchange reserves							
In billions of U.S. dollars, end-of-period	245.6	257.1	269.9	300.5	311.1	...	...
In months of retained imports	33.2	27.5	24.6	26.5	26.4	...	...
In percent of broad money (M3)	28.7	27.9	26.0	26.0	23.9	...	...
Exchange rate							
Linked rate (fixed)							
Market rate (HK\$/US\$1, period average)	7.752	7.769	7.783	7.755	7.756	...	...
Real effective rate (period average, 2005=100)	90.1	87.8	84.3	85.7	87.6	...	...

Sources: CEIC; and IMF staff estimates.

1/ Expenditure includes HK\$50bn allocated for one-off health care reform for FY2015/16.

2/ Current account as a percent of GDP expressed in the BPM6 format.

**Table 2. Hong Kong SAR: Balance of Payments, 2009–13 1/**

	2009	2010	2011	2012	2013
	(In billions of U.S. dollars)				
Current account	21.2	16.0	13.8	4.1	5.6
Goods balance	13.3	3.3	-7.5	-18.9	-26.2
Services balance	3.6	10.1	17.0	21.9	29.1
Income balance	4.3	2.6	4.2	1.2	2.8
Primary income balance	6.4	4.8	6.8	3.8	5.4
Secondary income balance	-2.1	-2.3	-2.5	-2.6	-2.7
Capital and financial account	-18.6	-11.4	-14.5	-8.7	-5.2
Capital account	-0.4	-0.6	-0.3	-0.2	-0.2
Financial account	-18.3	-10.9	-14.3	-8.5	-5.0
Net direct investment	-3.7	-15.7	0.2	-13.2	-14.9
Assets	-57.9	-98.4	-95.9	-88.1	-91.5
Liabilities	54.3	82.7	96.1	74.9	76.6
Portfolio investment	-40.0	-57.0	-1.4	-4.1	-43.0
Assets	-50.8	-80.6	-20.0	-40.1	-60.8
Liabilities	10.8	23.7	18.6	36.0	17.8
Financial derivatives	3.2	2.4	2.9	2.0	1.0
Assets	48.5	35.9	46.2	39.7	45.0
Liabilities	-45.4	-33.5	-43.5	-37.8	-44.0
Other investment	101.3	67.0	-4.6	31.2	59.3
Assets	83.1	-69.5	-100.3	-17.1	-66.0
Liabilities	18.2	136.5	95.7	48.2	125.4
Reserve assets (net change)	-79.0	-7.6	-11.1	-24.4	-7.5
Net errors and omissions	-2.5	-4.6	0.7	4.6	-0.4
<i>Memorandum item:</i>					
<i>Nominal GDP in USD bn</i>	213.1	229.2	249.0	261.7	273.6
	(In percent of GDP)				
Current account	9.9	7.0	5.5	1.6	2.1
Goods balance	6.2	1.4	-3.0	-7.2	-9.6
Services balance	1.7	4.4	6.8	8.4	10.6
Income balance	2.0	1.1	1.7	0.4	1.0
Capital and financial account	-8.7	-5.0	-5.8	-3.3	-1.9
Capital account	-0.2	-0.2	-0.1	-0.1	-0.1
Financial account	-8.6	-4.7	-5.7	-3.3	-1.8
Net direct investment	-1.7	-6.9	0.1	-5.1	-5.4
Portfolio investment	-18.7	-24.9	-0.6	-1.6	-15.7
Financial derivatives	1.5	1.0	1.2	0.7	0.4
Other investment	47.3	28.9	-1.9	11.9	21.7
Reserve assets (net change)	-37.1	-3.3	-4.5	-9.3	-2.7
Net errors and omissions	-1.2	-2.0	0.3	1.7	-0.2

Sources: CEIC; and Census and Statistics Bureau.

1/ Data published using the Balance of Payments Statistics Manual 6.

**Table 3. Hong Kong SAR: Consolidated Government Account, 2010/11–2019/20 1/**  
(In percent of GDP, unless otherwise stated)

	2010/11	2011/12	2012/13	Est. 2013/14	Staff projections					
					2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
Consolidated revenue	21.2	22.6	21.7	21.3	21.2	21.4	21.2	21.1	21.3	21.4
Operating revenue	16.9	17.5	16.9	16.6	17.2	17.0	17.0	17.0	17.1	17.2
Capital revenue	4.3	5.1	4.8	4.7	4.0	4.4	4.2	4.0	4.3	4.2
Taxes	13.6	14.2	13.7	13.4	13.7	13.9	13.7	13.6	13.7	13.8
Direct taxes	8.1	9.1	9.0	8.5	...	...	...	...	...	...
<i>Of which:</i>										
Salaries tax	2.5	2.7	2.5	2.6	...	...	...	...	...	...
Profits tax	5.2	6.1	6.2	5.6	...	...	...	...	...	...
Indirect taxes	5.5	5.1	4.8	4.7	...	...	...	...	...	...
Nontax	7.6	8.4	8.0	7.9	7.4	7.5	7.5	7.5	7.6	7.6
<i>Of which:</i>										
Land premium	3.7	4.4	3.4	4.0	3.4	3.7	3.6	3.4	3.6	3.5
Investment income	1.9	1.9	1.9	1.7	2.0	2.0	1.9	1.8	1.9	1.9
Consolidated expenditure	17.0	18.8	18.5	20.5	18.5	21.0	18.9	18.6	18.4	19.0
Current expenditure 2/	13.5	15.3	14.9	16.0	14.7	16.6	14.5	14.5	14.5	14.9
<i>Of which:</i>										
Personnel related (including pensions)	4.1	4.0	4.1	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Capital expenditure	3.5	3.5	3.7	4.6	3.9	4.3	4.4	4.1	3.9	4.1
<i>Of which:</i>										
Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	4.2	3.8	3.2	0.8	2.6	0.5	2.4	2.5	2.9	2.4
Memorandum items:										
Operating balance 3/	3.4	2.2	2.0	0.6	2.6	0.4	2.5	2.5	2.6	2.3
Primary balance 4/	2.4	1.9	1.3	-0.9	0.7	-1.5	0.5	0.6	1.1	0.6
Structural balance 5/	0.9	1.2	0.8	-0.8	0.4	-1.0	0.9	1.2	1.6	1.0
Fiscal reserves	33.5	34.6	36.0	35.3	35.1	33.2	33.4	33.7	34.4	32.1
(Months of spending)	23.7	22.1	23.3	20.7	22.7	19.0	21.2	21.8	22.5	22.5

Sources: CEIC; and IMF staff estimates.

1/ Staff projections assume government spending targets in the latest medium-term budget document and staff revenue forecasts, including stamp duties from demand-management measures on property. Fiscal year begins on April 1.

2/ This refers to the authorities' measure of operating expenditure, including the HK\$50 bn assigned for health care reform expenditure for 2015/16.

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

4/ Balance excluding investment income.

5/ Staff estimate used to measure the impact of fiscal policy on domestic demand. It excludes asset transactions and cyclical fluctuations.

**Table 4. Hong Kong SAR: Medium-Term Macroeconomic Framework, 2009–19**

	2009	2010	2011	2012	2013	Staff projections					
						2014	2015	2016	2017	2018	2019
Real GDP (percent change)	-2.5	6.8	4.8	1.5	2.9	3.7	3.8	3.9	3.9	4.0	4.0
Contribution											
Real domestic demand	0.5	6.7	5.9	3.8	3.9	3.6	3.8	3.9	3.9	3.9	3.9
Private consumption	0.1	3.8	5.1	2.6	2.7	2.6	2.6	2.6	2.6	2.6	2.6
Government consumption	0.2	0.3	0.2	0.3	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Gross fixed capital formation	-0.7	1.7	2.3	1.6	0.8	0.8	0.9	1.0	1.0	1.0	1.0
Inventories	1.0	0.9	-1.7	-0.8	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	-2.9	-0.2	-1.4	-2.2	-0.9	0.1	0.0	0.1	0.0	0.0	0.1
Output gap (in percent of potential)	-2.7	0.1	1.1	-0.8	-1.3	-1.1	-0.9	-0.6	-0.4	-0.2	0.0
Growth rates											
Real domestic demand	0.6	7.1	6.2	3.9	3.9	3.7	3.8	3.9	3.9	4.0	4.0
Private consumption	0.2	6.1	8.4	4.1	4.2	3.9	4.0	4.0	4.0	4.0	4.0
Government consumption	2.3	3.4	2.5	3.6	2.7	2.6	3.0	3.3	3.5	3.8	3.8
Gross fixed capital formation	-3.5	7.7	10.2	6.8	3.3	3.4	3.7	3.9	3.9	3.9	3.9
Saving and investment (percent of GDP)											
Gross national saving	31.7	30.9	29.4	26.8	25.6	26.8	27.2	27.2	27.5	27.7	27.9
Gross investment	21.8	23.9	24.1	25.2	23.5	23.5	23.3	23.2	23.2	23.1	23.0
Saving-investment balance	9.9	7.0	5.2	1.6	2.1	3.3	3.9	4.0	4.3	4.6	5.0
Inflation (percent change)											
Consumer prices	0.5	2.4	5.3	4.1	4.3	4.0	3.8	3.5	3.5	3.5	3.5
GDP deflator	-0.4	0.3	3.9	3.7	1.2	3.5	3.4	2.8	2.9	3.1	3.1
Employment (percent change)	-1.1	0.0	2.9	2.2	1.8	1.1	1.0	0.9	0.9	0.9	0.9
Unemployment rate (percent, period average)	5.4	4.4	3.4	3.3	3.1	3.1	3.1	3.1	3.2	3.2	3.2
Merchandise trade (percent change)											
Export volume	-12.5	17.3	3.4	1.8	6.7	8.4	8.4	8.4	8.4	8.4	8.4
<i>Of which: re-exports</i>	-12.0	17.9	3.6	1.6	6.9	8.5	8.5	8.5	8.5	8.5	8.5
Import volume	-9.5	18.1	4.7	3.0	7.6	8.0	8.1	8.1	8.1	8.1	8.1
Retained import volume	-3.8	19.7	7.8	3.5	6.3	3.8	4.0	4.0	4.1	4.1	4.1
Export value	-12.1	22.7	11.5	5.0	6.3	7.4	8.0	8.2	8.6	8.4	8.4
Import value	-10.6	25.6	13.3	7.0	6.8	7.0	7.4	7.9	8.3	8.1	8.1
External balances (in billions of US\$) 1/											
Balance of goods and services 1/	16.9	13.4	9.6	3.0	2.9	3.1	4.5	4.5	4.0	4.3	4.8
In percent of GDP	7.9	5.9	3.9	1.1	1.1	1.1	1.4	1.3	1.1	1.1	1.1
Exports of goods and services	381	469	529	567	614	656	705	759	819	883	952
Imports of goods and services	-364	-456	-519	-564	-612	-653	-701	-754	-815	-879	-947
Current account 1/	21.2	16.0	13.8	4.1	5.6	10.3	13.0	14.2	16.2	18.7	21.7
In percent of GDP	9.9	7.0	5.6	1.6	2.1	3.5	4.1	4.2	4.5	4.8	5.2
Foreign exchange reserves (end-year) 1/	245.6	257.1	269.9	300.5	311.1	325.8	338.2	351.9	366.2	382.4	401.0
In percent of GDP	114.7	112.4	108.6	114.4	113.7	110.9	107.2	104.4	101.6	99.0	96.8

Sources: CEIC; and IMF staff estimates.

1/ External balances expressed in Balance of Payments Manual 6 (BPM6) format.

Table 5. Hong Kong SAR: Vulnerability Indicators, 2003–13

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Latest 2013
<b>Public sector</b>											
Fiscal surplus (in percent of GDP)	-3.2	1.6	1.0	4.1	7.5	0.2	1.8	4.2	3.8	3.2	0.8
Accumulated fiscal surplus (in percent of GDP)	21.9	22.5	22.0	24.6	29.9	29.0	31.4	33.5	34.6	36.0	35.3
<b>External sector</b>											
Total export volume (percent change)	14.0	14.9	10.4	9.3	7.0	1.9	-12.5	17.3	3.4	1.8	6.7
Domestic exports	-6.8	2.2	6.2	2.8	-19.3	-19.2	-26.6	-0.1	-1.2	9.8	-2.4
Reexports	15.9	15.8	10.7	9.7	8.6	2.9	-12.0	17.9	3.6	1.6	6.9
Total import volume (percent change)	13.1	13.7	8.0	9.2	8.8	1.8	-9.5	18.1	4.7	3.0	7.6
Current account (in billions of U.S. dollar)	17.4	16.8	21.6	24.6	27.6	32.9	21.2	16.0	13.8	4.1	5.6
Gross official reserves (in billions of U.S. dollar)	111.9	116.4	114.1	126.7	139.4	164.2	245.4	256.9	270.5	300.7	311.2
In months of retained imports	21.9	19.9	18.1	17.7	17.8	19.8	33.2	27.4	24.6	26.5	26.4
In percent of monetary base	296.4	306.3	311.1	332.5	339.4	250.8	188.3	192.1	195.7	191.2	192.1
In percent of broad money 1/	22.8	21.7	20.2	19.5	17.8	20.3	28.8	28.0	26.1	26.0	24.0
In percent of Hong Kong dollar M3	41.0	40.8	37.7	35.2	33.0	39.0	52.8	51.5	51.8	51.3	50.2
Short-term debt (in billions of U.S. dollar) 2/	251.8	311.6	312.0	371.4	545.7	485.6	497.0	649.4	718.1	752.3	864.2
In percent of gross reserves	212.7	252.1	251.1	278.8	357.4	266.1	194.3	241.6	251.6	237.0	...
One-year forward exchange rate premium (in pips, annual average)	31.7	-710.4	-437.8	-601.6	-557.1	-336.0	-165.7	-212.1	-241.1	-55.7	-69.6
Real exchange rate (percent change)	-7.0	-5.4	-2.0	-1.0	-5.2	-5.3	2.4	-2.5	-4.0	1.7	2.1
<b>Financial sector</b>											
Hang Seng index (percent change, end-year) 3/	34.9	13.2	4.5	34.2	39.3	-48.3	52.0	5.3	-20.0	22.9	2.9
Residential property prices (percent change, end-year) 3/	0.9	27.4	8.2	4.1	25.7	-11.1	28.5	21.0	11.1	25.7	7.7
<b>Banking sector 4/</b>											
Loan-to-deposit ratio	57.1	55.8	56.8	51.9	50.5	54.2	51.5	61.6	66.9	67.1	70.4
Domestic credit growth 5/	-2.0	4.9	7.7	2.3	15.2	11.0	-2.1	20.9	12.5	7.0	10.6
Real credit growth 5/	-0.1	4.6	6.3	0.0	11.0	8.7	-3.6	17.5	6.4	3.1	6.1
Capital adequacy ratio 6/	15.3	15.4	14.8	14.9	13.4	14.8	16.8	15.8	15.8	15.7	15.9
Nonperforming loans (in percent of total loans) 7/ 8/	3.9	2.3	1.4	1.1	0.8	1.2	1.4	0.8	0.6	0.5	0.5
Net interest margin (in percent of interest-bearing assets) 8/	1.9	1.7	1.7	1.8	1.9	1.8	1.5	1.3	1.2	1.4	1.4
Return on assets (post-tax) 8/	1.2	1.4	1.4	1.4	1.5	0.9	1.0	1.0	1.0	1.1	1.4
Net open spot position (in billions of U.S. dollar)	15.9	28.2	30.7	52.0	78.8	56.8	38.1	39.0	34.7	66.6	57.5
Net open forward position (in billions of U.S. dollar)	-6.4	-24.5	-25.9	-46.2	-71.8	-43.8	-27.6	-34.6	-31.7	-57.0	-48.1
Exposure to the Mainland (in percent of total assets)	2.0	2.3	2.6	5.9	6.5	7.1	8.3	11.6	14.9	16.2	19.7
Exposure to property sector (in percent of domestic credit) 9/	56.0	54.7	54.1	54.5	52.4	52.5	55.6	53.9	52.1	50.6	48.2
Deposits (in percent of liabilities)	55.0	54.2	56.1	57.3	56.7	56.3	60.0	55.8	55.2	55.8	54.2
<b>Contagion indicator</b>											
Hang Seng-NASDAQ Composite correlation (daily)	0.9	0.6	0.8	0.5	0.8	0.9	1.0	0.8	0.8	0.5	0.2

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

1/ Broad Money refers to M2.

2/ Official statistics on Hong Kong SAR's external debt are available from the first quarter of 2002.

3/ Refers to year-to-date change since end of previous year.

4/ For all authorized institutions, unless otherwise specified.

5/ Domestic credit refers to loans for use in Hong Kong SAR, not including trade finance. Latest figures (2011) refer to year-on-year percentage change.

6/ For all locally incorporated authorized institutions.

7/ Refers to total gross classified: "substandard," "doubtful," and "loss."

8/ For retail banks, which comprise all the locally incorporated banks plus a number of the larger foreign banks whose operations are similar to those of the locally incorporated banks, in that they operate a branch network and are active in retail banking.

9/ Exposure to property sector includes loans to finance property investment and development as well as residential mortgage loans.







**Table 6. Hong Kong SAR: General Government Statistics**

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
(HKD mln)											
<b>Statement of government operations</b>											
Revenue	204,324	246,537	277,108	305,352	368,242	330,289	335,793	395,879	459,937	...	...
Expense	266,967	253,661	277,516	245,787	263,074	316,293	312,157	309,148	369,223	...	...
Gross operating balance	-58,861	2,720	9,702	68,961	114,504	23,924	34,219	96,702	101,437	...	...
Net operating balance	-62,643	-7,124	-408	59,565	105,168	13,996	23,636	86,731	90,714	...	...
Net acquisition of nonfinancial assets	9,868	5,755	-19,809	2,394	-2,362	3,302	5,501	13,180	17,596	...	...
Net lending/borrowing	-72,511	-12,879	19,401	57,171	107,530	10,694	18,135	73,551	73,118	...	...
Net acquisition of financial assets	-58,183	25,205	59,557	72,333	124,151	26,027	49,370	105,070	108,531	...	...
Net incurrence of liabilities	14,328	38,084	40,156	15,162	16,621	15,333	31,235	31,519	35,413	...	...
Statistical discrepancy	...	...	...	...	...	...	...	...	...	...	...
<b>Balance sheet</b>											
Net worth	224,097	374,937	380,806	435,832	531,017	551,584	568,345	644,505	644,079	...	...
Nonfinancial assets	136,632	305,558	285,937	291,922	289,781	297,621	305,254	317,955	335,798	...	...
Financial assets	455,130	475,128	540,774	614,177	738,305	764,337	814,325	958,341	1,066,787	...	...
Liabilities	367,665	405,749	445,905	470,267	497,069	510,374	551,234	631,791	758,506	...	...
<b>Revenue</b>											
Revenue	204,324	246,537	277,108	305,352	368,242	330,289	335,793	395,879	459,937	...	...
Taxes	130,933	155,611	175,069	187,699	230,137	217,201	207,400	240,496	274,992	...	...
Social contributions	23	20	18	17	17	16	14	13	13	...	...
Other revenue	73,368	90,906	102,021	117,636	138,088	113,072	128,379	155,370	184,932	...	...
<b>Expense</b>											
Expense	266,967	253,661	277,516	245,787	263,074	316,293	312,157	309,148	369,223	...	...
Compensation of employees	68,772	64,051	62,703	63,919	67,090	70,866	70,494	71,656	78,875	...	...
Uses of goods and services	60,421	49,995	48,718	70,698	78,831	82,314	86,933	102,437	100,366	...	...
Consumption of fixed capital	3,782	9,844	10,110	9,396	9,336	9,928	10,583	9,971	10,723	...	...
Interest	35	752	1,083	1,038	1,015	901	874	963	1,359	...	...
Subsidies	247	333	313	216	182	277	451	365	322	...	...
Grants	52	73	59	61	314	2,352	7,036	489	162	...	...
Social benefits	62,870	61,214	87,406	33,883	35,859	40,702	42,561	43,118	52,318	...	...
Other expense	70,788	67,399	67,124	66,576	70,447	108,953	93,225	80,149	125,098	...	...
<b>Transactions in assets and liabilities</b>											
Change in net worth from transactions	-62,643	-7,124	-408	59,565	105,168	13,996	23,636	86,731	90,714	...	...
Net acquisition of nonfinancial assets	9,868	5,755	-19,809	2,394	-2,362	3,302	5,501	13,180	17,596	...	...
Fixed assets	7,538	5,207	-17,163	3,162	2,490	6,475	6,616	15,682	17,524	...	...
Change in inventories	2,330	548	-2,646	-768	-4,852	-3,173	-1,115	-2,502	72	...	...
Net acquisition of financial assets	-58,183	25,205	59,557	72,333	124,151	26,027	49,370	105,070	108,531	...	...
Net incurrence of liabilities	14,328	38,084	40,156	15,162	16,621	15,333	31,235	31,519	35,413	...	...

Source: Hong Kong SAR authorities, Government Finance Statistics. Accrual-based data. 2012 statistics will be available only in 2014:Q2.



## Appendix 1. Hong Kong SAR: Risk Assessment Matrix 1/ 2/

Nature of Threat	Likelihood	Impact	Recommended Policy Response
 Surges in global financial market volatility in relation to the exit of unconventional monetary policy	High	<b>Medium.</b> Hong Kong SAR has weathered EM volatility rounds in the last year quite well. Still, volatile asset prices and capital flows could lead to financial distress and slow growth.	<ul style="list-style-type: none"> <li>· Ensure bank lending standards and risk management practices are sound. Adjust countervailing macroprudential measures to contain risks.</li> <li>· Provide liquidity through existing facilities (such as discount window, foreign exchange swaps, and term repos)</li> </ul>
 Disorderly correction of housing prices	Medium	<b>High.</b> Falling collateral values and negative wealth effect could trigger adverse feedback loop between economic activity, bank lending, household indebtedness, and the property markets.	<ul style="list-style-type: none"> <li>· Adjust macroprudential measures while safeguarding financial stability.</li> <li>· Deploy fiscal measures to address demand-supply imbalances.</li> <li>· Ensure adequate supply of land and public housing in the medium term.</li> </ul>
 Protracted slow growth in global economies (due to adverse impact of deleveraging larger than currently expected, slower trend growth in emerging markets, and delayed reforms and fiscal adjustment)	Medium	<b>High.</b> As a small open economy, financial center, and key trading hub, Hong Kong SAR growth and financial markets would be impacted.	<ul style="list-style-type: none"> <li>· Deploy fiscal stimulus to support domestic demand with emphasis on low-income and vulnerable households. Options include targeted tax relief, increased transfers to households, and support for smaller enterprises.</li> </ul>
 Financial stability risks arising from incomplete global regulatory reforms over the medium term	Medium	<b>Medium.</b> Uneven progress on reform across major jurisdictions and uncertainty on the design of future regulatory landscape could lead to regulatory arbitrage and exacerbate financial fragmentation, which could reduce the willingness of foreign banks in Hong Kong SAR to maintain cross-border exposures and operations.	<ul style="list-style-type: none"> <li>· Ensure regulatory and supervision standards and risk management practices are sound.</li> <li>· Continue to maintain close relationship with foreign financial supervisory agencies in the formulation and implementation of global regulatory framework.</li> </ul>
 Steadfast implementation of reforms in China in economic transition over the medium term	Medium	<b>High.</b> Steadfast implementation of the third plenum reform blueprint will lead to higher-quality and more sustainable growth in China over the medium term. These would improve growth potential for Hong Kong SAR through closer trade and financial links, although growth may slow in the near term.	<ul style="list-style-type: none"> <li>· Continue to undertake reforms and investment to enhance domestic competitiveness through improving labor market flexibility, human capital, and upgrading public infrastructure that would provide synergy to benefit from China's higher-quality growth over the medium term.</li> </ul>
 A sharp slowdown in China in the medium term	Medium	<b>High.</b> Deterioration of corporate balance sheets, worsening of bank asset quality (related to cross-border exposures and trade links), and drop-off of tourism affecting the Mainland contribution to consumption spending in Hong Kong SAR.	<ul style="list-style-type: none"> <li>· Combination of fiscal stimulus and liquidity support described above. In addition, work closely with Mainland counterparts to facilitate an orderly resolution of distressed assets and address any weaknesses in banks' balance sheets.</li> </ul>

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 of risks listed 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 of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Nonmutually exclusive risks may interact and materialize jointly.

2/ Downside risks are represented in red arrows whereas blue arrow indicates upside risks.



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

April 23, 2014

## STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION DISCUSSIONS—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department (in consultation with other  
departments)

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<b>FUND RELATIONS</b>	<b>2</b>
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## 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 authorities requested an FSAP, which has been undertaken in conjunction with the 2014 Article IV consultation.

### 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.

### Resident Representative

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

## STATISTICAL ISSUES

Data provision is adequate for surveillance purposes. Hong Kong SAR provides statistics to the Fund on a timely basis for surveillance and publication in the *International Financial Statistics (IFS)*.

Hong Kong SAR subscribes to the Fund's Special Data Dissemination Standard and is fully compliant with its requirements.

Hong Kong SAR publishes comprehensive balance of payments data and international investment position statistics for 2000 onwards, and also publishes quarterly external debt statistics according to the recommendations given in the *External Debt Statistics: Guide for Compilers and Users*.

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 subannual data are provided for publication in the *IFS*.

Hong Kong SAR participates in regular reporting of Financial Soundness Indicators (FSIs) to the IMF for dissemination. The reported data are quarterly and cover all core FSIs and 12 additional FSIs for the deposit takers sector.

In late 2009, the HKMA began reporting quarterly monetary 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 *IFS*, which uses monthly data periodicity.

**HONG KONG SAR—TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE**

(As of March 31, 2014)

	Date of Latest Observation	Date Received	Frequency of Data <sup>5</sup>	Frequency of Reporting <sup>5</sup>	Frequency of Publication <sup>5</sup>
Exchange rates	Mar. 2014	Mar. 2014	D	D	D
International reserve assets and reserve liabilities of the monetary authorities <sup>1</sup>	Jan. 2014	Mar. 2014	M	M	M
Reserve/base money	Jan. 2014	Mar. 2014	M	M	M
Broad money	Jan. 2014	Mar. 2014	M	M	M
Central bank balance sheet	Jan. 2014	Mar. 2014	M	M	M
Consolidated balance sheet of the banking system	Jan. 2014	Mar. 2014	M	M	M
Interest rates <sup>2</sup>	Mar. 2014	Mar. 2014	D	D	D
Consumer price index	Jan. 2014	Mar. 2014	M	M	M
Revenue, expenditure, balance and composition of financing <sup>3</sup> —central government	Jan. 2014	Mar. 2014	M	M	M
Stocks of central government and central government-guaranteed debt <sup>4</sup>	Jan. 2014	Mar. 2014	M	M	M
External current account balance	Q4/13	Mar. 2014	Q	Q	Q
Exports and imports of goods and services	Q4/13	Mar. 2014	Q	Q	Q
GDP/GNP	Q4/13	Mar. 2014	Q	Q	Q
Gross external debt	Q4/13	Mar. 2014	Q	Q	Q
International investment position	Q4/13	Mar. 2014	Q	Q	Q

<sup>1</sup> 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.

<sup>2</sup> Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> Including currency and maturity composition.

<sup>5</sup> Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).



INTERNATIONAL MONETARY FUND



Press Release No. 14/238  
FOR IMMEDIATE RELEASE  
May 23, 2014

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2014 Article IV Consultation with People's Republic of China—Hong Kong Special Administrative Region**

On May 9, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with Hong Kong Special Administrative Region.

Hong Kong SAR's growth recovered to 2.9 percent in 2013 as resilient domestic demand helped offset the continued drag from net exports. As the global recovery takes hold, external demand is forecast to improve and lift growth to around 3¾ percent in 2014, while domestic demand remains solid. Inflation is expected to remain at around 4 percent, given the slow pass-through of housing costs. The labor market has remained strong, with unemployment slightly above 3 percent. The current account is projected to improve gradually in line with the global recovery.

Credit growth has been rapid since 2010. Low interest rates have fueled both corporate and household borrowing. As a result, corporate and household debt is at a record high. Financial integration with the Mainland has continued. More recently, credit has been driven mainly by lending to Mainland affiliates. Nonbank Mainland China exposure has risen to about 170 percent of GDP or 19 percent of total bank assets. The banking system is highly capitalized (Tier 1 capital ratio is just over 13 percent) and Nonperforming Loans (NPLs) are low at 0.5 percent. With larger pool of offshore RMB in Hong Kong SAR and more varieties of RMB-denominated assets, offshore RMB in Hong Kong SAR has already become one of the most traded emerging market currencies.

After a prolonged rise, both residential and commercial property prices have leveled off, albeit at an elevated level. The authorities' have proactively implemented measures to safeguard financial stability and stabilize the property market. Supply-side measures have also been proposed with more land supply and a new 10-year housing target. Despite the recent price stabilization,

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<sup>1</sup> 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.

housing affordability remains a concern with the highest price-to-income ratio among regional peers.

Rising inequality and population aging are adding to fiscal spending pressures and has led to a number of one-off initiatives in recent years, including waiving rates (annual fee paid by most property owners and occupiers), paying rents for public housing tenants, one-off tax relief, subsidies for electricity, transfers to the poor and elderly, and higher capital spending. A Commission on Poverty was established in December 2012 and published the first official poverty line last September, which will be used to facilitate policy formulation and assess policy effectiveness. A statutory minimum wage was introduced in 2011 and increased by 7.1 percent in May 2013. In line with the improved economic outlook, the 2014/15 budget includes a reduction in one-off measures of about 1.9 percent of GDP.

### **Executive Board Assessment<sup>2</sup>**

Executive Directors welcomed Hong Kong SAR's recovery from the 2012 slowdown and the favorable prospects for strong growth, low unemployment, and stable inflation. They noted, however, that Hong Kong SAR is susceptible to adverse effects from the Federal Reserve's tapering and developments in the Mainland, and to risks from a potential price correction in domestic property markets. Directors, accordingly, recommended persevering with prudent policies, and welcomed the authorities' determination to remain vigilant and take necessary steps to safeguard Hong Kong SAR's macroeconomic and financial stability.

Directors welcomed the authorities' plan to increase housing supply to improve affordability. They noted that the counter-cyclical prudential policies implemented over recent years should provide buffers to the financial system in the event of a property price correction. These measures should be unwound with caution as circumstances permit.

Directors welcomed the findings under the Fund's Financial Sector Assessment Program (FSAP) that Hong Kong SAR's financial system is well regulated and supervised, and commended the high level of compliance with international standards. They noted, nonetheless, that there may be scope for improvements as regards financial sector resolution and the oversight of the insurance sector. Directors also welcomed the FSAP stress test results, which suggest that the financial sector has the capacity to withstand a diversity of large and global shocks. They advised, however, that the large and rapidly growing exposure to the Mainland requires the continuation of close monitoring and cooperation with Mainland supervisors.

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<sup>2</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Directors took note of staff's assessment that Hong Kong SAR's external position is consistent with medium-term fundamentals and desirable policies. They agreed that robust and proactive financial supervision and regulation, prudent fiscal management, flexible markets, and the Linked Exchange Rate System (LERS) have worked well to keep the external position broadly in balance. Directors generally agreed that the LERS remains the best arrangement for Hong Kong SAR.

Directors commended the authorities' track record of fiscal discipline. They considered the unwinding of stimulus in this year's budget to be appropriate and welcomed efforts to cast fiscal policy in a long-term framework, as proposed by the Working Group on Long-Term Fiscal Planning. They noted that fiscal policy will need to strike a balance between addressing population aging and inequality-related needs while fulfilling the authorities' commitment to low taxes and fiscal prudence.



## Hong Kong SAR: Selected Economic and Financial Indicators, 2009–15

	2009	2010	2011	2012	2013	Staff projections	
						2014	2015
Real GDP (percent change)	-2.5	6.8	4.8	1.5	2.9	3.7	3.8
Contribution							
Domestic demand	0.5	6.7	5.9	3.8	3.9	3.6	3.8
Private consumption	0.1	3.8	5.1	2.6	2.7	2.6	2.6
Government consumption	0.2	0.3	0.2	0.3	0.2	0.2	0.3
Gross fixed capital formation	-0.8	1.7	2.3	1.6	0.8	0.8	0.9
Inventories	1.0	0.9	-1.7	-0.8	0.1	0.0	0.0
Net exports	-2.9	-0.2	-1.4	-2.2	-0.9	0.1	0.0
Inflation (percent change)							
Consumer prices	0.5	2.4	5.3	4.1	4.3	4.0	3.8
GDP deflator	-0.4	0.3	3.9	3.7	1.2	3.5	3.4
Employment (percent change)	-1.1	0.0	2.9	2.2	1.8	1.1	1.0
Unemployment rate (percent, period average)	5.4	4.4	3.4	3.3	3.1	3.1	3.1
Real wages	-1.5	-0.4	2.7	1.6	1.0	...	...
Government budget (percent of GDP)							
Revenue	19.2	21.2	22.6	21.7	21.3	21.2	21.4
Expenditure 1/	17.4	17.0	18.8	18.5	20.5	18.5	21.0
Consolidated budget balance 1/	1.6	4.2	3.8	3.2	0.8	2.6	0.5
Fiscal reserves as of March 31	31.4	33.5	34.6	36.0	35.3	35.1	33.2
Money and credit (percent change, end-period)							
Narrow money (M1)	39.6	12.8	10.8	22.2	9.7	...	...
Broad money (M3)	5.2	8.0	12.9	11.0	12.4	...	...
Loans for use in Hong Kong SAR (not including trade financing)	-2.1	20.9	12.5	7.0	10.6	...	...
Interest rates (percent, end-period)							
Best lending rate	5.0	5.0	5.0	5.0	5.0	...	...
Three-month HIBOR	0.1	0.3	0.4	0.4	0.4	...	...
Asset prices							
Hang Seng stock index (end of period, 1964=100)	21,873	23,035	18,434	22,657	23,306	...	...
Hang Seng stock index (percent change)	52.0	5.3	-20.0	22.9	2.9	...	...
Residential property prices (end of period, percent change)	28.5	21.0	11.1	25.7	7.7	...	...
Merchandise trade (percent change)							
Export volume	-12.5	17.3	3.4	1.8	6.7	8.4	8.4
Import volume	-9.5	18.1	4.7	3.0	7.6	8.0	8.1
Current account 2/	9.9	7.0	5.6	1.6	2.1	3.5	4.1
Foreign exchange reserves							
In billions of U.S. dollars, end-of-period	245.6	257.1	269.9	300.5	311.1	...	...
In months of retained imports	33.2	27.5	24.6	26.5	26.4	...	...
In percent of broad money (M3)	28.7	27.9	26.0	26.0	23.9	...	...
Exchange rate							
Linked rate (fixed)							
Market rate (HK\$/US\$1, period average)	7.752	7.769	7.783	7.755	7.756	...	...
Real effective rate (period average, 2005=100)	90.1	87.8	84.3	85.7	87.6	...	...

Sources: CEIC; and IMF staff estimates.

1/ Expenditure includes HK\$50bn allocated for one-off health care reform for FY2015/16.

2/ Current account as a percent of GDP expressed in the BPM6 format.

**Statement by Tao Zhang, Executive Director for the People's Republic of China—  
Hong Kong Special Administrative Region and  
Michael Cheng, Advisor to Executive Director  
May 9, 2014**

On behalf of the Hong Kong SAR authorities, we would like to thank the Article IV and the Financial Sector Assessment Program (FSAP) teams for the candid and constructive dialogue held during the missions. We broadly agree with staff's assessment of the economic outlook and we welcome staff's view that Hong Kong SAR's financial system is well regulated and resilient.

**Latest economic development and outlook**

The Hong Kong SAR economy continued to grow at a stable pace. The year-on-year real GDP growth rate was steady at about 3.0 percent throughout the four quarters of 2013, as private consumption demand held up well on the back of full employment, while exports of goods and services strengthened alongside the gradual recovery in external demand. Recent releases of high-frequency economic indicators suggest that the Hong Kong SAR economy will remain firm in the near term, and the authorities project the full-year growth rate to pick up to 3–4 percent in 2014 from 2.9 percent in 2013.

Inflation remained moderate, with the year-on-year underlying consumer price inflation rate staying at about 4.0 percent since the second half of 2013, thanks to the restrained food price inflation and slower pass-through of market rentals. Looking ahead, consumer price inflation is expected to be contained by reduced market rental inflation and stable global commodity prices, and the authorities project the annual underlying inflation rate to ease to 3.7 percent in 2014 from 4.0 percent in 2013.

The authorities agree with staff that an increased volatility in global capital flows and markets associated with the exit from unconventional monetary policy in the U.S. is a key source of uncertainty facing the global economy. Meanwhile, the firm commitment by the Chinese government to deepen and broaden economic reforms would help to put the Mainland economy on a robust and sustainable growth path in the medium to longer term, to the benefit of Hong Kong SAR and the global economy, even though the structural transformation might result in slightly slower growth in the short run. The authorities will stay vigilant to all these developments and take necessary actions to safeguard the macroeconomic and financial stability of Hong Kong SAR.

**Linked Exchange Rate System**

The authorities welcome staff's continued support for the Linked Exchange Rate System. The positive assessment of the IMF on the suitability of the Linked Exchange Rate System

for Hong Kong SAR has greatly helped consolidate public confidence in the System. The authorities also welcome staff's balanced assessment of the external position of Hong Kong SAR.

### **Property market**

The residential property market has softened since February 2013, with residential property prices consolidating and transaction volume staying subdued. The authorities welcome staff's support for property-related measures deployed to address the exceptional exuberant property market caused by the tight supply situation and the low interest rate and abundant liquidity environment. These measures have helped stabilize the overheated property market, reduce the risk of a property bubble, and safeguard macroeconomic and financial stability. For instance, the six rounds of countercyclical macroprudential measures introduced since 2009 have resulted in a reduction of the actual loan-to-value ratio for new mortgages and the debt-servicing ratio, thus strengthening the resilience of banks against any property market downturn. Moreover, the authorities are also determined to tackle the housing problem at source by increasing land supply. The latest Policy Address has set out a target of providing a total of 470,000 housing units in the coming ten years, with public housing accounting for 60 percent of the total.

That said, the countercyclical demand-side management measures are extraordinary measures introduced under the present exceptional circumstances. The authorities have an unwavering determination to uphold free market principles and the market mechanism, and will continue to closely monitor the property market and consider adjusting or even withdrawing these measures as and when appropriate.

### **Fiscal policy**

Hong Kong SAR's fiscal position continued to be strong, with the fiscal balance registering surplus for the tenth consecutive year in FY2013/14, buoying fiscal reserves alongside. While the fiscal position is expected to remain healthy in the short to medium term, the authorities will continue to uphold fiscal discipline to ensure the sustainability of public finances by aligning the growth of government expenditure with the growth of the economy and government revenue, and will put in place a more vigorous internal control and monitoring mechanism for assessing and prioritizing competing funding needs with appropriate offsettings from different programs. Meanwhile, the authorities would strive to preserve, stabilize, and broaden the revenue base having regard to the competitiveness of Hong Kong SAR and the impact on the community.

## Financial sector

As assessed by the FSAP mission, Hong Kong SAR's financial system is regulated at the global forefront in many areas and the financial regulatory framework has a high level of compliance with international standards. The comprehensive set of stress tests also indicates that the banking system is highly resilient, with no aggregate capital shortfall and liquidity shortage even under extreme scenarios. This result is attributed to the proactive measures taken by the authorities to safeguard financial stability.

Apart from the countercyclical measures in relation to mortgage lending, in light of the relatively strong credit growth in the past few years, the authorities have stepped up supervisory efforts on credit risk management of the banks since 2010. These include regular and thematic onsite examinations on banks' credit underwriting processes; regular supervisory stress-testing to assess banks' resilience to credit shocks; and introduction of a Stable Funding Requirement since the fourth quarter of 2013 to ensure that the loan growth of the banks are supported by adequate long-term funding and would therefore be more sustainable against possible future deterioration in the liquidity situation.

While growth in Mainland-related lending has contributed to a notable part of the overall loan growth in Hong Kong SAR, it is a natural consequence of the growth of the Mainland economy and development of Mainland corporates. It also reinforces Hong Kong SAR's role as a significant international financial center. Such Mainland-related lending encompasses a high degree of heterogeneity with regard to lender types, borrower industries, loan use, and credit risk mitigations. The loans include those extended to Mainland enterprises obtaining funds to finance their business expansion and acquisitions both on the Mainland and in other markets, and also to local and international corporates for supporting their business ventures on the Mainland. On the lenders' side, foreign banks have increasingly participated in the relevant intermediation activities using their branches in Hong Kong SAR, which account for some 40 percent of the total. The results of supervisory work suggest that the risks of Mainland-related loans are properly managed. At the end of 2013, the classified loan ratio of the Hong Kong SAR banking sector's Mainland-related lending portfolio stood at 0.29 percent, lower than that of the sector's total lending portfolio (0.48 percent). Despite the absence of any early signal of credit quality deterioration, the authorities will continue to closely monitor banks' asset quality and ensure banks are resilient to credit loss throughout the economic cycle by maintaining strong capital positions and, where necessary and appropriate, regulatory reserves.

Looking ahead, the authorities are committed to ensuring that the financial regulatory framework follows international best practices. Specifically, the authorities are:

- advancing the plans to establish in 2015 an independent Insurance Authority with enhanced legal capacity, financial and operational independence, and more explicit

powers. In the meantime, the authorities are developing a framework for the supervision of insurance groups and introduction of a risk-based capital regime for consultation with the industry;

- pushing forward the plans to establish an effective resolution regime for financial institutions including financial market infrastructures. The second public consultation exercise will take place later this year, with a view of introducing legislation proposals into the Legislative Council in 2015;
- preparing proposals to enhance the independence of the regulatory regime for auditors of listed entities, with a view to better aligning with international standards and enhancing international recognition of local auditors. The authorities aim to conduct public consultation in mid-2014, and introduce amendment legislation into the Legislative Council by 2015; and
- working on the legislation to introduce capital buffers and liquidity standards following the successful implementation of the minimum capital requirements under Basel III.

### **Offshore RMB business**

Offshore RMB business in Hong Kong SAR has been developing steadily, with increasing depth and breadth of the offshore RMB market, and the RMB deposit pool, trade settlement, financing activities, foreign exchange transactions, and investment products continuing to grow at a vibrant pace. Meanwhile, channels for the circulation of RMB between the onshore and offshore markets have been expanding steadily.

As RMB becomes more widely used and circulated in different parts of the world, it is natural that banks and financial institutions globally are starting to offer RMB services to serve the needs of their clients. This would be conducive to Hong Kong SAR's sustainable development as the leading offshore RMB business center. For instance, when the scale of RMB activities of overseas enterprises and banks grows, so would the demand for financing and correspondent banking services offered by banks in Hong Kong SAR. Apart from being a pioneer with a decade of experience and solid foundation in offshore RMB business, Hong Kong SAR's biggest and unique edge is its very close economic and business links with the Mainland. Supported by these links, Hong Kong SAR's offshore RMB market has developed with greater size, depth, and breadth, and such intrinsic advantages will not erode simply because of the introduction of RMB business in other offshore markets.

Looking ahead, to ensure that the offshore RMB business develops further in an efficient and robust manner, the authorities will continue to enhance its financial infrastructure, work with the Mainland authorities in expanding the channels for RMB fund flows with the onshore market, and strengthen links between Hong Kong SAR and overseas markets in RMB business.