People's Republic of China—Hong Kong Special Administrative Region
Preliminary Conclusions of the 2011 Article IV Mission

October 25, 2011

THE ECONOMIC OUTLOOK

Hong Kong's economy has experienced robust growth and rising living standards

1. Hong Kong's rebound from the damage wreaked by the global financial crisis has been dynamic and compelling. Concerted policy efforts, Hong Kong's flexible economic system, and strong up-drafts from Mainland China have all contributed to the growth trajectory. Unemployment has fallen to very low levels, real incomes have grown, and living standards are generally improving. However, with external demand weakening the momentum in Hong Kong's economy is set to moderate. As a result, growth will ease to 5¾ percent this year, slowing further to 4 percent in 2012.

But this has brought with it inflationary pressures

2. The government has rightly recognized inflation as a cause for concern. As labor markets have tightened and the economy surpassed potential output, price pressures have grown. A rise in food price inflation, largely imported from the Mainland, and the pass through of higher property prices have added to the cost of living. Going forward, the slowing economy and waning food prices on the Mainland should take some of the impetus out of inflation. Nevertheless, the delayed pass-through from higher house prices, to rents, and on to consumer prices will likely continue for much of 2012. Consequently, inflation will end the year at 5½ percent, remaining in the 4-5 percent range throughout 2012.

The property market appears calmer

3. For the past few years, property values have been propelled upward by the buoyant economy, strong demand for housing, a limited pipeline of new apartments, and cheap financing. This has put significant pressure on many middle-class families who are increasingly finding that owning a home is a challenging proposition. Nevertheless, over the past few months, the dynamic in the residential housing market appears to have shifted somewhat with a decline in transaction volumes and a modest decline in prices.

Future fiscal support should be focused on lower income groups

4. Given the economy is operating above potential and there are concerns about inflation, fiscal policy should seek to provide some countercyclical restraint. The fiscal outturn this year is likely to register a significant surplus, once again outperforming the budget targets. Nevertheless, fiscal policy is still exerting a moderate expansionary effect on the economy, in part due to a range of one-off measures put in place to provide support to households. In the upcoming budget, in the absence of a major external shock, many of these measures could be discontinued, particularly those taking the form of universal transfers. There is, however, scope for targeted support to lower income groups and the elderly through increases in means-tested social assistance and reductions in public housing rents.

RISKS AND SPILLOVERS

The key risk ahead is from an external shock emanating from Europe

5. The global economy has reached a dangerous point. Risks in the euro area have risen as policy uncertainty has interacted with sovereign funding strains and banking sector stress, feeding back into the real economy. Should such downside risks materialize, Hong Kong would be hit hard through both trade and financial channels. Staff estimate that, in the event of a sudden downside shock that radiates out from Europe and reduces global growth by around 3 percentage points, Hong Kong SAR would fall into recession with growth dropping 4-4½ percentage points below our baseline forecast. Given the large consequences of such a low probability scenario, it should certainly be factored into policymakers' contingency planning.

Or a slowdown in the Mainland economy

6. Similarly, while also a low probability scenario, a hard landing in Mainland China would create significant turbulence in Hong Kong's economy. There would be multiple channels of transmission. Trade in goods and services would decline, Hong Kong equity markets would fall, the quality of credit supplied to Mainland corporations would weaken, and overall confidence would be negatively affected. In addition, economic distress on the Mainland could create a downturn in Hong Kong's real estate sector.

Policymakers have a formidable arsenal of policies at their disposal

7. If such external risks are realized, Hong Kong should respond with a significant and immediate fiscal stimulus. Measures could include reductions in taxation (particularly for salaries and profits taxes), direct transfers to households (especially to the poor, elderly, and other groups most exposed to a deteriorating economy), and fiscal support for smaller enterprises (including through loan guarantees). Insofar as is possible, Hong Kong should also aim to accelerate ongoing public sector infrastructure projects. Depending on the severity of the situation, the government might also need to consider extraordinary measures—such as those introduced in 2008—to prevent financial contagion and market dislocation from washing ashore. This would include being ready to provide Hong Kong dollar liquidity through the tools already available to the HKMA and reactivating the contingent backstopping of Hong Kong bank capital using the resources of the Exchange Fund. The recent enhancements to the Deposit Protection Scheme should be sufficient to provide confidence to depositors but, in a very extreme scenario, there may be a case for reintroducing the broad-based guarantee of bank deposits; doing so, though, would best be decided in consultation and coordination with other jurisdictions in the region. Finally, in the event that downward pressures spread to the property market, the authorities could, as part of their countercyclical toolkit, gradually roll back some of the tightening measures linked to residential real estate that were introduced over the past few years.

THE PROPERTY MARKET

The government's measures have helped tackle soaring house prices…

8. Recognizing the macroeconomic and financial risks associated with the emergence of a property bubble, the government has taken appropriate measures to limit leverage, prevent speculation, increase land supply, and protect the financial system. Lower loan-to-value ratios have contained leverage and the Special Stamp Duty has discouraged high frequency trading in property. The government has announced important steps to provide new land to the market for the construction of residential real estate and to build

out the government's land reserve over the medium to long term. Finally, the authorities have deployed an effective communication strategy to warn of the risks of households over-extending themselves in their mortgage payments and becoming overexposed to the real estate cycle. Staff analysis suggests that such measures have been effective in lowering transaction volumes, restraining credit to housing, and preserving the health of the banking system.

…but it would be premature to assume that the prospects for a property bubble have dissipated

9. The difficulty now is to gauge whether the current property slowdown is going to endure. Many of the drivers that have pushed the market up over the past years remain in place. On the other hand, mortgage rates are moving up, the supply of land has been increasing, and expectations of future price growth appear to have softened. These countervailing forces may be sufficient to cool down the market but it is too early to declare victory. Policies will need to remain data-driven. Should housing prices resume their upward swing in the coming months, the government should be ready to further tighten macroprudential tools, increase the taxation of property, and expand land sales. Inevitably, there are risks in increasing the supply of land. Given the lags between the initiation of new housing projects and the time when those properties actually reach the market, it is possible that government efforts could serve to exacerbate the housing cycle rather than dampen it. This underlines the importance of the policy response continuing to be measured, carefully calibrated, and proportional to the risks and pressures that are emerging in the property market.

The high cost of housing places a large social burden on renters and new households that do not yet own a property

10. The redistributive impact of the recent rise in housing costs should not be underestimated. With over half of households owning their home, the majority of Hong Kong residents not in public rental housing have seen a significant wealth gain from the rise in housing prices. However, there is still a substantial segment of the population which is not eligible for public housing but does not yet own a home. The burden on this group has been high. Rents have been rising fast and the combination of higher prices and falling loan-to-value ratios has meant that, for the median household looking to purchase a home, the minimum downpayment has reached around 3½ years of disposable income (higher than at any point since mid-1998). It is fitting, therefore, that the government has been working to lessen this burden by increasing the availability of public housing, introducing schemes such as the My Home Purchase Plan to help partially overcome the rising barriers to home ownership, and, most recently, reactivating the Home Ownership Scheme.

Credit And The Financial System

The recent pace of credit growth is a concern…

11. Credit has been growing at an extraordinary pace, particularly for loans in foreign currency. This is not surprising given the very low costs of Hong Kong and U.S. dollar financing, the high levels of liquidity in local banks, and the strong demand for credit, particularly from companies with operations in the Mainland. However, international experience would suggest that this rapid pace of credit growth has the potential to lead to a worsening of average credit quality, particularly if the business cycle swings into reverse.

…and is contributing to rising funding pressures

12. The rise in lending is also creating strains on bank funding. For example, loan-to-deposit ratios in non-renminbi foreign currency have risen to around 63 percent, 20 percent higher than a year ago. This is still low by international comparisons and even when compared with Hong Kong's own history but the upswing should not be ignored.

The regulatory response will help mitigate these underlying risks

13. In this regard, the regulatory authorities have continued to be forward-looking and proactive in protecting the financial system from an eventual turn in the credit cycle. The regulators have issued instructions to banks to ensure that future lending plans are consistent with the availability of funds. They are also conducting on-site examinations to check that underwriting standards are not being weakened and are asking banks to increase their buffers—including through higher regulatory reserves—in order to offset potential risks. These steps are the right response given the uncertainty in the outlook and the potential for global foreign currency funding strains to emerge if risk aversion again intensifies.

THE LINKED EXCHANGE RATE SYSTEM

There has been considerable debate on the exchange rate regime…

14. Rising property and consumer price inflation has led to a recent upsurge in criticism of the Linked Exchange Rate System. It is true that the current loose monetary conditions are incongruous with Hong Kong's current stage in the economic cycle. These low interest rates are also likely to persist for some time given the Federal Reserve's announcement that economic conditions warrant exceptionally low levels for the federal funds rate at least through mid-2013.

…but the Linked Exchange Rate System remains the best option for Hong Kong

15. However, proposals to abandon the currency board and repeg the Hong Kong dollar to a basket of currencies or pursue some form of crawling peg are ill-conceived. Such changes to the currency regime would give Hong Kong no more monetary autonomy than it has today but would sacrifice the benefits of monetary and financial stability that have been hard-won over the past 28 years. Instead, Hong Kong has made the clear social choice to have an economic system that adjusts to the changing environment through movements in nominal wages and prices. The preconditions to sustain such a system—including an extremely strong fiscal position, robust and proactive financial oversight, and one of the most flexible labor, product and asset markets in the world—are fully in place. Hong Kong's economic flexibility facilitates a quick and effective adjustment of the real exchange rate so as to avoid sizable or persistent misalignments. While always difficult to assess due to the rapidly changing nature of the Hong Kong economy, staff analysis finds no strong evidence that the currency is out of line with economic fundamentals. All in all, the Linked Exchange Rate System is a simple, credible, and effective exchange rate regime that merits continued support.

THE OFFSHORE RENMINBI BUSINESS

Hong Kong has established itself as the premier offshore renminbi center

16. The offshore renminbi business in Hong Kong SAR has developed quickly with generally positive results. As the dim sum bond market has deepened, investors have become more focused on the credit risk profile of issuers. Separately, until recently, some investors were viewing the offshore renminbi market as a close proxy for the onshore currency. Recent developments have highlighted that these are two separate assets, which move together over a longer horizon but which can diverge significantly over the shorter term. This realization should lead to a healthy realignment of investor expectations. Finally, policy steps to allow Mainland nonfinancial corporations to issue dim sum bonds, create a renminbi Qualified Foreign Institutional Investors scheme, and open the door to renminbi foreign direct investment are facilitating the further expansion, deepening, and maturation of this offshore market.

The channels for financial spillovers between the Mainland and Hong Kong are widening

17. As the renminbi market develops further there will be greater avenues for spillovers between Hong Kong and Mainland as their financial markets become ever more interconnected. For example, the shift of deposits into renminbi may have reduced the availability of funds that can be lent in other currencies. This, in part, is a factor contributing to greater competition for non-renminbi deposits and higher costs of funding and credit. Over time, as the market develops and as renminbi FDI flows grow, a greater proportion of credit should be provided in renminbi, creating a more balanced situation in terms of renminbi assets and liabilities.

Going forward, the offshore market will need to be supported by a progressive opening to renminbi capital flows …

18. To some extent, an expectation of renminbi appreciation over the medium-term has aided the rapid development of the offshore market. For the project to be fully successful, the growing outflows of renminbi will have to be supported by an expansion of the conduits by which that renminbi can flow back to the Mainland. This will need to involve a steady increase in the convertibility of the Mainland's capital account. However, particularly where this involves short-term portfolio flows into the Mainland's bond and equity markets, this should be paced in accordance with progress on liberalization and reform of the Mainland's financial system.

…and an improvement in the provision of information

19. Much has been done to help investors better understand the workings of the fast-developing offshore renminbi market, including through a proactive communication strategy by the Hong Kong Monetary Authority. As the offshore renminbi market expands, more information could help facilitate further market development. This could include regular reporting on the direction of renminbi settlement in goods and services, on renminbi capital flows, and on the renminbi assets and liabilities of Hong Kong's financial institutions.

In closing, the mission would like to thank the Hong Kong government for its kind hospitality and for the productive nature of our discussions.