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**Statement by Mr. Zhang and Mr. Cheng on People's Republic of China-Hong Kong  
Special Administrative Region  
Executive Board Meeting  
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.