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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/100-4

4:55 p.m., December 13, 2019

4. People's Republic of China—Hong Kong Special Administrative Region—2019 Article IV Consultation Discussions

Documents: SM/19/268, and Cor. 1, and Sup. 1, and Sup. 1, Cor. 1

Staff: K. Kang and J. Kang, APD; Koeva Brooks, SPR

Length: 37 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	**Alternate Executive Directors**
	B. Jappah (AE), Temporary
	H. Razafindramanana (AF)
	C. Moreno (AG), Temporary
	J. Shin (AP), Temporary
	F. Antunes (BR), Temporary
Z. Jin (CC)	
	A. Arevalo Arroyo (CE), Temporary
	C. Williams (CO), Temporary
	E. Endlich (EC), Temporary
H. de Villeroché (FF)	
	I. Fragin (GR), Temporary
	Y. Indraratna (IN)
	C. Quaglierini (IT), Temporary
	K. Chikada (JA)
J. Mojarrad (MD)	
H. Beblawi (MI)	
	H. Etkes (NE), Temporary
	J. Sigurgeirsson (NO)
	D. Shestakov (RU), Temporary
	R. Alkhareif (SA)
	S. Yoe (ST), Temporary
	C. Wehrle (SZ), Temporary
S. Riach (UK)	
	A. Grohovsky (US), Temporary

H. Al-Atrash, Acting Secretary
O. Vongthieres, Summing Up Officer
E. Mannefred, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: F. Han, J. Kang, K. Kang, N. Yang. Communications Department: D. Ma. Legal Department: N. Rendak. Monetary and Capital Markets Department: P. Ananthakrishnan. Strategy, Policy, and Review Department: P. Koeva Brooks. Western Hemisphere Department: W. Ho. Executive Director: M. Mouminah (SA), T. Tanaka (JA). Senior Advisors to Executive Directors: M. Gilliot (FF), Y. Liu (CC).

Advisors to Executive Directors: S. Belhaj (MD), T. Chrimes (UK), O. Diakite (AF), D. Fadhel (MI), I. Skrivere (NO).

4. PEOPLE'S REPUBLIC OF CHINA—HONG KONG SPECIAL ADMINISTRATIVE REGION—2019 ARTICLE IV CONSULTATION DISCUSSIONS

The staff representative from Asia and Pacific Department submitted the following statement:

1. This statement contains information that has become available since the staff report was finalized on November 25, 2019. It does not alter the staff's assessment of policy issues and recommendations contained in the report or the staff appraisal.

2. Data releases for October are broadly in line with staff projections.

- Tourist arrivals and retail sales declined further in October by 43.7 and 24.3 percent (y/y), respectively, compared to 34.2 and 18.2 percent (y/y) in September.

- Merchandise trade also declined further in October with exports and imports declining by 9.2 and 11.5 percent (y/y), respectively, compared to 7.3 and 10.3 percent in September.

- House prices declined marginally in October by 0.3 percent (m/m, sa).

- Banking sector buffers remained broadly unchanged in 2019Q3, with the Common Equity Tier 1 capital ratio at 16.3 percent and the liquidity coverage ratio at 153 percent.

3. The government announced a new fiscal stimulus of HKD 4 million (about 0.1 percent of GDP) on December 4, mainly aimed at helping small and medium-sized enterprises.

Mr. Jin and Ms. Lok submitted the following statement:

On behalf of the authorities of the Hong Kong Special Administrative Region (SAR), we would like to thank staff for the comprehensive and useful report. Our authorities appreciated the constructive dialogues during the mission visit, and broadly agree with staff's appraisal. The Hong Kong SAR economy is facing challenges on both external and domestic fronts. That said, the robust fundamentals and sound institutions continue to underpin the resilience of the economy, and the financial system continues to function in an

orderly manner. The considerable buffers built up over the years will enable Hong Kong SAR to withstand possible shocks.

Latest Economic Developments and Outlook

Economic activity has weakened notably as a result of both external and domestic factors. Growth has moderated since last year amid a slowing global economy and uncertainties surrounding US-China trade tensions, which have affected trade-related activities and investment globally. Local social incidents since the summer have weighed on inbound tourism and consumption. Real GDP contracted by 2.9 percent in the third quarter of 2019 from a year earlier, which moderated noticeably from the positive growth of 0.6 percent and 0.4 percent registered in the first and second quarters respectively. Considering the actual outturn of a 0.6 percent contraction in the first three quarters of 2019 and persistent downward pressures, the authorities project the economy to record -1.3 percent growth for 2019 as a whole.

Underlying consumer price inflation went up from 2.9 percent in the second quarter to 3.3 percent in the third quarter of 2019, largely due to a faster increase in pork prices. Price pressures on other major consumer price index components remained largely moderate. Looking ahead, modest global inflation and subdued economic conditions would help reduce price pressures in the rest of 2019.

Meanwhile, the financial systems in Hong Kong SAR have been holding up well. The monetary and financial markets in Hong Kong SAR continue to function in an orderly manner. The Linked Exchange Rate System operates smoothly according to its design, as it has for the past 36 years, weathering many turbulent periods. The capital and liquidity positions of banks in Hong Kong SAR remain well above international standards. The authorities will stay vigilant and closely monitor market vulnerabilities. So far, no sign of volatile capital outflows from the Hong Kong dollar or the banking system is observed. Free flow of capital will continue to be guaranteed under the Basic Law.

Hong Kong SAR's core competitiveness as one of the best places to do business remains well in place, and is still recognized by many international institutions. It includes a transparent and simple tax system, efficient infrastructure, sound regulatory regime, rule of law, and high-quality professional services. These strengths are cornerstones of Hong Kong SAR's success and will continue to underpin its competitiveness as an international financial center.

The authorities broadly share staff's assessment of the macroeconomic outlook. Externally, downside risks come from a soft global economic growth and uncertainties arising from US-China trade tensions, together with the related repercussions on global sentiment, trade and investment activities, and financial markets. The development of the domestic sociopolitical situation would also have a significant bearing on the economy. In the face of these challenges, the authorities will continue to monitor developments closely. Four rounds of relief measures have already been rolled out to support the economy and the authorities stand ready to do more as needed. As recognized by staff, a history of prudent macroeconomic policies has left Hong Kong SAR with strong buffers to tackle both cyclical and structural challenges.

Fiscal Policy

Thanks to prudent fiscal management over the years, the authorities have built up ample fiscal space to help the economy navigate through negative shocks while maintaining long-term sustainability. The authorities will continue to make good use of its reserves to implement timely and appropriate countercyclical fiscal measures to stimulate the economy and relieve the economic burden of citizens. As of 4 December 2019, the authorities have rolled out four rounds of relief measures amounting HK$25 billion (US$3.2 billion) to support enterprises, especially small and medium enterprises, and residents. These measures, together with the package of one-off relief measures worth HK$42.9 billion (US$5.5 billion) in the 2019/20 Budget, are estimated to have a stimulus effect on the Hong Kong SAR economy of around 2 percent of GDP. Going forward, the authorities stand ready to roll out further measures as and when necessary.

In the longer term, the authorities recognize the challenges that population aging could pose to fiscal sustainability. But given large fiscal reserves and the challenging economic outlook, the authorities have no plan to introduce new taxes in the immediate future.

Linked Exchange Rate System

The authorities welcome staff's continued support for the Linked Exchange Rate System (LERS), which has been the anchor of Hong Kong SAR's monetary and financial stability. Despite the recent social unrest and rising global uncertainties, the LERS has continued to function smoothly, demonstrating once again its robustness and resilience. The authorities have the capability, resources, and determination to maintain the LERS and will

continue to step up public communication to reinforce public confidence in the system. Meanwhile, the authorities also appreciate staff's balanced assessment of the external position of Hong Kong SAR.

Property Market

The authorities consider that the three-pronged approach—comprising macroprudential measures, demand-side management measures, and increase in housing supply—remains appropriate in containing housing market risks. The authorities share staff's view that their current macroprudential stance remains appropriate. The eight rounds of countercyclical macroprudential measures on property mortgage loans introduced by the Hong Kong Monetary Authority (HKMA) since 2009 have enhanced banks' resilience to risks associated with the property market. Adjustments to the current stance would only be made having regard to the evolving property market cycle and financial stability risks.

The property market has softened in the last few months. That said, the level of private residential property prices remains elevated and still out of line with economic fundamentals, and the authorities do not intend to relax or withdraw any demand-side management measures at this time. The authorities will remain vigilant and closely monitor the property market developments, and act in a timely manner when needed to help ensure the healthy development of the property market and to safeguard broader economic and financial stability.

The authorities remain committed to increasing land and housing supply to address the housing supply-demand imbalance. Continuous efforts are being made to increase both public and private housing. In her 2019 Policy Address, the Chief Executive of the Hong Kong SAR has announced a number of short- and medium-term support measures, such as exploring the feasibility of redeveloping factory estates for public housing use, making more flats available for sale under the subsidized home ownership schemes, making an additional residential site available for sale in 2020 for a second "Starter Homes" pilot project, etc.

Financial Sector

The authorities share staff's assessment that Hong Kong SAR's financial systems remain sound. The authorities will continue to strengthen regulatory and supervisory frameworks, having regard to international standards and financial stability risks. The 2019 Financial Sector Assessment

Program (FSAP) on Hong Kong SAR is ongoing, and the authorities look forward to staff's detailed assessment and policy recommendations. The recently completed Mutual Evaluation by the Financial Action Task Force and the Asia-Pacific Group on Money Laundering concluded that Hong Kong SAR has a sound regime to fight money laundering and terrorist financing that is delivering good results. The authorities will closely monitor any emerging risk areas in the financial systems. As noted by staff, the authorities will continue to strike a proper balance between facilitating innovation and managing associated risks, particularly arising from the rapid adoption of technology in the financial sector.

Promoting Long-Term Competitiveness

As noted by staff, the authorities will step up efforts in maintaining Hong Kong's competitiveness by capitalizing on the opportunities from the development of fintech, green finance, and the Greater Bay Area (GBA). On fintech, significant progress has been made recently, such as the granting of virtual bank licenses, the launch of the Faster Payment System, and cross-border collaboration. Earlier this year, the authorities have announced a three-pronged strategy to encourage banks to take a proactive approach in managing climate-related risks, to promote responsible investment, and to build capacity in the green finance sector. On GBA, the authorities will work closely with their counterparts in Mainland China to ease the flow of capital and cross-border access of financial services within the area, including launching a wealth management connect scheme.

Mr. Doornbosch and Mr. Jost submitted the following statement:

We would like to thank Mr. Jin and Ms. Lok for their informative statement and staff for their well drafted set of reports. The developments in Hong Kong SAR illustrate the impacts which risks, often external ones such as trade tensions, can have on open economies. We welcome that staff recognizes the importance of the consistent track record of robust fiscal and macro-prudential policies implemented by the authorities. Indeed, the commitment to prudent policies, including in economically favorable years, are commendable and will help the authorities to address challenges, now that downside risks are materializing. In our view, this can be considered as a good example of risk management in times of a more volatile global economy. We welcome the authorities' commitment to monitoring developments closely and taking actions as necessary.

The success of Hong Kong SAR's economic development, including the success of its financial industry - supported by a range of factors including predictable and consistent policies - also brings about challenges, as mentioned in the report. Rising inequalities, illustrated for instance by affordability concerns in the housing market, are among them. Regarding the real estate sector, continued efforts remain necessary, both in terms of financial risks and equity considerations. More specifically, we agree with staff that more can be done in terms of public investment and when it comes to increasing the supply side in the real estate sector. Here, we found Annex V, which provides a good summary of property market measures introduced since 2009, helpful. Staff mentions rapid price developments in the real estate sector in recent years. We would like to ask staff to what extent they consider that the low interest rate environment has contributed to this development?

The staff report rightly underscores that recent economic indicators point to important challenges faced by Hong Kong SAR, including regarding GDP, export figures or business confidence. At the same time, fiscal, economic and financial fundamentals remain strong and buffers are substantial. Fiscal reserves of roughly 40% of GDP or low unemployment data of 3.1% are two examples. Regarding fiscal policies we broadly agree with staff that, while budgetary resources should be used to counteract the downturn, including in education, and targeted transfers to reduce inequalities, prudence remains warranted when it comes to longer term fiscal risks. In this context, we very much welcome the fact that staff's advice is well balanced, i.e. it does not discard long term fiscal risks, including pension liabilities and costs of climate change. We support staff's recommendations on increasing the effectiveness of public spending.

The financial sector, while encountering pressures from a tense real estate market and external headwinds, remains sound and well regulated, as also acknowledged by staff. Robust capital and liquidity positions in the banking sector are a good illustration. We welcome the implementation of key components of the 2014 FSAP exercise, including key Basel III standards. Similarly, we were pleased to read that the AML/CFT framework has been found to deliver well. Given the size and interconnectedness of the financial center, we encourage the authorities to continue implementing macro-prudential policies in line with staff's advice. We welcome the fact that staff, even if only briefly, referred to opportunities in green finance and climate change related developments in their assessment of the financial sector.

Mr. Ray, Mr. Tan, Mr. Shin and Ms. Yoe submitted the following joint statement:

We thank staff for the well-written report, and Mr. Jin and Ms. Lok for their informative Buff statement.

Despite its strong economic fundamentals, Hong Kong's small and open economy remains susceptible to external shocks. Economic activity has slowed on the back of a global trade slowdown, rising US-China trade tensions and domestic social unrest. However, the buildup of buffers should help Hong Kong to weather the cyclical downturn and to withstand potential shocks. Over the longer term, Hong Kong must address structural challenges associated with population ageing, high income inequality and insufficient housing supply to maintain its economic dynamism and competitiveness.

Hong Kong has sufficient fiscal space to stimulate the economy amid the cyclical downturn. Given its strong fiscal buffers, Hong Kong is in a good position to deal with the near-term cyclical downturn. We welcome the authorities' timely use of fiscal stimulus to cushion the vulnerable households from the downturn and to provide support to SMEs to preserve jobs. We also support staff's recommendation to align short term measures with long term goals as this approach balances the need for near-term fiscal support while preserving fiscal sustainability to meet longer term challenges. The analysis in Annex IV on the macroeconomic impact of fiscal measures to foster inclusion is thus useful in this regard. As the authorities stand ready to provide more support as needed, can staff comment on whether there is a need for further fiscal measures this fiscal year?

We support greater policy focus on fostering inclusive growth to sustain longer term competitiveness. We note that population ageing and the need to address high income inequality and inadequate housing supply would create greater spending pressures on the government. However, delays in addressing these structural challenges would affect Hong Kong's competitiveness in the longer run. Can staff discuss the impact of population ageing on labor productivity, and the need for labor market reforms? To ensure fiscal sustainability and competitiveness in the longer run, we agree with staff on the need to consider medium term fiscal measures that would foster greater equity. To help the authorities weigh the different policy options, we encourage staff to provide further analysis of the effectiveness of the proposed measures in reducing income inequality.

The authorities must continue to address the housing market imbalances to safeguard financial stability and housing affordability. We take positive note that macroprudential measures and stamp duties have been effective in containing vulnerabilities in the banking system and house price growth. However, to avert the risk of a disorderly price correction given the high house price overvaluation and rising household debt, there remains an

urgent need to increase housing supply to fundamentally address the housing supply-demand imbalances. We welcome the authorities' measures to increase housing supply including through boosting land supply for housing. Does staff see the need for further demand-side macroprudential measures to safeguard housing affordability?

Hong Kong's sound financial sector and well-functioning Linked Exchange Rate System (LERS) continue to be the anchors of stability in the economy. Hong Kong's financial sector continues to remain sound and resilient in face of the weaker economic conditions. This can be attributed to the strong regulatory framework and effective supervision. As Hong Kong continues to tap growth opportunities from the development of the Greater Bay Area (GBA), we also encourage the authorities to continue to monitor risks from deeper financial linkages with Mainland China and stand ready to introduce measures to safeguard financial stability. We note the important role that LERS plays in anchoring Hong Kong's monetary and financial stability against external shocks, including through crisis. The smooth functioning of the LERS amid increased global volatility is a testament of the resilience and credibility of the currency board arrangement. The authorities must continue to enhance public communication and to preserve the strong institutional framework so as to reinforce confidence in the arrangement.

Mr. Beblawi and Ms. Abdelati submitted the following statement:

We thank staff for the high-quality analysis in the report, which highlights Hong Kong SAR's long-term strengths, structural challenges, and recent external and domestic shocks. Its success, as a regional trading hub and global financial, sector reflects the efficient institutions, international best standards, and high international competitiveness. The high dependence on the export-oriented service sector has left it vulnerable to the trade tensions between U.S. and China, which together with domestic protests, has pushed the economy into recession. The staff report rightly focuses on how the authorities can best use their ample buffers, strong institutions, and sound policy frameworks to address the cyclical and structural challenges.

We agree that greater countercyclical support is desirable. Further to the 0.8 percent of GDP in stimulus measures already announced, the authorities say they stand ready to roll out additional fiscal measures in the current fiscal year ending March 2020, targeted to vulnerable households and SMEs. However, it is not clear that they agree to staff's suggestions of fiscal spending increases of around 1½ percent of GDP per year over the next five years to fill the negative output gap, as outlined in ¶17. Staff clarification would be welcome.

Staff highlights the medium-term fiscal challenges of rapid population aging and income inequality. We support the intention to consider higher revenues (VAT, excise, and income taxes) in the future to ensure fiscal sustainability amid population aging, especially since the tax burden is low compared to other financial centers. Understandably, it is important to carry out broad public consultations to enlist support. We support staff's suggestion to prepare a long-term healthcare spending strategy and to consider using proceeds from the issuance of green bonds for environmentally friendly projects. To reduce inequality, staff suggests expanding programs to raise female and elderly employment and to carry out regular expenditure reviews to ensure that tackling income inequality is addressed. We would appreciate further elaboration of how income inequality is to be addressed, and whether additional education/training programs and housing supply are also called for over the longer term.

Containing housing risks and increasing housing affordability remains a high priority. Staff analysis indicates that downside risks to house prices have increased in the past few quarters. House affordability has declined as the house-price to income ratio and the price to rent ratio have both significantly deteriorated over the past decade. Increasing land supply remains key to resolve the structural imbalances between supply and demand. We therefore welcome the land resumption initiatives announced in the 2019 Policy Address.

Despite the slowing economy, the banking sector and capital markets have functioned smoothly, attesting to the resilience of the financial sector and its ample buffers. We are pleased to know that regulatory agencies have strengthened market surveillance to ensure that no regulatory gaps exist. It will be important to continue to strengthen supervision and monitor risks from high corporate debt, especially in the areas where pockets of vulnerability were identified by staff.

We support the authorities' view that the Linked Exchange Rate System remains appropriate. The currency board arrangement continues to function smoothly despite increased global financial volatility. Annex 9 confirms that the current account surplus is broadly in line with the level implied by medium-term fundamentals and desirable policies.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for a well-written report and Mr. Jin and Ms. Lok for their helpful Buff statement.

Skillful economic management and robust policy frameworks have helped Hong Kong SAR, a regional trading hub and a global financial center, enjoy sustained growth and accumulate sizable buffers over the past few years. In 2019, however, amid low inflation and unemployment, real GDP has contracted as significant external and domestic headwinds took their toll on the economy. While growth should resume next year, the pace of recovery is expected to be gradual with a negative output gap over the medium term. Downside risks to the outlook, including from trade and technology tensions between the U.S. and China, place a premium on efforts to stabilize the economy and raise potential growth by providing near-term fiscal support, safeguarding financial stability, and addressing structural challenges of insufficient housing and high-income disparity. We concur with the thrust of staff appraisal.

Fiscal policy, under the balanced budget rule, should align short-term stimulus with long-term sustainability and equity goals. Given low tax rates, fiscal expansion could be better delivered through increased spending. We support frontloading targeted transfers to vulnerable households and SMEs, additional outlays on housing and related infrastructure, and increased spending on education and training to cope with the cyclical downturn and close the output gap over the medium term. Notwithstanding ample fiscal reserves, rapid population aging and the growing pension and healthcare outlays call for higher revenues by introducing a VAT, raising excise taxes, and increasing the top PIT rate, as well as enhanced spending efficiency. Could staff indicate if the authorities intend to develop a long-term healthcare spending strategy? We also see merit in reducing reliance on property-related revenues and avoiding systemic under-execution of operating expenditures.

The linked exchange rate system (LERS), a currency board arrangement governed by a transparent set of rules, has anchored monetary and financial stability against external shocks for the past four decades and remains appropriate. We take positive note of the recent narrowing of interest rate differentials between HKD and USD, which has further contributed to USD/HKD exchange rate stability. The HKMA should continue to enhance public communication on the functioning of the LERS, the related foreign exchange interventions, and the money market developments to safeguard LERS credibility.

The banking system has large capital and liquidity buffers and the asset quality remains high, with the NPL ratio below 1 percent. Implementation of key recommendations from the 2014 FSAP has helped

enhance regulation and supervision. However, elevated household and corporate debt and pockets of vulnerability in certain corporate sectors pose risks and require vigilance. Could staff indicate if the authorities plan to introduce sectoral macroprudential measures to limit concentration risk of financial institutions? We note innovative opportunities offered by the development of the green finance and the Greater Bay Area, welcome recent granting of licenses to virtual banks and insurers to improve efficiency and reduce costs, and underscore the need to bolster cyber security and the supervision of fintech risk management. We look forward to the findings of the ongoing 2019 FSAP, as indicated by Mr. Jin and Ms. Lok, to further strengthen the financial sector's resilience.

The three-pronged housing market strategy, aimed at mitigating risks and increasing affordability, has served the economy well and should continue. While macroprudential measures have helped alleviate the demand pressure and contain price rises, increasing difficulties in securing land have caused a shortage in housing supply and resulted in a structural supply-demand imbalance. The newly announced measures to boost land supply for residential housing are appropriate and should be complemented by streamlined and expedited procedures to identify land and building sites and issue relevant authorizations. We also encourage the authorities to monitor the impact of recent changes in the eligibility criteria for the mortgage insurance program and make policy adjustments as warranted by evolving property market and financial sector risks.

We wish the authorities continued success in their endeavors.

Mr. Sigurgeirsson and Ms. Skrivere submitted the following statement:

We thank staff for a very well-written report and Mr. Jin and Ms. Lok for their insightful Buff statement. Hong Kong SAR remains among the most open economies in the world, and with the U.S. and China as its two main trading partners, it is particularly hard-hit by the ongoing trade tensions. Additionally, the continued social unrest has negatively affected the domestic economy, including through a drop in tourism. However, sound and prudent policies have led to the accumulation of significant buffers, which should help weather cyclical and structural challenges. Moreover, upside risks remain should trade tension ease and the Greater Bay Area (GBA) offers good prospects. We broadly share staff's appraisal and add the following points on fiscal policy, housing market developments, and financial sector for emphasis.

With large accumulated buffers, Hong Kong SAR has room to increase spending to cope with the cyclical downturn, while recognizing sustainability over the long term. Hong Kong SAR has demonstrated prudent fiscal policy over a long period of time, resulting in an accumulation of fiscal reserves. In light of the materialization of downside risks and the weakening of economic outlook, we agree with staff that there is room to provide some fiscal impulse to the economy. We welcome the authorities' intention to carefully determine the size and composition of additional fiscal measures to maximize their effectiveness. We note, however, that a quarter of the population is projected to be over 65 years old by 2030. Given the implications this poses to the fiscal position, productivity, and competitiveness, we emphasize the need to maintain fiscal sustainability in the long term.

Despite the recent softening in prices, Hong Kong SAR's housing market remains highly unaffordable, and the authorities should consider ways to address the demand-supply imbalance. We note that the residential property prices have almost quadrupled since the GFC, and the economy is vulnerable to a sharp adjustment in the property market. We share staff's views that the three-pronged approach (boosting housing supply to match demand, macroprudential measures to limit stability risks, and stamp duties to contain speculative activity and external demand) remains appropriate. Going forward, we particularly emphasize the need to boost the housing supply, including through increasing land allocation for residential housing. We encourage the authorities to monitor potential regulatory leakages to the non-bank financial sector (including, mortgage financing by property developers).

The financial sector regulatory and supervisory framework remains robust; however, emerging vulnerabilities need to be carefully monitored. We commend the authorities for the progress with implementing the 2014 FSAP recommendations, and we thank staff for the comprehensive overview presented in Annex VII. Nevertheless, we note with concern the very high levels of non-financial corporate debt, and encourage the authorities to carefully monitor the developments, particularly in more vulnerable corporate sectors. With the rise of fintech, we welcome the authorities' increased supervisory efforts in this area and agree that a careful balance needs to be struck between innovation and regulation.

We encourage the authorities to consent to publication of the report.

Ms. Mannathoko and Mr. Jappah submitted the following statement:

We thank Mr. Jin and Ms. Lok for their informative Buff statement and staff for the well written report. Hong Kong SAR is facing a challenging period when both domestic shocks and external risks are weighing down on growth. The adverse impact of slowing global growth, heightened US-China trade tensions and protracted domestic socio-political challenges is showing in the data, with recession projected for 2019. We are reassured, nevertheless, that the authorities' robust safeguards and strong buffers are providing adequate cushion against these shocks; safeguarding macroeconomic stability and enabling economic recovery to occur sooner rather than later. Furthermore, the Linked Exchange Rate System has continued to provide a strong anchor for monetary and financial stability and capital flows do not as yet present a challenge.

Fiscal policy: We support the authorities' ongoing measures that leverage the benefits of prudent fiscal management by tapping into ample buffers to finance a stimulus package that will help to close the medium-term output gap, and cushion impacts on vulnerable households through targeted transfers. We also favor enhancing support for industry-relevant education and retraining programs, targeted financing for SMEs, and related measures to improve female labor force participation, reduce unemployment, and narrow income inequality. At the same time, we note that more effort is required to improve the efficiency of budget execution and reduce reliance on property taxes. For the medium-to-long term, given the rapidly aging population and the possibility of climate change costs, we note that additional revenue measures will be needed to maintain long term fiscal sustainability. New tax measures should, however, be calibrated with an awareness of the impacts on Hong Kong's competitiveness as a global financial hub alongside the need to reduce inequality. Staff views are welcome.

Inequality: While we commend Hong Kong SAR's exemplary economic governance record which has ensured the adequacy of buffers and enabled it to weather large shocks while sustaining robust long-term performance, we note nevertheless, that equitable growth remains a challenge with about a fifth of the population living in poverty and the country's Gini coefficient possibly being the highest among advanced economies. The current social and political sentiment may be a partial reflection of this, and we encourage the authorities to focus on the effectiveness and robust targeting of measures aimed at reducing inequality and protecting and employing the poor. There is the view in some quarters that that the design of the current tax regime inadvertently enables inequality and should be reviewed. Staff comments on this are welcome. We also agree with authorities that now may not be the time to raise VAT and excise taxes and we would propose a broader

analysis of the distributional impact of the different components of the tax regime, and a tax reform strategy that takes this analysis into account, while ensuring the appropriate timing of reform measures in order to protect the vulnerable. Staff views are welcome.

Financial sector and housing: Hong Kong's sound and well-regulated financial system with strong safeguards, including robust capital and liquidity positions in the banking sector and adoption of key Basel III standards is commendable. However, as the country is a leading global financial services center, we agree with staff that additional measures are needed to safeguard financial sector resilience and stability amidst rising global financial volatility. To this end, we encourage the authorities to address vulnerabilities from high non-financial corporate debt, including concentration risks of financial institutions. In addition, the rapid rise in household debt alongside high house price overvaluation also warrants monitoring in the event new macroprudential measures as needed. In this regard, we support extending the supervisory perimeter pertinent to the housing market, to reduce regulatory arbitrage. Given housing shortages, we support the authorities' intensified efforts to close the protracted housing supply bottlenecks that have pushed prices up to unaffordable levels and exacerbated inequality. We also welcome measures to increase land supply. We note that a year has passed since the December 2018 Task Force report. Do staff see any implementation challenges? If so, views are welcome on how these might be resolved.

We welcome the implementation of key aspects of the 2014 FSAP recommendations and advances made in the supervision of fintech risk management and operational resilience. We note furthermore, the support that the rich fintech ecosystem provides for financial inclusion and are pleased that the authorities are pursuing ways to leverage this to reduce inequality. Could staff elaborate on the likely magnitude of impact (for inclusiveness) from virtual banks, and how this service will differ from mobile banking? Given the elevated global risk environment, we also encourage the closing of regulatory gaps, strengthening cyber-security risk management, and monitoring of underwriting standards. We welcome the strong performance of the country's AML/CFT framework, while we encourage the authorities to address priority actions identified in the recent Mutual Evaluation Report. Finally, we applaud the authorities' attention to green finance and addressing climate-related risks to financial stability.

With these comments, we wish the authorities continued success.

Ms. Levonian, Mr. Guerra, Ms. McKiernan, Mr. Weil and Ms. Arevalo Arroyo submitted the following joint statement:

We thank staff for the comprehensive paper and Mr. Jin and Ms. Lok for the very informative Buff statement. The authorities' commitment to prudent and sound macroeconomic policies has been reflected in their track record of building strong fiscal and reserve buffers in the past years. While sizeable buffers will be useful to counter external and domestic uncertainty, Hong Kong SAR can foster growth and remain as a competitive global financial center by addressing long-term structural challenges.

The impact of global trade tensions on Hong Kong SAR makes a strong case for the need to work multilaterally to solve trade tensions. Due to its role as a global financial center and its strong interlinkage to global value chains, Hong Kong SAR has been adversely affected by the escalation of the U.S and China trade tensions through several channels, including the close trade and business cycle link to the countries. We thank staff for the work done in Annex I, which outlines the impact of trade disputes on the economy. An easing of trade tensions, as staff rightly points out, is considered an upside risk as this would not only benefit Hong Kong SAR due to its trade links to these countries but would benefit from a global surge of confidence and investment. Given the dual impacts of trade tensions and domestic unrest, could staff provide greater clarity on the predominant driver of the slowdown in growth and how these shocks are manifesting themselves differently?

In the face of negative shocks, increased countercyclical fiscal support will be crucial to support growth and protect the most vulnerable. In line with the authorities' view to use fiscal buffers to counter the effects of economic downturns, we agree with staff that additional fiscal stimulus to boost growth, target vulnerable groups, and address structural issues including high income inequality and increasing the housing supply is warranted. We are encouraged by the fiscal measures announced by the authorities with these objectives and their commitment to stand ready to provide more near-term support if needed.

Raising revenues and diversifying its sources, along with more effective public spending, will be important for fiscal sustainability in light of structural challenges. We commend the authorities for their conservative fiscal management, which has allowed the accumulation of substantial fiscal reserves. Notwithstanding the sizeable buffers, structural challenges including high income inequality and rapid population ageing will require a substantial increase in spending. Considering a significant decrease in real estate related fiscal revenue, we believe there is scope to find viable revenue enhancing

measures while preserving competitiveness vis-à-vis other global financial centers. We take note that the authorities' plans do not include tax increases in the near future as stated in Mr. Jin and Ms. Lok's Buff. However, we recall the establishment of a Tax Policy Unit in recent years aimed at reviewing possible tax-broadening measures. Can staff comment on any developments regarding the Tax Policy Unit analysis? Moreover, we agree that the effectiveness of budget planning and execution should be improved.

The authorities' three-pronged approach to managing elevated housing market risks remains appropriate. The authorities' tight macroprudential stance is warranted given systemic risks from the housing market, and they should monitor the buildup of vulnerabilities associated with increased lending outside of regulated financial sector. Stamp duties have been effective at containing household leverage, and we support staff's assessment of the NSRD as a CFC/MPM in line with the Fund's Institutional View. We agree that the most effective way to durably reduce the housing market imbalance is by boosting housing supply including through investments in public housing, vacancy taxes, and by facilitating the supply of land for residential units. We took note of the planned twenty-fold increase in the amount of land to be resumed by the government from private owners, over the next five years, under the Lands Resumption Ordinance. Does staff have concerns that such a large increase in the use of this government instrument could negatively impact the business climate? Is there scope to streamline zoning and permitting regulations to help accelerate residential construction on the target lands?

Adequate frameworks and buffers appear to be in place to mitigate risks from increased financial linkages. Hong Kong SAR's strong regulatory framework and prudential supervision will help mitigate key risks to financial stability from a potential housing price correction, tightening of global financial conditions, or slowdown/disorderly adjustment in Mainland China. The authorities should be commended for their strong implementation of the key recommendations from the 2014 FSAP. We also welcome the steps taken to leverage financial technology to boost competition and improve financial inclusion without creating significant stability concerns, as well as the authorities' plans to address climate-related risks facing the financial sector and achieve sustainable green financing.

The Linked Exchange Rate System continues to serve Hong Kong SAR well. The credibility of the currency board arrangement will continue to be underpinned by the HKMA strong track record of communication regarding the arrangement and its FX and money market operations.

Mr. Mozhin and Mr. Shestakov submitted the following statement:

We thank staff for the informative report and Mr. Jin and Ms. Lok for their well-written Buff statement. Ongoing social unrest and escalated trade tensions took the toll on the Hong Kong SAR economy, which fell into a technical recession in the third quarter of 2019. While substantial buffers to counter the adverse shocks are in place, several structural challenges remain to be addressed, including worsening housing affordability, high income inequality, and rapid population aging.

Economic activity deteriorated in 2019 due to heightened trade uncertainty and intensified social unrest. New trade barriers and increased volatility on financial markets caused trade flowing through Hong Kong SAR to fall. Social unrest hit tourism-related sectors and adversely affected economic sentiment, with consequences for private consumption and investment decisions. Hong Kong SAR's core competitiveness and sound institutions will help to tackle both cyclical and structural challenges. We agree with staff's assessment in the RAM that ongoing retreat from multilateralism represents a high risk for the Hong Kong SAR economy, and temporary fiscal stimulus centered on vulnerable households is a timely policy to mitigate the shock.

Fiscal impulse in 2018 and 2019 was the right step to bolster economic activity, especially with a widened projected fiscal surplus over the medium term. As monetary policy is determined through a currency board arrangement, countercyclical fiscal policy should step up and support the slowing economy in the near term. Short-term measures could be aligned with long-term goals of supporting the housing market and countering demographic headwinds.

Low housing affordability makes it harder to attract talent and places a burden on households, which constrains long-run economic growth. A stress test by the Hong Kong Monetary authority confirms that sharp price correction could result in a credit loss, comparable in its magnitude with the loan losses during the AFC. Therefore, we welcome the HKMA's macroprudential measures to address financial stability risks, and would advise to tighten these measures, if housing prices start to increase rapidly again. We recognize that the land supply is a hard constraint to boosting housing supply and encourage the authorities to look for an optimal mix of measures, including public housing, transitional housing, and vacant property tax.

Income inequality remains high, even when measured post tax and transfers, and is expected to grow larger. An important driver of the rising inequality is increasing health needs of the aging population. Reduction of

inequality through greater redistribution, greater health expenditures, and public housing supply could boost economic growth in the medium term. We support staff's recommendation to prepare a long-term healthcare spending strategy. The 2018 SIP reported that as of 2016 over 10 percent of the population lived in poverty, with no downward trend in the poverty ratio. We would like to get an update on the poverty ratio numbers, and on the authorities' policies to address the poverty issue.

The currency board system has served as a good anchor for the Hong Kong SAR highly-open economy, demonstrating robustness and resilience, and remains an appropriate arrangement for Hong Kong SAR.

With these remarks, we wish the authorities all the success.

Mr. Inderbinen and Ms. Wehrle submitted the following statement:

We broadly concur with staff's assessment of the recent economic developments and prospects for Hong Kong SAR. As one of the most open economies in the world, Hong Kong SAR is particularly vulnerable to external risk factors. Over the past six months, Hong Kong's economy has been affected by local social unrest, a weakening of the global economy, and trade tensions between the US and China. We are nonetheless confident that Hong Kong SAR is well prepared to tackle both cyclical and structural challenges, thanks to a high-quality institutional framework, sound macroeconomic and prudential policies, and substantial fiscal buffers.

We agree that Hong Kong SAR's healthy fiscal position has created some leeway for supportive measures. A prudent fiscal policy on the expenditure side over the past 15 years, combined with consistent revenue over-performance, has allowed Hong Kong SAR to accumulate comfortable fiscal reserves. This provides the authorities with some flexibility to counteract the current economic downturn. We support staff's suggestion that near-term measures should focus on (i) tackling the high-income inequality, (ii) addressing the insufficient housing supply, and (iii) improving labor market competitiveness by raising education and infrastructure spending. Over the medium-term, measures should focus on the revenue side, as well as on optimizing spending. Overall, the policy response will need to be carefully calibrated in order to safeguard long-term sustainability, in particular in the face of an aging population and the prospects for higher social spending.

The Linked Exchange Rate system has continued to function well amid the currently difficult circumstances. The LERS remains underpinned by ample FX and fiscal reserves. It has proven resilient in past phases of regional

and global financial volatility, including the recent domestic events. We agree with staff that the credibility of the currency board arrangement remains strong, thanks to a transparent set of rules governing the arrangement. Overall, LERS remains an important element to support monetary and financial stability.

Despite increasing vulnerabilities, Hong Kong SAR's financial sector needs to remain open and ensure legal certainty and confidence to foreign institutions. We commend the authorities for the implementation of many of the 2014 FSAP recommendations. We welcome that the authorities have strengthened the regulatory and supervisory framework, including by implementing the key Basel III standards and fulfilling AML/CFT requirements. Hong Kong SAR's financial infrastructure is robust, and has demonstrated its ability to function smoothly in challenging conditions. We encourage the authorities to continue to further strengthen the competitiveness of the financial center, including through continued international cooperation. The build-up of expertise in the areas of fintech and green finance, as well as the positioning of Hong Kong SAR as an offshore renminbi center, will continue to provide significant potential for growth and development. Nevertheless, a close monitoring of financial stability remains important, particularly given the increased financial linkages with Mainland China. The authorities will also need to closely monitor the introduction of virtual banking, which is likely to affect the financial landscape.

Policy measures to address structural imbalances on the housing market continue to be decisive. Systemic risks in the housing market remain elevated as a result of high house price valuations and rising household debt. The rise in housing prices also represents a systemic risk to the social climate. We agree that the three-pronged approach, consisting of (i) boosting housing supply, (ii) macroprudential measures to limit stability risks, and (iii) the implementation of a stamp duty, is appropriate and should remain in place. Moreover, the authorities should closely monitor mortgage lending by non-banks, which has been growing much faster than bank mortgage lending.

Mr. Tanaka, Mr. Chikada and Mr. Nagase submitted the following statement:

We thank staff for the informative papers and Mr. Jin and Ms. Lok for their well-balanced buff statement. It is encouraging to see that the Hong Kong SAR's robust fundamentals and sound institutions continue to underpin the resilience of the economy, and the business environment remain broadly stable notwithstanding the adverse shocks and significant uncertainties on both external and domestic fronts. However, Hong Kong SAR also faces

longstanding structural challenges, including aging population, high income and wealth inequality and severe shortages of affordable housing as highlighted in the staff report. If unaddressed appropriately, these challenges could exacerbate social discontent and divisions. Accordingly, we would like to offer following comments:

Macroeconomic Outlook

Delays in addressing the structural challenges could further deteriorate the sociopolitical situation, weaken economic activity and negatively affect the city's prominence in the long term. In this regard, staff's assumption for the growth projection that "ongoing social unrest stabilizes in the first quarter of 2020 although underlying factors persist" may sound somewhat optimistic. We would appreciate staff's elaboration on which sectors are more vulnerable to the social unrests if prolonged, and its possible spillover effects to asset prices and the financial sector.

Fiscal Policy

To address rapid population aging and high income and wealth inequality, medium-term revenue and expenditure reforms would be warranted. In the near-term, as staff recommends, certain temporary government spending increase would be needed to address the cyclical downturn and adverse external and domestic headwinds. However, what is more important and could be more pressing are the medium to long term fiscal and social security strategies.

On the expenditure side, following the staff's recommendation, a long-term healthcare spending strategy should be prepared to manage its increase.

More importantly, on the revenue side, expanding tax base and increasing tax rate would be needed to cope with the expected increase in social security spending and also to address high income and wealth inequality. On this point the staff report mentions that the authorities have no plan to increase tax rate in the immediate future, however, we encourage the authorities to embark on the consideration to conduct necessary tax reforms as soon as possible because it will likely take considerable time to implement necessary overhaul. As a possible measure to broaden tax base in light of rapid population aging and to address income and wealth inequality, we would like to hear the staff's view towards introducing inheritance tax, and pros and cons for staff's recommendation of introducing VAT.

Housing Market Reform

Supply side reforms should be accelerated to address severe shortages of affordable housing, which in turn could also mitigate social discontent. We commend the authorities for their skillful macroprudential policies and demand management policies, which have been effective to manage the speed of housing price increases and avoid sharp price corrections for more than a decade. However, as staff report argues there exist large supply-demand imbalances and house price to income ratios remain well above international peers. To mitigate the structural imbalances, we concur with staff that the authorities need to accelerate supply side reforms, including more efforts to increase land allocation for residential housing. We are of the view that the supply side efforts would also help mitigate social discontent and lessen a risk of sharp adjustment in the property market.

Financial Sector

To maintain the competitiveness as a global financial center, the authorities should maintain their effort to secure financial sector resilience and financial volatility. On this point, we welcome the fact that the authorities have strengthened the regulatory and supervisory framework and key recommendations from 2014 FSAP have been implemented. In addition, we commend the good results of the Financial Action Task Force (FATF) assessment over the Hong Kong SAR's legal and institutional framework related to AML/CFT issues. We expect the authorities to continue their effort to further improve their financial sector policy, including the respond to the fintech, to secure their competitiveness.

Mr. von Kleist and Mr. Fragin submitted the following statement:

We thank staff for an insightful report and Mr. Jin and Ms. Lok for their helpful Buff statement.

We concur with the thrust of staff's assessment. Amidst rising trade tensions between the U.S. and China and recent months' social unrest, Hong Kong SAR's short-term economic outlook has become rather gloomy and growth forecasts for 2019 and 2020 were revised sharply down. Furthermore, the recent slowdown in global activity weighs on Hong Kong SAR's highly open economy. Aside from recent shocks, structural challenges such as the insufficient housing supply, high income inequality, and rapid population aging remain. Solid fiscal and prudential buffers do, however, provide room to address both cyclical and structural challenges. Moreover, Hong Kong SAR's

strong fundamentals, including the free movement of capital and information, a sound regulatory system, and rule of law, provide a robust foundation for competitiveness and growth.

In light of current headwinds for economic activity, years of prudent fiscal management resulting in fiscal reserves of about 40 percent of GDP are paying off. We take positive note of authorities' agreement on additional fiscal measures to counter the recent downturn. We acknowledge staff's case for an increase in government spending, including targeted transfers to vulnerable households and SMEs, spending on education and training, and on housing and related infrastructure developments. With respect to housing supply specifically, considering the mixed assessment of the authorities' strategy so far, more ambitious efforts in this area seem pivotal. In our view, staff rightly points to the importance of increasing land supply for residential housing.

Moreover, we would accentuate the crucial role of automatic stabilizers, as also briefly mentioned by staff, especially given the absence of monetary policy's stabilizing role under Hong Kong SAR's currency board arrangement. A prudent and sustainably-financed strengthening of expenditure-side automatic stabilizers could thus have merits. In this context, and also considering the high-income inequality, we concur with staff's suggestion to reconsider the 2018 lowering of effective personal income tax (PIT) rates, once macroeconomic conditions improve.

Given Hong Kong SAR's position as a leading global financial centre, we take positive note of the authorities' continuous efforts in establishing a strong regulatory framework and prudential supervision over the last years. We see merits in the authorities' decision to include virtual banks under the supervisory framework, taking into account the growing role of fintechs in the banking sector. Going forward, we encourage the authorities to closely monitor asset quality in this growing sector. We agree with staff that, given the subdued credit growth since the second half of 2018, the recent lowering of the countercyclical capital buffer appears warranted.

We echo staff's assessment that the Linked Exchange Rate System (LERS) continues to serve as a stability anchor. In light of Hong Kong SAR's linkage to the U.S. business cycle via its currency board arrangement whilst also being a major trading and processing hub for Mainland China, we wonder about possible repercussions of escalating trade tensions on the LERS. Staff's comments are welcome.

Last but not least, we take note that staff highlights certain sustainability issues, such as the introduction of a carbon tax, the issuance of Green Bonds for investment in environmentally-friendly projects, or the heightened relevance of Green Finance. In order to better understand staff's work on these topics in the case of Hong Kong SAR, we would welcome additional comments (including authorities' views on these policies).

Mr. Ronicle and Mr. Chrimes submitted the following statement:

We thank staff for the report and the insightful associated annexes, and Mr. Jin and Ms. Lok for their helpful buff statement. Hong Kong SAR has been a remarkable economic success story, built on openness and a robust macroeconomic policy framework. Both staff and the authorities acknowledge that economic policymakers are facing challenges on external and domestic fronts. These challenges are contributing to crystallization of some previously-identified risks in the household and corporate sectors. Underlying economic fundamentals seem mostly solid. The authorities' strong fiscal position and significant foreign exchange reserves, developed over many years, mean they are equipped with significant buffers to help steer the economy through the shocks it is now experiencing.

While we would of course welcome a return to positive GDP growth in 2020, as in staff's central projection, we agree that risks to the outlook appear tilted to the downside. The nexus of high-likelihood, high-impact risks flagged in the Risk Assessment Matrix is striking. With its openness, status as a financial center, and links to global value chains, Hong Kong SAR is particularly exposed to trade tensions through several channels, and staff's analysis shows some of the impacts this has had already. This reinforces the case for sustainably resolving trade tensions. We agree with the balanced recommendations on fiscal policy: that if growth falters more than envisaged in staff's central scenario, further near-term countercyclical fiscal support may be merited, but also that over a longer time horizon, it will be important to consider steps to ensure fiscal sustainability and deliver greater equity. Staff call for an increase in targeted spending to vulnerable households and to SMEs as an effective way of delivering fiscal stimulus. On SMEs, given measures previously announced, we would welcome more detail on how further support should be targeted, and on the potential impacts on productivity.

We welcome the inclusion of at-risk frameworks in this report. On growth-at-risk, staff refer to analysis suggesting an adverse scenario would see GDP contract "by 1.8% or more over the next four quarters under a severely adverse scenario (fifth percentage of the distribution)", looking at the impact of changes in financial conditions on growth and financial stability. We would welcome further details from staff both on their approach to

applying the GDP-at-risk framework in this specific case and any policy implications they draw from the results.

The report and annexes offer a generally positive assessment of the currency board arrangement and the external position. We are reassured that staff and the authorities agree that the Linked Exchange Rate System remains appropriate and can continue to be an anchor for stability. We agree with staff that the authorities should continue to implement policies to support it. There is also informative commentary on capital flow management measures, as well as Hibor volatility and the Hibor-Libor spread. The authorities observe that capital outflows have been limited. We would welcome more detailed insights from staff on the drivers, nature and composition of capital flows and associated risks in Hong Kong SAR.

Continuing to strengthen the robust regulatory and supervisory frameworks for the financial sector will be crucial to maintain resilience. We are pleased to read that key recommendations from the 2014 FSAP have been implemented, and also that the AML/CFT system is delivering good results, though we agree with staff that further progress will be important in helping to support Hong Kong SAR's reputation as a leading global financial center.

The focus on the housing market is thoughtful and we broadly support the associated recommendations on containing risks and increasing affordability – though we were interested to see staff unreservedly advocate moving ahead the Lantau Tomorrow Vision without referencing wider environmental and cost concerns, which we trust the authorities are considering carefully: we note the sustainable development axle of the initiative, as set out in the Chief Executive's 2018 Policy Address. We welcome references to climate and environmental issues elsewhere in the report, on green finance initiatives and on policies to support climate and revenue-raising objectives. We encourage staff to build on this in future work.

Mr. de Villeroché, Mr. Rozan and Ms. Gilliot submitted the following statement:

We thank staff for their interesting set of documents and Mr. Jin and Ms. Lok for their insightful Buff statement. We concur with the thrust of staff's assessment regarding the soundness of the macroeconomic and prudential policy framework. Uncertainty is however looming overgrowth baseline projections amid risks of further escalation in trade tensions. The government's proactivity to deal with medium- and long-term challenges including demographics, income inequality and insufficient housing supply is encouraging and should be maintained to increase productivity and inclusiveness. We wish to make some additional remarks for emphasis.

Outlook and Risks

After a sharp contraction in 2019, the economy is expected to recover, even though we note the rising external risks as well as the domestic structural challenges. The materialization of the external and domestic risks identified in the Risk Assessment Matrix, some of which with a high likelihood, may impair further the optimistic baseline projections for 2020. This is indeed reflected in staff's own calculations of the growth-at-risk. Echoing the current discussion under the Comprehensive Surveillance Review, we see here a scope to look deeper into the optimism bias in article IV projections by paying more attention at risks to the baseline using the RAM and the Growth-at-Risk model. Nevertheless, we share staff assessment that thanks to its strong macroeconomic buffers, Hong Kong SAR should be in a strong position to weather these uncertainties and their materialization.

Fiscal Policy

An expansionary fiscal policy is warranted to bolster economic recovery and preserve employment while ensuring stronger fairness of the economic model of the SAR. Greater countercyclical fiscal support is all the more warranted that the country has deep buffers and a very sizable current account surplus. The comfortable level of fiscal reserves allows for higher public spending targeted toward vulnerable households and SMEs. Fiscal buffers should indeed be put to good use to upgrade education and job training, increase investment in R&D but also invest in digital innovation, especially in the banking sector which remains one of the driving engines of the economy. Medium-term fiscal measures are also needed to increase revenues and address structural challenges to come including adverse demographics. Tax relief measures should be aimed at protecting the disposal income of the poorest and most vulnerable in the first instance. Likewise, additional revenues through new taxes, higher excise taxes and increases in top Personal Income Tax bracket should be carefully designed to enhance tax progressivity. Overall, the steps highlighted in the authorities' response are positive and point to their willingness to act decidedly.

We commend the authorities for setting ambitious target to reduce carbon emissions and encourage them to pursue in this direction to reach the 2030 carbon intensity target laid out in the government's Climate Action Plan 2030+.

Housing Market

The three-pronged strategy to contain housing market pressures focusing on reducing housing supply-demand imbalances and using tight macroprudential measures and stamp duties seems adequate but more needs to be done to raise housing supply. We thank staff for the interesting and very

useful summary of property market measures and share staff's recommendations aimed at increasing spending on housing infrastructure on the fiscal side and increasing land supply and residential housing production on the supply side. However, given the limited remaining space for housing construction in the long run, a creative and sustainable management of "urban policy" will be important. The Greater Bay Area, as well as other initiatives like the launch of the transport mobile app "HKeMobility" may offer in that sense, an opportunity for Hong Kong to become an innovation hub, a high-level technological research center for AI and Fintech and smart city with full connectivity. We agree that current macroprudential stance appears appropriate and should be adjusted going forward based on evolving financial stability risks including those related to mortgage lending from non-banks like property developers. We believe phasing out the New Residential Stamp Duty (NRSD) and replacing it by non-discriminatory macroprudential measures could be contemplated without exacerbating systemic risks stemming from non-resident capital inflows.

Financial System

Hong Kong's financial system remains sound, resilient, well supervised and regulated. We command the monetary authorities for the strengthening of both regulatory and supervision frameworks including risk management of household bank loans, stock lending by brokers, resolution regime and AML-CFT system. If financial linkages with Mainland China have been strengthened, action measures to attract oversea investors to issue bonds in Hong Kong have also been implemented. Though the cross-border initiative "Bond Connect" is firstly aimed at deepening the mutual access between Mainland China and Hong Kong's capital markets, it has also reinforced the role of Hong Kong SAR as a key financial intermediary between the Mainland and the rest of the world. How does staff assess the balance between risks and opportunities of this initiative? In addition, investment opportunities for Mainland and overseas as well as international green finance investors have been developed though the Pilot Bond grant Scheme and the Green Bond Grant Scheme included in the 2018-2019 Budget. We commend the authorities for their leadership in these issues.

Digital innovation has become a new and key focus for the financial sector, reflected in the virtual banking licenses recently granted by the HKMA. We appreciate the interesting box on virtual banking which underscores the willingness of the authorities to support the diversification of the financial industry in a safe environment. In this area, digital services infrastructure robustness will be essential, and we welcome the authorities' leadership in this regard. We welcome HKMA's strategy to spur innovation and set a level playing field for new players through a coordination of standards and practices and a strong supervisory framework.

Mr. Bhalla and Ms. Indraratna submitted the following statement:

We thank the staff for the detailed report on the Article IV consultations and Mr. Jin and Ms. Lok for the informative Buff statement.

The Hong Kong economy contracted in the last two quarters of 2019 sliding into a recession hit by both external and domestic shocks. External shocks emanating from trade and technology tensions and the slowdown in the Chinese economy have adversely affected growth while social unrest and structural issues relating to the property market have had their toll on the economy. Weak private domestic consumption, a contraction in aggregate investment spending and poor export performance are contributors to the dismal economic performance. However, the significant domestic and external buffers built up over the years due to the strong track record in macroeconomic management, trade related links to mainland China and Hong Kong's role as a major global financial center, will enable Hong Kong SAR to withstand pressures arising from the deterioration in the economic environment. We broadly agree with the staff appraisal and the recommendations proposed.

We concur with the staff recommendation that countercyclical fiscal policies are needed to stabilize the economy given the sizeable output gap, weak external demand and the currency board arrangement. Hong Kong SAR has strong fiscal buffers accumulated from budgetary surpluses over the years. In this context, we welcome the staff suggestion that additional fiscal spending be channeled to vulnerable households and SMEs, the housing sector and for education and training purposes as such spending will strengthen social safety nets and improve income inequality while further enhancing the competitiveness of the economy. The Hong Kong authorities have already rolled out relief measures to support small and medium enterprises and residents. However, in the medium to long-term, we echo the views of the staff that the authorities should consider measures aimed at raising revenue, optimizing expenditure, increasing labor force participation and improving the effectiveness of the budget planning and execution process in order to ensure fiscal sustainability as future claims for pension and health care benefits from a fast aging population can put pressure on fiscal reserves. In the case of revenue raising measures, we encourage the authorities to adopt measures that would not erode the competitiveness of Hong Kong SAR as a major international financial center.

Safeguarding financial stability should be a key priority for the Hong Kong SAR authorities with heightened uncertainties in both the local and

external environments. We note that the financial sector is subject to a strong regulatory framework and prudential supervision. The resilience of the financial sector is shown by adequate buffers and sound financial soundness indicators. Going forward however, banks should monitor closely credit risks arising from a weakened economic environment on household and corporate debt. Given that a substantial portion of corporate debt is channeled to SOEs in mainland China, a slowdown in the Chinese economy or problems in its financial sector could have adverse repercussions on the Hong Kong banking system. Moreover, despite the use of macroprudential measures, Hong Kong has a high level of household debt albeit with low credit risk at present. In the event the Hong Kong economy continues to be in recession or record anemic growth, the debt servicing ability of the household sector can significantly weaken due to a reduction in household income. This in turn will have an adverse impact on the financial sector. Has the staff conducted any sensitivity analysis to examine the impact of a reduction in household income on debt service ability? We are also encouraged to see the proactive engagement of the authorities on fintech matters in the banking sector with increased supervision of technology risk management and operational resilience. We also note the positive endorsement given by FATF on Hong Kong's solid AML/CFT framework and its ability to fight money laundering and terrorist financing activities.

We share the staff assessment that a sharp adjustment in the property market could pose a risk to the economy given the overvaluation in house prices and the rising household debt. The authorities' three-pronged approach of macroprudential, demand management and supply enhancing measures seems an appropriate strategy to contain housing market risks.

We note that the Hong Kong authorities face structural challenges such as income inequality, low female labor force participation rates and aging population. While rigid workplace policies and inadequate childcare facilities have held back younger mothers from joining the labor force in the recent past, what measures have the authorities taken to relax these constraints? Addressing these issues would improve productivity, enhance income equality while improving competitiveness and growth.

We wish the authorities success in all their future endeavors.

Mr. Kaya and Ms. Endlich submitted the following statement:

We thank staff for the informative report, and Mr. Jin and Ms. Lok for their helpful Buff statement. Following years of solid growth, Hong Kong's

economy weakened significantly in 2019 amid weaker global growth, trade tensions between the U.S. and China, and domestic unrest. The near-term outlook remains clouded due to high external and domestic risks as well as significant structural challenges related to population ageing, housing affordability, and high-income inequality. However, buffers to address cyclical and structural challenges remain strong. We broadly share staff's assessment and emphasize the following points.

Fiscal space is ample and should be used to counter the cyclical downturn. We note the continued underperformance of fiscal expenditures in the last two decades and agree with staff that fiscal space should be used to address structural challenges, especially the lack of housing supply and the high income inequality. We share staff's advice that fiscal sustainability needs to be ensured in the medium term amid rapid population aging, including by raising revenues, improving budget planning and increasing labor participation. Could staff inform on the implementation of measures to increase female labor force participation?

The Linked Exchange Rate System (LERS) has been preserving Hong Kong's stability in the past three decades. We note that Hong Kong's economic cycles and financial conditions are still to a large extent influenced by the U.S. and the global economic/financial developments, despite its strengthening financial linkages with Mainland China. We welcome that the currency board arrangement continues to function well and remains the appropriate arrangement for Hong Kong.

Housing market imbalances warrant close and continued attention. We support the authorities' ongoing three-pronged approach to containing housing market risks and call for the steadfast implementation of the planned measures to increase housing supply. We note that demand-side macroprudential measures have so far been effective in limiting banks' exposure to the housing boom. We note that the authorities responded to the fast growth of mortgage financing by property developers through introducing supply-side macroprudential measures. We call for continued close and system-wide monitoring of mortgage related lending within or outside the regulatory perimeter and for timely tightening of measures if risks increase.

The financial sector remains resilient and sound with ample buffers, but vigilance is needed as pockets of vulnerabilities exist. We note that the key recommendations from the 2014 FSAP have been implemented and are looking forward to the results of the 2019 FSAP. Can staff inform on the focus topics of the 2019 FSAP? We take note of the deepening financial

linkages with Mainland China and call for continued monitoring especially of large exposures towards Mainland China. We see merit in limiting concentration risk in the corporate sector by introducing macroprudential measures as corporate debt levels are very high, pockets of vulnerabilities exist in certain sectors, and the economy is expected to improve only gradually. We commend the authorities for promoting financial innovation and inclusion by granting eight banking licenses to virtual banking operators and call for close monitoring of their underwriting standards, asset quality as well as AML/CFT compliance.

Mr. Mouminah, Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for the well-focused report and Mr. Jin and Ms. Lok for their helpful Buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

We take positive note that Hong Kong SAR is well-placed to withstand shocks. Thanks to the longstanding prudent policies and sizable buffers the country was able to face the current challenges from a position of strength. Indeed, the robust fundamentals and strong institutions continue to support economic resilience. This is especially important as economic activity has weakened while medium-term risks have increased significantly, including from trade and technology tensions. In this connection, the authorities should continue their efforts toward strengthening growth, including through short-term stimulus. Also, addressing medium- to long-term structural challenges, particularly, insufficient housing supply, high income inequality, and population aging is important.

We support the authorities' plan to use fiscal stimulus to take timely countercyclical fiscal measures to help support the economic recovery. Here, we take positive note of the recently introduced relief measures to cushion residents and enterprises, especially SMEs, affected by the downturn. We are also encouraged by the authorities' willingness to deploy additional fiscal measures should economic downturn further deepen. Looking ahead, medium-term fiscal challenges, including from rapid population aging, warrant consideration of additional measures to ensure fiscal sustainability and promote a more sustainable and inclusive growth. Here, we note that the authorities are not planning to deploy new taxes in the immediate future and support their views that prior public consultation is important to garner broad support.

The three-pronged approach to contain housing market risks and increase affordability remains appropriate and should continue. In this context, we welcome the authorities' efforts to ensure greater housing supply, including by increasing land allocation to residential housing, to help resolve the structural supply-demand imbalance. Also, we take note that the current macroprudential measures are deemed appropriate to address stability risks. Going forward, close monitoring of the property market developments is warranted as potential disorderly adjustment in the currently elevated price levels and rising household debt could pose a risk to the economy. We encourage the authorities to use the macroprudential policy flexibly to address any financial stability risks.

Efforts to further support financial sector resilience and safeguard financial stability should continue. Here, we are encouraged by the strong regulatory and supervisory frameworks, which have helped in building large buffers to mitigate potential shocks. We welcome the assessment that the AML/CFT framework is solid and look forward to the implementation of the priority actions identified in the Mutual Evaluation Report.

With these remarks, we wish the authorities further success.

Mr. Raghani and Mr. Diakite submitted the following statement:

We thank staff for the well-written reports and Mr. Jin and Ms. Lok for their informative Buff statement.

Hong Kong achieved over the recent years a solid growth supported by strong domestic demand and exports. However, in 2019, Hong Kong SAR's real GDP is expected to shrink markedly due to a weakening of private consumption, investment and exports induced by domestic and external shocks. In spite of this trend, economic fundamentals remain strong with ample foreign reserves, current account and fiscal surpluses and a solid net international investment position. A legacy of prudent macroeconomic policies and a very supportive business environment are helping the economy to remain resilient in the face of shocks and these achievements should contribute to the recovery expected in 2020. Nevertheless, the increasing downside risks to the outlook, stemming notably from global trade tensions, economic slowdown in Mainland China and inadequate house supply should be mitigated through macroeconomic, prudential and structural policies to strengthen Hong Kong's competitiveness and enhance potential growth. We

broadly concur with staff's policy recommendations and offer the following comments for emphasis.

The balanced budget rule has served Hong Kong well and we encourage the authorities to use their comfortable fiscal buffers to implement a countercyclical policy and address medium term challenges. We commend the authorities for their prudent fiscal policy under the balanced budget rule which has created strong buffers to withstand shocks. As a result of the prudent policy stance, Hong Kong SAR enjoys adequate fiscal space which should be used to provide stimulus in the current economic cycle as highlighted in the Buff statement. In this regard, the authorities should continue to increase expenditures related to transfers to vulnerable segments of the population, support to SMEs, infrastructure and housing spending. In the medium term, the authorities would need to upgrade the training of workers impacted by the economic slowdown and address the ageing of the population. We would welcome staff's elaboration on the macroeconomic adjustments needed to address this demographic change. Although Hong Kong SAR has sizable surpluses that should be used to this effect, it will also be important to broaden the tax base to enhance revenues, including by introducing a VAT system. These efforts together with further improvements in the efficiency of expenditures will help tackle these medium-term challenges.

In the housing sector, the high house prices are a potential source of vulnerability both for macroeconomic and financial sector stability. We encourage the authorities to continue addressing the structural constraints in the housing sector through their multipronged policy approach. This approach adequately combines supply-side measures to buttress housing growth, macroprudential measures and tax measures to address risks to the financial sector and reduce speculation. However, addressing the structural constraints in the housing sector would require increasing significantly housing supply alongside the implementation of appropriate macroprudential measures to mitigate macro financial stability risks.

The authorities are encouraged to pursue their efforts aimed at strengthening financial sector stability. In this regard, while we take positive note of the resilience of the financial sector, we encourage the authorities to remain vigilant to the risk created by the high level of private sector credit, especially the corporate sector, given the current global financial conditions. We welcome the authorities' efforts aimed at reinforcing the regulatory and supervisory framework with the implementation of critical standards under Basel III. We also see merit in the increased collaboration between regulatory

agencies to ensure better financial surveillance. We commend the authorities for their strong AML/CFT framework and encourage the implementation of measures recommended in the Mutual Evaluation Report on AML/CFT to strengthen Hong Kong SAR's position as a first-class international trade and financial hub.

With these comments, we wish the authorities of Hong Kong SAR success in their endeavors.

Mr. Fanizza and Ms. Quaglierini submitted the following statement:

We thank Mr. Jin and Ms. Lok for their helpful Buff statement and staff for a clear and well-written report. We share the staff's appraisal and underscore the importance of using fiscal buffers to counteract the economic downturn and to address structural challenges related to aging. We appreciate the analysis on housing market risks, support the multi-pronged policy strategy, and a continued monitoring of the sector. We add the following points for emphasis.

We agree with staff that a substantial counter-cyclical fiscal policy response to the recent drop-in economic activity is appropriate, given the large fiscal buffers of Hong Kong SAR and its prudent fiscal framework. We concur that the expansionary fiscal policy package should be based on targeted social transfers to vulnerable households, increasing spending on education and training, and measures to raise the supply of housing. We would like to underscore the need to address high social inequality.

We note the vulnerabilities linked to a fast aging society in the longer term that should be addressed by structural measures, in line with those indicated in paragraph 19 of the staff report. We agree with staff that taxes, including personal income taxes, VAT and excise taxes, are low in comparison with other financial centers and may provide the fiscal space to accommodate age-related costs. Additional actions on the labor market to increase the participation of the elderly are needed.

Housing market risks. Several housing-market indicators (e.g. house price-to-rent and house price-to-income ratios) point to high vulnerabilities. We welcome the three-pronged approach based on a) macro-prudential measures, b) stamp duties, and c) a larger housing supply. We underscore particularly the latter measures to address the structural imbalance between housing demand and supply, and encourage a careful monitoring of developments.

We appreciate the analysis on corporate vulnerabilities (Annex VI), given that non-financial debt levels are high by international standards. Private sector indebtedness is also high for households whose debt as a share of GDP has increased rapidly, mostly because of consumer loans.

We note staff's analysis of the soundness of the Hong Kong SAR financial sector and the ongoing strengthening of the regulatory framework. We appreciate the analysis on virtual banks and the elaborations on Fintech. The financial sector is a gateway to China's financial markets and has a relevant exposure to Mainland's firms. We share staff's suggestions to further improve the sector regulatory and supervisory framework to limit risks stemming from fintech and green finance.

Mr. Rosen, Ms. Pollard and Mr. Grohovsky submitted the following statement:

Hong Kong's economy is one of the most competitive and open in the world. However, it faces several challenges and the outlook is uncertain. So far, risks have been mitigated by Hong Kong's strong institutions and prudent macroeconomic policies. In particular, strong management of the financial sector and the exchange rate, the transparent and consistent rule of law, a high-quality regulatory framework, and flexible markets have helped Hong Kong weather an uncertain outlook. Going forward, the authorities should continue to tackle the economic challenges that arise, including by drawing down fiscal buffers, increasing land and housing supply, tightening prudential policies, and continuing to affirm the transparent and consistent rule of law.

In the past, the Fund has called for countries to "fix the roof while the sun is shining." In this spirit, the Hong Kong authorities notably built up significant fiscal and external buffers for many years. Now that the economy is entering recession, we echo staff's call to utilize countercyclical fiscal policy to help support demand, particularly as monetary policy is constrained through the currency board. We welcome staff's detailed options of short- and medium-term fiscal measures, particularly on housing and related infrastructure which is one of the most pressing issues.

On risks, we agree that the housing market is one of the largest concerns given the significant supply-demand imbalance, and that increasing supply is one of the most effective ways of tackling the issue. Strong macroprudential policies can complement these efforts and also help tackle risks from rising debt levels. Given the CFM/MPM nature of the New Residential Stamp Duty, could staff comment on the balance of risks

stemming from resident versus non-resident buyers? We also appreciated the details of how financial linkages with Mainland China have deepened in recent years but would have also welcomed more analysis on the risks from this development.

Additionally, we would have welcomed more quantitative analysis on the impact of external versus domestic factors, particularly the recent social unrest. For example, the decline in private consumption is a significant driver of the recent slowdown, and knowing the extent to which this is driven by domestic issues would have been useful. Staff elaboration on how this unrest is affecting consumption, investment, and productivity would be welcome. Furthermore, given Hong Kong's deepening ties with Mainland China, we would have welcomed more details on how the slowdown in China, including from its deleveraging campaign, is affecting Hong Kong. Finally, on trade, the report focuses on the downside risks, but we would also note potential upsides from a trade deal, including more open markets and less uncertainty.

The Acting Chair (Mr. Furusawa) made the following statement:

Economic activity in Hong Kong Special Administrative Region weakened significantly in 2019. Ongoing social unrest and trade tensions have negatively affected the economy. But, as Directors noted in their gray statements, Hong Kong SAR has ample buffers, owing to a history of sound macroeconomic and prudential policies. The authorities and Directors agree that these buffers should be used to counter the cyclical downturn and address longer-term structural challenges, such as an aging population, high income inequality, and housing affordability.

The staff representative from the Asia and Pacific Department (Mr. Kang), in response to questions and comments from Executive Directors, made the following statement:[1]

We thank Directors for their gray statements. We have provided written answers to all of the technical questions, but let me briefly summarize our answers to two of the overlapping questions that were raised in the gray statements; one on the new tax measures and the other on the ongoing social unrest.

On the new tax measures, let me just clarify two things. First, the staff did not call for an introduction of any new measures immediately. As we highlight in the report, the government has ample fiscal buffers--as of now,

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

about 40 percent of GDP--and the economy is in a downturn. So it is not the right timing for them to introduce new tax measures. However, we provided several options that the government could consider over the medium and long term to secure their fiscal sustainability. We are asking them to start a comprehensive study of those options because it takes some time to reach a broad social agreement. In particular, we are of the view that Hong Kong's specific situation should be considered very carefully because these new tax measures will have implications not only on the fiscal revenues but also on other areas, including inequality and competitiveness. We provide some details in our written answers.

The next one is the impact of social unrest. The ongoing social unrest continues to weigh on economic activity in Hong Kong, including tourism flows into Hong Kong, with a large negative impact on a few industries, including hotels, restaurants, and other tourism-related industries. However, let me assure you that the financial markets in Hong Kong remain quite resilient, including the equity market, the bond market, and FX markets. There is still little sign of any unusual capital flows out of Hong Kong, which we believe demonstrates the market confidence about Hong Kong's strong financial system and its robust regulatory framework.

As of now, we do not think that this ongoing social unrest will be any threat to Hong Kong's currency board arrangement, the Linked Exchange Rate System, both in terms of sustainability and also on the operational side.

Ms. Moreno made the following statement:

I thank staff for the report and Mr. Jin and Ms. Lok for the buff statement.

After a slowdown and then a technical recession in the third quarter of 2019, Hong Kong's recovery is projected to be slow. Medium-term risks have increased significantly; including rising protectionism, weaker-than-expected global growth, especially in Mainland China, an intensification of domestic social unrest, and a disorderly contraction of house prices. The economy has been resilient, applying a strong countercyclical fiscal policy.

On the monetary side, staff and the authorities agree that the linked exchange rate system remains appropriate and can continue to be an anchor for stability.

Downside risks are being mitigated by a set of measures, amounting to 8 percentage points of GDP spread over five years. We commend the authorities for these efforts that will have a significant stimulus effect on the economy.

We also welcome that the authorities are ready to roll out further measures, if necessary, without introducing new taxes in the immediate future. They will continue to prioritize the use of reserves and buffers, with a permanent role for automatic stabilizers.

Hong Kong faces longstanding structural challenges, including an ageing population, high income and wealth inequality, and severe shortages of affordable housing. If not addressed appropriately, they could exacerbate social discontent.

We agree with staff on the need to increase government spending in the areas of social safety nets, education and retraining, and infrastructure. This should be complemented with measures to ensure fiscal sustainability and greater equity.

The financial sector is sound, as was already mentioned, and liquidity and solvency ratios are well above international standards. Nevertheless, the financial linkages with Mainland China have deepened in recent years through linkages with banks, non-banks, capital market exposure, offshore renminbi businesses. Therefore, a significant growth slowdown or a disorderly adjustment of the financial system in Mainland China could have a large impact on Hong Kong.

Vulnerabilities in the corporate sector could be important for financial stability. Debt-at-risk could increase significantly under adverse shocks to firms' earnings and borrowing costs.

Regarding the risks in the housing market, we take positive note of the authorities' commitment to the three-pronged strategy, the fact that they do not intend to relax or withdraw any demand-side management measures at this time, and their commitment to swiftly address the housing supply-demand imbalances. We commend the authorities for remaining vigilant and willing to strengthen regulatory and supervisory frameworks.

Finally, the characteristics that support Hong Kong's competitiveness as an international financial center remain in place; namely, a transparent and simple tax system, efficient infrastructure, a sound regulatory regime, rule of law, and high-quality professional services. Moreover, the authorities are moving forward an agenda of fintech—for example, virtual banking licenses and green finance—and these things could boost long-term competitiveness. We wish them the best.

Ms. Yoe made the following statement:

We thank staff for the well-written report and helpful responses to the technical questions. We also thank Mr. Jin and Ms. Lok for the informative buff statement.

Hong Kong is facing a cyclical downturn, as it confronts the combined effects of trade tensions and social unrest. However, even amidst the gloomy economic outlook, there are bright spots.

First, Hong Kong has strong fiscal reserves to combat the downturn. The authorities have responded with a fiscal stimulus to support the economy, although we note staff's view that there is scope for further fiscal measures.

Next, we note from the staff response that Hong Kong's role as a global financial center remains unaffected, even amidst the severe economic pressures. The financial sector continues to be stable, with limited spillovers from the social unrest, thanks to the robust regulatory framework and strong capital positions of the banks.

Finally, the linked exchange rate system is underpinned by a strong and credible rules-based framework and has continued to function smoothly. Having a dependable and stable currency will help to anchor Hong Kong's stability amidst the volatility. However, Hong Kong needs to start planning for the long term. Its ageing population is set to increase; and, at the same time, the city faces structural challenges related to income inequality and housing market imbalances. With social expenditures expected to rise correspondingly, it will put greater pressure on public coffers in the long run.

It is helpful to note that staff agrees with the authorities, that now is not the right time to raise taxes; although the authorities should start studying their options, as it will take time to build broad support for tax reforms, which are almost always politically difficult.

We appreciate staff's response, that tax measures should be carefully calibrated to balance the trade-offs between growth, efficiency, competitiveness, and distributional effects. It has provided us a good flavor of the complex considerations behind how revenue mobilization and spending efficiency can be tailored to Hong Kong's context.

To support the authorities' policymaking, we think it would be useful in future staff reports to provide a further analysis of potential tax reform options and the resulting impacts on growth, competitiveness, and income inequality.

Mr. Chikada made the following statement:

We thank staff for the informative papers and the detailed answers and Mr. Jin and Ms. Lok for their well-balanced buff statement.

As well articulated in both the staff report and the buff statement, Hong Kong has strong institutional and policy frameworks and ample buffers to withstand the current external headwinds. That said, we have a somewhat more cautious view toward the ongoing social unrest. If prolonged and further exacerbated, it could not just weaken economic activity, but could have a considerable negative impact on asset prices, including real estate prices which, in turn, could pose financial stability risks. Also, in the medium to long term, Hong Kong's prominence as a global financial and business center could also be undermined.

We are of the view that one of the underlying causes of the social unrest and discontent is the high and widening income inequality, which was pointed out in the staff report. We support staff's policy recommendations on tax policies to address the issue, which would also be helpful in coping with demographic challenges.

Speaking of inequality, I would also add wealth inequality, as wealth inequality is the other side of the severe supply and demand imbalances in housing. On this front, we also welcome staff's recommendations to accelerate supply-side reforms.

Besides housing, affordable office space is also in short supply in Hong Kong. Indeed, that is one of the impediments to doing business in Hong Kong that Japanese firms point out. I know that some firms have downsized their operations in Hong Kong or have relocated to other parts of Asia because of high rent.

When I was running a Bank of Japan (BoJ) small shop in Hong Kong, I, myself, had a hard time explaining to the BoJ's budget office why the office rent was so high.

It is, to some extent, ironic that the most business-friendly city is also one of the most unaffordable places to work and live. I will refrain myself from going into urban planning issues, but I think there is some room to increase the land supply, even in places like Hong Kong.

I understand the increasing tax rates and the more interventionist supply side of real estate reforms do not fit well with Hong Kong's laissez faire business model, but these efforts would be helpful for the sustainability of Hong Kong's standing as one of the global financial and trading hubs.

With these remarks, I wish the authorities all the best for their further success.

Ms. Wehrle made the following statement:

Hong Kong is currently facing major challenges due to social unrest and a weakening of the global economy. Nonetheless, we believe that it is well equipped to overcome both the cyclical and structural challenges due to its high-quality institutional framework, sound macroeconomic and prudential policies, and highly competitive economy and financial sector.

The situation in Hong Kong shows the usefulness of having strong fiscal buffers in cases of shock. We believe that the fiscal approach chosen by the authorities strikes the right balance between supporting the most vulnerable segments of the economy and long-term sustainability, in particular, in the face of an ageing population.

We support the authorities' three-pronged approach to combat the pressing issue of housing affordability by boosting housing supply macroprudential measures to limit stability risks and the implementation of a stamp duty. We take good note that the stamp duty, while a capital flow measure, is deemed appropriate by staff and should be replaced by nondiscriminatory macroprudential measures when systemic risks subside.

We also encourage the authorities to carefully monitor the activities of non-banks, i.e. property developers in the mortgage market, and to strengthen the supply-side macroprudential measures, if needed.

Mr. Grohovsky made the following statement:

We welcome this timely discussion on Hong Kong's economy, particularly given the public attention on Hong Kong in recent months. We issued a gray statement.

Hong Kong's economy is incredibly open and competitive, and it is one of the major global financial centers. Much of this is driven by its commitment to the rule of law, sound regulatory framework, transparent institutions, and flexible markets. Ms. Moreno highlighted this quite well in her remarks. We were also glad that the report took note of these critical elements and the importance of preserving them in the future.

On the economic projections, we note that the baseline has a number of assumptions that are quite uncertain. For example, the baseline assumes that social unrest stabilizes in the first quarter of 2020 and that interest rates fall in the United States, in line with a loosening cycle. Given this uncertainty, we wonder whether staff looked at the impact across a range of scenarios. And

staff's comments on how the outlook changes under a varying set of realistic assumptions would be welcome.

On the policy responses, Hong Kong has built up considerable fiscal buffers. We welcome the call for greater countercyclical fiscal policy, particularly given that monetary policy is constrained by the currency board. We appreciated the detailed recommendations of both near-term and medium-term fiscal measures in the report, which staff alluded to at the beginning of the meeting today.

We also welcome the annex on the assessment of corporate vulnerabilities. We think this section did a good job of highlighting the increased financial linkages between Hong Kong and Mainland China, and we think these linkages should be a focus of future reports.

Mr. Alkhareif made the following statement:

I join others in thanking staff for the excellent work and Mr. Jin and Ms. Lok for their informative buff statement. We have issued a gray statement.

The longstanding prudent policies, the strong fundamentals, and the sizable buffers have helped the country face the current challenges from a position of strength. Like Mr. Grohovsky, we very much support the authorities' plan to use the fiscal stimulus, to use countercyclical fiscal policies to help weather the current economic downturn.

We also note that the authorities are not planning to deploy new taxes in the immediate future, as highlighted by the mission chief, and we appreciate this. We support the view that a public dialogue on the tax discussion will be important to gain the public's support. I would also like to echo the point raised by the mission chief, that taking inequality into account is important.

Like Ms. Moreno and Ms. Wehrle, we welcome the three-pronged approach to contain housing market risks and increase affordability. We encourage the authorities to use macroprudential policies flexibly to minimize the financial stability risks stemming from the housing market.

Finally, efforts to further support financial sector resilience should continue. We are encouraged by the strong regulatory and supervisory framework, which will help build strong buffers to weather downturns and shocks to the economy and financial sector.

We welcome the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework assessment, that it is solid.

We look forward to the implementation of the priority actions identified in the Mutual Evaluation Report.

With these remarks, we wish the authorities continued success.

Ms. Riach made the following statement:

We thank Mr. Kang and his team for the useful set of papers and Mr. Jin and Ms. Lok for the buff statement.

Hong Kong's model and approach has served it well through good times and through tougher times. It is that which has enabled economic policymakers to build up the buffers which gave them some resilience amid the challenges they are now facing.

On trade tensions, we welcome reports that a "phase one" deal between the United States and China has been agreed. This will be welcome news for the markets, but we also hope that it is the start of a process that can provide a durable resolution that will be beneficial not just for Hong Kong, Mainland China, and the United States, but also for the global economy.

We share the assessment that, to flourish sustainably in the long term, the Hong Kong economy will also need to adapt to address significant societal trends, including demographic change and high inequality. The suggestions in the paper represent a useful start, including on housing and land reform. We encourage the authorities to advance these in a proactive and sustainable manner.

Finally, we remain seriously concerned at the ongoing social unrest in Hong Kong and the recent violent clashes between protesters and the police, which are increasingly having an impact on the economy. Political dialogue is the only way to resolve the situation. It is incumbent upon all communities to engage in good faith to achieve a peaceful resolution.

With that, we wish the authorities and the people of Hong Kong all the best.

Mr. Williams made the following statement:

We thank staff for the report and the answers to our questions, as well as to Mr. Jin and Ms. Lok for their helpful buff statement.

In the July Article IV for China, staff provided two sets of recommendations, depending on assumptions around the path of trade tensions. It was an innovative approach and a most welcome one, given the risks to the outlook posed by the escalating trade tensions. Given that key

assumptions in the baseline for Hong Kong are subject to significant uncertainty, we feel that this Article IV report might have benefited from a similar scenario-based approach.

We took note of a Fitch Ratings downgrade of Hong Kong in September, which cited concerns that the ongoing unrest has damaged international perceptions, the governance system, rule of law, and have called into question the stability of the business environment. Within that context, we welcome the information this afternoon from staff that, despite this, the financial system remains resilient.

Recent events have also raised questions about the independence of the Hong Kong legal system from the party-controlled legal system in Mainland China.

With these remarks, we wish the people of Hong Kong the best.

Mr. de Villeroché made the following statement:

I will start with a question about the current level of uncertainty linked to social unrest. I would like to associate myself with the remarks of Ms. Riach. It is clearly weighing on the economy, on the outlook. It is weighing on investment confidence in the long run. Only good political dialogue will help to bring back confidence. We fear that the level of uncertainty that Hong Kong has reached could hamper the growth outlook in the short run.

Second--and in line with what Ms. Riach said, on inclusion--we think that Hong Kong has large fiscal and financial buffers which could help to support the economy in this difficult time but should be targeted to the most vulnerable households, while Hong Kong has knowingly large inequalities. Additional fiscal stimulus may be warranted to counter the effects of the economic slowdown and address structural challenges. We welcome the authorities' recent decision to roll out relief measures for small and medium-sized enterprises and residents and their willingness to be ready to do more, if need be. But we would definitely recommend the authorities to look at the social transfers.

Lastly, I would like to welcome the work done on the housing market by staff.

Ms. Indraratna made the following statement:

We thank staff for the detailed report and the Article IV consultation and Mr. Jin and Ms. Lok for the informative buff statement.

The Hong Kong economy is in a recession, hit by both external and domestic shocks. External shocks come from trade and technology tensions and the slowdown in the Chinese economy, while social unrest and structural issues have also impacted growth. However, strong fiscal buffers will help Hong Kong to withstand pressures arising from the deterioration in the economic environment. Nevertheless, given the external and domestic headwinds that Hong Kong is facing at the moment, I would like to make some observations on the financial sector.

Although we note that Hong Kong has a resilient financial sector, with a strong regulatory framework and prudential supervision, supported by adequate buffers, going forward, banks should monitor closely credit risks on household and corporate debt. Given the high level of household debt, anemic growth in the Hong Kong economy could significantly weaken the debt service ability of the household sector. Furthermore, as a substantial portion of corporate debt is channeled to SOEs in Mainland China, a slowdown in the Chinese economy could have adverse repercussions on the Hong Kong banking sector. A sharp adjustment in the property market could also pose a risk to the economy, given the overvaluation in house prices and the rising household debt.

The Hong Kong authorities must also take steps to overcome structural challenges, such as income inequality, low female labor force participation, and an ageing population. Addressing these issues would improve productivity, enhance income equality, while increasing competitiveness and growth.

With these remarks, we wish the Hong Kong authorities success in all their future endeavors.

The staff representative from the Asia and Pacific Department (Mr. Kang), in response to further questions and comments from Executive Directors, made the following additional statement:

Thank you very much for additional comments this afternoon. If I understand correctly, there was one additional question about our outlook projections and underlying assumptions.

As was noted in the report, the economy is now facing both external and domestic headwinds, and there is a large amount of uncertainty there, so we have to come to a few assumptions to make our growth projections. Even though we make a strong assumption that the ongoing protests will stabilize in the first quarter of next year, we make it clear that the underlying factors may persist for the time being. But more than that, Hong Kong is a highly open economy, so it depends quite a lot on the external environment, the external developments.

Today's announcement of a potential phase one deal between the United States and China will be another offsetting factor for the growth outlook for Hong Kong. At the same time, we have to carefully monitor the developments in global trade before we make any additional adjustment in our forecasts. If needed, we will make an additional forecast revision in the forthcoming April WEO.

Mr. Jin made the following concluding statement:

We would like to express our appreciation for the excellent work of the mission team, led by Mr. Kang. As always, the discussions between the authorities and the staff have been constructive and candid. We also thank Executive Directors for their support and insightful comments, which shall be conveyed to the authorities. I will focus my remarks on a few issues of interest to Directors.

On the economic outlook, as indicated in our buff statement, economic activity has weakened notably as a result of both external and domestic factors. Facing notable downside risks to the outlook, the authorities will continue to monitor developments closely and will take measures accordingly to safeguard macroeconomic stability. More importantly, robust fundamentals and sound institutions continue to underpin the resilience of the economy.

As recognized by staff and many Directors, a history of prudent macroeconomic policies has left Hong Kong SAR with strong buffers to tackle both cyclical and structural challenges. So far, four rounds of fiscal relief measures have already been rolled out to support the economy, the latest being a package amounting to HK$4 billion to support enterprises and employment. The authorities shall stand ready to take further measures, if and when necessary.

The financial system of Hong Kong SAR has been holding up well. Monetary and financial markets continue to function in an orderly manner. The linked exchange rate system operates smoothly, according to its design, as it has for the past 36 years. The banking system remains well capitalized and liquid. So far, no sign of volatile capital outflows from the Hong Kong dollar or the banking system is observed. The free flow of capital will continue to be guaranteed under the basic law. Hong Kong SAR's core competitiveness, as an international financial center, remains in place.

Looking forward, the authorities will step up efforts in maintaining Hong Kong SAR's competitiveness by capitalizing on the opportunities from the development of fintech, green finance, and the Greater Bay Area, which roughly encompasses the entire Pearl River Delta.

On the housing market, the authorities' three-pronged approach to contain housing market risks remains appropriate. The authorities will remain vigilant and act in a timely manner, when needed, to help ensure healthy market developments and safeguard broader economic and financial stability. The authorities remain committed to increasing the land and housing supply to address the housing imbalances. Continuous efforts are being made to increase both public and private housing, including the various support measures announced in the 2019 Policy Address of the chief executive of Hong Kong Special Administrative Region.

On tackling income inequality, the authorities are guided by the philosophy to encourage self-reliance through continuous employment, while a reasonable and sustainable social security and welfare system is in place to help those who cannot provide for themselves. A series of measures was announced in the 2019 Policy Address to further enhance the social security system, such as enhancements to employment support services and a relaxation of eligibility criteria for supplements and special grants, like rent allowances.

Finally, on publication, as in the past, the Hong Kong Special Administrative Region intends to publish this year's report. The authorities are in the process of completing the necessary internal procedures to provide formal consent to publication.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They noted that economic activity in Hong Kong SAR has deteriorated significantly on account of the global growth slowdown, U.S.-China trade tensions, and ongoing social unrest. While the balance of risks is tilted to the downside going forward, Directors agreed that Hong Kong SAR's robust policy frameworks and ample buffers will help the economy weather the challenges ahead. They welcomed the authorities' readiness to use these buffers as and when necessary.

Amid the growth slowdown and strong headwinds, Directors agreed that countercyclical fiscal support would continue to be essential. They welcomed the recently announced stimulus targeted at the most vulnerable households and small- and medium-sized enterprises. Directors recommended a comprehensive medium-term fiscal package to cope with the cyclical downturn and address longer-term structural challenges associated with housing market imbalances, population aging, and income inequality, while preserving fiscal sustainability. In light of the envisaged spending pressures, Directors encouraged the authorities to consider tax reform over the medium to long term to boost revenues and foster equity. On the expenditure side, they

saw scope for improving budget planning and execution, as well as developing a long-term healthcare spending strategy.

Directors supported the authorities' three-pronged approach to contain housing market risks and improve housing affordability, with priority given to increasing land allocation for residential housing. Noting the effectiveness of macroprudential measures, Directors concurred that any adjustment should be based on evolving financial stability risks. They encouraged the authorities to phase out the new residential stamp duty and replace it with alternative non-discriminatory macroprudential measures once systemic risks from nonresident inflows dissipate.

Directors underscored the importance of safeguarding financial stability amid rising global volatility. They commended the authorities for the progress in implementing the 2014 FSAP recommendations. Continued efforts would be needed to monitor vulnerabilities in the corporate sector, further strengthen the regulatory and supervisory framework, and facilitate innovation while managing risks. Directors noted that further development of green finance and the Greater Bay Area would help maintain Hong Kong SAR's competitiveness.

Directors observed that Hong Kong SAR's external position is broadly in line with medium-term fundamentals and desirable policies. They agreed that the Linked Exchange Rate System remains an appropriate anchor of stability. They stressed that preserving a track record of public communication would be key to the credibility of the currency board arrangement.

It is expected that the next Article IV consultation discussions with Hong Kong SAR will be held on the standard 12-month cycle.

APPROVAL: October 14, 2022

CEDA OGADA
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. *Given the dual impacts of trade tensions and domestic unrest, could staff provide greater clarity on the predominant driver of the slowdown in growth and how these shocks are manifesting themselves differently?*

- In 2019, Hong Kong SAR was adversely affected by the impact of trade tensions between China and the U.S. as well as the domestic unrest that started in the summer. The exact impact of each shock on the economy is hard to quantify given that they occurred at the same time. In staff's view, each shock likely contributed to around half to the slowdown. Trade tensions resulted in much lower trade flows through the city with exports and imports projected to contract by 6-7 percent (y/y) in 2019. Social unrest negatively impacted the tourism, restaurant and hotel sector, contributing to the projected decline in private consumption by 2.3 percent in 2019). The sharp decline in investment (projected to be more than 10 percent in 2019) can be attributed to both weak domestic sentiment due to social unrest and increased global uncertainty stemming from trade tensions.

2. *We would appreciate staff's elaboration on which sectors are more vulnerable to the social unrests if prolonged, and its possible spillover effects to asset prices and the financial sector.*

- Prolonged social unrest would likely have further negative impact on tourism, restaurant and hotel sector. Visitor arrivals have declined by about 40 percent (y/y) in August-October, hotel occupancy rates fell to 63 percent (y/y) in September, restaurant receipts declined 13.6 percent (y/y) in value in Q3, and tourism-related retail sales declined by 37 percent (y/y) on average in August-October.
- Prolonged social unrest could also negatively affect asset prices and banks' profitability and asset quality. However, the spillover effects have been limited so far given the robust regulatory framework and the strong resilience of the financial sector. Stock prices have stabilized in recent months, house prices have declined only marginally, and banks' capital and liquidity positions remain stable.

3. *We would welcome further details from staff both on their approach to applying the GDP-at-risk framework in this specific case and any policy implications they draw from the results.*

- Growth-at-risk is an exercise that looks at tail risks for growth based on the evolution of financial conditions and the current growth rate. Studies have shown that excessive and

prolonged easy financial conditions could lead to financial crisis and growth contractions over the medium term. In this context, the primary motivation to use GaR for Hong Kong SAR is to assess the impact of financial conditions on growth risks, particularly given the recent increases in household and corporate leverage. Based on current financial conditions and the technical recession, the analysis indicates that even though prolonged low growth over the next three years is a tail risk, the impact in terms of output loss could be significant, suggesting the need to address the current deep cyclical downturn with a comprehensive fiscal policy package.

4. *Staff elaboration on how this unrest is affecting consumption, investment, and productivity would be welcome.*

- See responses to Question 1 above.

Fiscal Policy

5. *Can staff comment on whether there is a need for further fiscal measures this fiscal year?*

- Given the large decline in growth in 2019 due to the effects of the China-U.S. trade tensions and domestic social unrest, staff recommend a further increase in fiscal spending by about 0.7 percentage points of GDP in FY2019/20 ending next March, focused on targeted transfers to vulnerable households and SMEs, and education and re-training initiatives for the workers affected by the growth slowdown. This increase comes in addition to measures announced by the authorities in August and October, which are already included in staff's baseline projections.
- Last week, the authorities announced another round of fiscal measures, aimed to help the SMEs and the tourism industry. These measures are estimated to cost HKD 4 billion (not including fee and rent waivers), or around 0.1 percent of GDP.

6. *However, it is not clear that they agree to staff's suggestions of fiscal spending increases of around 1½ percent of GDP per year over the next five years to fill the negative output gap, as outlined in ¶17. Staff clarification would be welcome.*

- The authorities share the view that counter-cyclical fiscal measures would help the economy navigate through negative shocks while maintaining long-term sustainability. In view of mounting economic headwinds, the government has rolled out several rounds of measures since August 2019, amounting to over HK$25 billion, to support enterprises (especially SMEs), safeguard jobs and relieve people's financial burden. These measures, together with the package of one-off relief measures worth HK$42.9 billion in the 2019/20 Budget, are estimated to lift real economic output by around 2 percent of GDP.

- During the mission, Hong Kong SAR authorities agreed with staff that further fiscal stimulus will be needed given the size of the growth decline in 2019. They noted that the government should adopt an expansionary fiscal policy to support the economy, relief people's burden and stabilize confidence through countercyclical measures. They also added that they will maintain or even increase government expenditures with a view to reducing the pressure on citizens and enterprises as long as it is financially affordable, with the exact size and the composition of the stimulus depending on their analysis of the most affected sectors to ensure that the measures are efficient and well targeted.

7. ***Could staff indicate if the authorities intend to develop a long-term healthcare spending strategy?***

- Following the announcement in the 2016 Policy Address, the government set aside HK$200 billion for the implementation of a 10-year Hospital Development Plan (HDP) to cope with the increasing demand for healthcare services from the aging population and to implement early planning for healthcare facilities. This plan includes construction of a new hospital, redevelopment/expansion of existing 11 hospitals, and construction of new community health centers.

- The government also announced in the 2018/19 Budget, the second 10-year HDP and measures to strengthen healthcare training at an estimated cost of about HK$270 billion. The authorities have tentatively included 19 projects under this second HDP, providing additional hospital beds and other additional hospital facilities that would meet the projected service demand up to 2036.

8. ***New tax measures should, however, be calibrated with an awareness of the impacts on Hong Kong's competitiveness as a global financial hub alongside the need to reduce inequality. Staff views are welcome.***

- Raising revenues will have to be carefully considered as noted in the 2017 and 2018 staff reports. Staff conducted a simple international benchmarking analysis that suggests that Hong Kong SAR has lower taxes than many, or even all, other financial center in several areas. This analysis should be complemented by a careful analysis of growth, efficiency and equality impacts. For example, taxes that affect consumption, like excises or VAT/sales tax, would have a smaller detrimental impact on firms' competitive positions, and could be considered first but could have a larger impact on the distribution of welfare given their regressive nature. Recurrent taxes on housing, although high in a cross-country context, would also be efficient and probably improve equality but could act as a detriment in attracting talented labor.

9. ***There is the view in some quarters that that the design of the current tax regime inadvertently enables inequality and should be reviewed. Staff comments on this are***

welcome. We also agree with authorities that now may not be the time to raise VAT and excise taxes and we would propose a broader analysis of the distributional impact of the different components of the tax regime, and a tax reform strategy that takes this analysis into account, while ensuring the appropriate timing of reform measures in order to protect the vulnerable. Staff views are welcome.

- Hong Kong SAR's comparative advantage lies partly in its flexible, low-tax business environment and thus potential measures need to be carefully studied. Staff agree that now is not the right time to raise VAT and excise taxes as the authorities have time to study different options and implement those in the long run. But the emergence of a structural deficit over the long term requires early thought and the authorities should start actively studying options to raise revenue in a growth-friendly given the time needed to reach a broad social agreement. Personal income taxes could be made more progressive, as the top marginal tax is still low even compared to other financial centers.

10. ***We recall the establishment of a Tax Policy Unit in recent years aimed at reviewing possible tax-broadening measures. Can staff comment on any developments regarding the Tax Policy Unit analysis?***

- The Tax Policy Unit was set up in April 2017. So far, it has assisted in implementing the two-tiered profits tax rates regime and the provision of enhanced tax deduction for research and development expenditure. Its staff has also worked with other bureaus to study tax measures in, for example, insurance and ship leasing business. Since July, the Unit has been moved under direct supervision of the Financial Secretary's Office to better support the government's work on the overall economic development of Hong Kong SAR. To staff's knowledge, a fundamental review of Hong Kong SAR's tax system or new revenue sources is still at an early stage.

11. ***As a possible measure to broaden tax base in light of rapid population aging and to address income and wealth inequality, we would like to hear the staff's view towards introducing inheritance tax, and pros and cons for staff's recommendation of introducing VAT.***

- New sources of revenues will have to be carefully considered by the authorities going forward, as noted in the staff reports of 2017 and 2018 Article IV Consultation Discussions. Staff conducted a simple international benchmarking analysis that suggests that Hong Kong SAR has lower taxes than many, or even all, other financial center in several areas. Taxes that affect consumption, like VAT (or sales tax) would have a smaller detrimental impact on firms' competitive positions, but could have a larger impact on the distribution of welfare given their regressive nature. Inheritance tax could be also considered as it would be highly progressive and could help reduce intergenerational transmission of inequality while

providing source of revenues to the government. However, the potential impact on the asset management business should also be considered together.

12. ***On SMEs, given measures previously announced, we would welcome more detail on how further support should be targeted, and on the potential impacts on productivity.***

- Further measures aimed at SMEs should support sectors most adversely affected by trade tensions and the impact of ongoing social unrest, namely tourism, restaurants, small entrepreneurs, and firms servicing the trade sector. Further reduction in fees, charges and rent payments, utility subsidies, as well as expansion of the SME loan Guarantee Fund could also be considered.
- In this context, the latest round of relief measures, which was announced in early December, include the reduction of water and sewage charges, provision of electricity subsidies, and some fee waiving measures for the tourism industry, recycling industry and securities industry.

Monetary and Exchange Rate Policies

13. ***In light of Hong Kong SAR's linkage to the U.S. business cycle via its currency board arrangement whilst also being a major trading and processing hub for Mainland China, we wonder about possible repercussions of escalating trade tensions on the LERS. Staff's comments are welcome.***

- After it was introduced in 1983, the LERS anchors the stability of Hong Kong SAR's highly-open economy with its large and globally integrated financial services industry. The currency board arrangement has anchored the city's monetary and financial stability against external shocks, including the Asian Financial Crisis and Global Financial Crisis. This credibility of the currency board arrangement has been ensured by a transparent set of rules governing the arrangement, ample fiscal and FX reserves, strong financial regulation and supervision, the flexible economy, and a prudent fiscal framework. So, staff do not see that the ongoing trade tensions would threaten the well-functioning of the LERS.
- Under a current board arrangement, compared to exchange rate adjustment for deviations between the market and fixed exchange rates, a more effective adjustment mechanism works through interest rates. Capital inflows (outflows) will lead to corresponding decreases (increases) in domestic interbank interest rates, which are also reflected in the positive (negative) forward premiums on the currency. Provided a currency board is credible, the resultant interest rate differential creates interest rate arbitrage opportunities, therefore generating offsetting capital flows. Since the three refinements in 2005 brought the HKD exchange rate regime into a narrow-band target zone (the Convertibility Zone between 7.75 and 7.85) with a currency board arrangement, the HKD exchange rate and interest rate differential dynamics have been fully consistent with this mechanism, including during the periods of increased market volatility such as the global

financial crisis and the recent monetary policy normalization of the U.S. Fed. So, staff is of the view that the rules-based nature and the credibility of the arrangement would ensure smooth functioning of the LERS amid rising financial volatility from the potential escalation of trade tensions.

14. ***We would welcome more detailed insights from staff on the drivers, nature and composition of capital flows and associated risks in Hong Kong SAR.***

- Earlier studies by staff (Select Issues Paper of the 2018 Art IV Consultation Discussions) suggest that global liquidity condition, asset market performance and growth differentials matter for cross-border capital flow. Empirical results show that easier global liquidity condition, higher domestic equity market returns and stronger growth relative to U.S. increase inflows into Hong Kong SAR. Episodes of outflows from Hong Kong SAR earlier in the year were largely driven by interest rate arbitrage activities from low Hibor relative to comparable Libor rates that made attractive borrowing in Hibor and investing the proceeds elsewhere with higher interest rates. In recent months, tighter interbank liquidity arising from quarter-end demand for cash as well as IPO activities, including from Alibaba, drove up HKD interest rates, closing the gap with USD counterparts. Higher domestic interest rates help stabilize the HKD exchange rate, trading within the convertibility range of 7.75-7.85.

Housing Sector

15. ***Staff mentions rapid price developments in the real estate sector in recent years. We would like to ask staff to what extent they consider that the low interest rate environment has contributed to this development?***

- The low interest rate environment and the housing supply shortage have been the main contributors to the house price increases in recent years. The protracted low interest rate environment has kept the HIBOR-based mortgage rates low since the global financial crisis (below 3 percent on average compared to almost 6 percent in 2006), resulting in rising demand for housing. Other factors such as increasing household formation and immigration have also contributed to the higher housing demand. Housing production also remained subdued in recent years, falling short of target by around 30 percent on average during 2015-18. These developments have led to large housing supply-demand imbalances and hence rapid house price increases in recent years.

16. ***Does staff see the need for further demand-side macroprudential measures to safeguard housing affordability?***

- Staff recommend that the demand-side macroprudential measures stand ready to adjust to address financial stability risks from housing market. If house prices and mortgage

lending start to increase rapidly again, further tightening of the macroprudential measures would be warranted, with due attention to the emerging risk of regulatory leakages.

- Staff are not recommending a further tightening of demand-side macroprudential measures at this stage for the following reasons: i) house prices have been declining in recent months amid the economic downturn; ii) Hong Kong SAR's macroprudential policies are already very tight compared to peer economies; and iii) without addressing the risk of regulatory leakages to non-bank institutions (e.g., mortgage financing by property developers), a further tightening of the macroprudential measures may not be as effective as intended.

17. ***Given housing shortages, we support the authorities' intensified efforts to close the protracted housing supply bottlenecks that have pushed prices up to unaffordable levels and exacerbated inequality. We also welcome measures to increase land supply. We note that a year has passed since the December 2018 Task Force report. Do staff see any implementation challenges? If so views are welcome on how these might be resolved.***

- The Hong Kong SAR government accepted all the recommendations in the December 2018 Report by the Task Force on Land Supply (TFLS). Since the publication of the TFLS report, the government has expedited the preparation work for brownfield development and land resumption, completed 60 percent of land re-zoning for housing development (mostly public housing), and drawn up detailed framework of the Land Sharing Pilot Scheme, among other efforts.
- Staff see implementation challenges particularly in the short to medium term. For brownfield development, the potential and pace for such development depends on whether the supporting infrastructures are in place and how to properly handle the affected brownfield operations (e.g., by helping them find alternative operating space and providing financial support). For land resumption, the government is planning to resume 400 hectares of land in the next five years compared to only 20 hectares in the last five years by invoking the Lands Resumption Ordinance (LRO). The legal constraints for the government when triggering the LRO to resume private land may prolong the process. Other factors such as environmental and transport considerations may also pose challenges to the implementation. Higher fiscal spending in public housing and infrastructure may help but justifications and principles for subsidizing these affected business operations should be carefully considered.

18. ***We took note of the planned twenty-fold increase in the amount of land to be resumed by the government from private owners, over the next five years, under the Lands Resumption Ordinance. Does staff have concerns that such a large increase in the use of this government instrument could negatively impact the business climate? Is there scope to streamline zoning and permitting regulations to help accelerate residential construction on the target lands?***

- The large increase in the land resumption expected by the government may affect the business operations on those private lands in the short term but such effects may be limited as i) a large proportion of the lands to be resumed is privately-owned agricultural lands, and ii) for the brownfield lands to be resumed, the associated improvement in infrastructure and related facilities should help business climate in the longer term.
- There is scope to streamline the zoning and permitting regulations to accelerate residential construction. Staff share the view of the Task Force on Land Supply that the government could expedite the approval process by reducing the duplicating approval procedures by different government departments and consolidating and rationalizing the standards and definitions adopted by various departments in scrutinizing the development proposals.

19. ***Has the staff conducted any sensitivity analysis to examine the impact of a reduction in household income on debt service ability?***

- A reduction in household income would lead to an increase in the household's debt-servicing ratio (DSR). Staff's rough estimates based on the HKMA's Research Memorandum titled "Understanding Household Indebtedness in Hong Kong" suggest that the decline in the median household income of about 13 percent in 1998 was associated with a roughly 6 percentage point increase in the DSR of outstanding mortgages. However, this sensitivity is only for stress periods (during the Asian Financial Crisis) and the sensitivity during normal periods could be much smaller. Staff analysis during the period after the global financial crisis suggests that a 1-percent decline in the median household income has been associated with a 0.1-ppt increase in the DSR for new mortgages.

20. ***Given the CFM/MPM nature of the New Residential Stamp Duty, could staff comment on the balance of risks stemming from resident versus nonresident buyers?***

- Staff assesses that the financial stability risks stemming from both residents and non-resident buyers are high. Staff's preliminary analysis suggests that i) housing demand from non-resident buyers has been a significant driver of house price growth in Hong Kong SAR in the past, and ii) a decline in house prices could lead to a rapid increase in the share of transactions conducted by non-residents.

- Staff assesses that as long as financial stability risks from non-resident inflows remain high, the New Residential Stamp Duty (NRSD) should remain in place. Once such risks subside, we suggest phasing out the NRSD and replacing it with alternative non-discriminatory macroprudential measures, consistent with the Fund's Institutional View on Capital Flow Management.

Financial Sector

21. ***Could staff indicate if the authorities plan to introduce sectoral macroprudential measures to limit concentration risk of financial institutions?***

- To contain property developers' mortgage lending to households, the authorities have introduced sectoral macroprudential measures for bank lending to property developers. In May 2017, the HKMA required banks to lower the financing caps for construction financing and set aside more capital for their lending to property developers that have a higher proportion of mortgage loans relative to equity.
- The authorities have not introduced sectoral macroprudential measures to contain vulnerabilities from corporate exposures, but are committed to monitoring developments and considering actions as appropriate to evolving financial market developments and risks.

22. ***We note furthermore, the support that the rich fintech ecosystem provides for financial inclusion and are pleased that the authorities are pursuing ways to leverage this to reduce inequality. Could staff elaborate on the likely magnitude of impact (for inclusiveness) from virtual banks, and how this service will differ from mobile banking?***

- The introduction of virtual banks—banks without physical branches, compared to mobile banking platforms from banks that have physical branches—has already introduced greater competition to Hong Kong SAR's banking sector, benefitting particularly small depositors and small business borrowers. For example, large retail banks have removed their minimum balance requirements and waived fees on bank accounts with small balances.
- Given the cost advantage of virtual banks (e.g. maintaining a physical branch), they could offer more competitive interest rates than traditional banks to absorb savings from small depositors. There are also incentives for virtual banks to better serve the borrowing needs of SMEs as they usually find it difficult to obtain credit from large banks. As virtual banks will leverage on their advantages in applying fintech in their operations and business models, a much wider range of banking services could become available to a greater group of borrowers. Unlike traditional banking services that typically require in-person transactions, virtual bank reduce transactions costs. Moreover, using big data, it would be more efficient for virtual banks to assess credit quality of their borrowers in determining the loan size and lending rate.

23. ***Though the cross-border initiative "Bond Connect" is firstly aimed at deepening the mutual access between Mainland China and Hong Kong's capital markets, it has also reinforced the role of Hong Kong SAR as a key financial intermediary between the Mainland and the rest of the world. How does staff assess the balance between risks and opportunities of this initiative?***

- Initiatives that fortify Hong Kong SAR's role as a financial center, both as a funding hub to Mainland corporates and a treasury and asset management center for international businesses, are beneficial to Hong Kong SAR. The Bond Connect scheme has provided international investors the opportunity to invest in onshore interbank bonds. The attendant activities, including more active presence in Hong Kong SAR to manage their RMB bond portfolios, have helped bolster Hong Kong SAR's role as a financing and investment platform for RMB-denominated assets. The viability of these businesses in Hong Kong SAR and the attractiveness of Hong Kong SAR as a capital market where international investors can freely participate in have helped Hong Kong SAR to remain one of the most active global capital markets.

24. ***Can staff inform on the focus topics of the 2019 FSAP?***

- The financial stability assessment will be structured around the three pillars (i) identifying key financial vulnerabilities and assessing the resiliency of the financial sector (bank stress testing and housing market risks) ; (ii) assessing the overall financial sector policy framework and management (focused assessments on banking, capital markets and insurance sector regulation, including special attention on fintech developments and associated risks; and (iii) examining financial sector safety nets and resolution mechanisms.

Structural Issues

25. ***Can staff discuss the impact of population ageing on labor productivity, and the need for labor market reforms?***

- Hong Kong SAR faces significant aging pressures, with the share of population aged 65 or above projected to raise from one to six currently to one in four by 2034. As noted in the 2018 Article IV Consultation Staff Report, these aging pressures are expected to lower potential GDP growth by 3/4 percentage points between 2020 and 2050 on average. To counter that trend, the authorities should consider policies aimed at raising female labor force participation, by increasing the number of childcare and after-school care facilities, including at subsidized rates and with extended operating hours and promote flexible work arrangements, as well as implement policies aimed at retaining older workers.
- Staff simulations that look at the impact of higher spending on education and training also provide a lesson on how such policies would help raise productivity (see Annex IV of the 2019 Article IV Staff Report). Increased spending on education and training to lower the

skills gap between low- and high-skilled workers would boost overall productivity by 1.75 percent, at a cost of around 0.4 percent of GDP annually over the next five years. With higher spending raising GDP over the medium term due to higher productivity and labor supply, these policies would lower fiscal reserves only by 1.1 percentage points of GDP by 2024.

26. ***To reduce inequality, staff suggests expanding programs to raise female and elderly employment and to carry out regular expenditure reviews to ensure that tackling income inequality is addressed. We would appreciate further elaboration of how income inequality is to be addressed, and whether additional education/training programs and housing supply are also called for over the longer term.***

- In addition to raising labor force participation of women and older workers, the authorities could also consider other measures to lower inequality and help increase inclusion. these include (see 2018 Article IV Staff Report):
    - increasing progressivity of the personal income tax,
    - ensuring adequate levels of spending on housing, health, education and social welfare. Spending on health and education are currently below levels of other advanced economies, in part due to the current demographic structure, but required expenditure is expected to increase due to aging pressures.
    - better targeting of existing benefits, in particular housing and education.

27. ***The 2018 SIP reported that as of 2016 over 10 percent of the population lived in poverty, with no downward trend in the poverty ratio. We would like to get an update on the poverty ratio numbers, and on the authorities' policies to address the poverty issue.***

- The latest data from the Hong Kong Poverty Situation Report 2017 indicate that the share of population living in poverty has increased slightly between 2016 and 2017, from 19.9 percent to 20.1 percent for a measure before government intervention, and from 10.4 percent to 10.5 percent for the measure after government intervention (recurrent cash and in-kind transfers).
- The authorities have several polices in place aimed to reduce poverty and promote inclusion, including the Statutory Minimum Wage, the Comprehensive Social Security Assistance Scheme, Working Family-, the Old Age Living- and the Personal Disability Allowances, transport subsidies and subsidized housing. The minimum wage was increased from May 2019 by 8.9 percent to HKD37.50 (US$4.80) an hour. In response to growth slowdown, the authorities have also introduced several measures aimed to support the most vulnerable part of the population, including providing extra one month of Comprehensive Social Security Assistance Scheme allowance and Old-Age Living Allowance, as well as transportation subsidies, student subsidies, and payment of one month of rent for all tenants in public housing. These measures are temporary, and higher spending on social welfare will likely be needed to decrease inequality and combat the effects of aging.

28. ***While rigid workplace policies and inadequate childcare facilities have held back younger mothers from joining the labor force in the recent past, what measures have the authorities taken to relax these constraints?***

- The authorities recognize that insufficient supply of childcare facilities has a negative impact on the labor force participation of women. In the 2019/20 budget, the government has allocated HKD 20 billion for the purchase of 60 properties for accommodating more than 130 welfare facilities, including day child care centers, neighborhood elderly centers, on-site pre-school rehabilitation services, etc., which are expected to benefit about 86,000 people.
- The Social Welfare Department will also introduce various enhancement measures to strengthen the after-school care program at primary school level, including addition of 2,500 full fee-waiving places, relaxation of application eligibility, increase of subsidy level, provision of extra subsidy for students with special educational needs, and streamlining of financial vetting process, etc. The enhancement measures are expected to roll out in October 2020 and benefit more than 5,700 students and their families.

29. ***Could staff inform on the implementation of measures to increase female labor force participation?***

- See responses to Question 28 above.

- Employees Retraining Board provides dedicated courses to improve the vocational skill level and employability of different social groups, including women, to assist them to enter the employment market.

30. ***In the medium term, the authorities would need to upgrade the training of workers impacted by the economic slowdown and address the ageing of the population. We would welcome staff's elaboration on the macroeconomic adjustments needed to address this demographic change.***

- Staff simulations that look at the impact of higher spending on education and training also provide a lesson on how such policies would help raise productivity (see Annex IV of the 2019 Article IV Staff Report). Increased spending on education and training to lower the skills gap between low- and high-skilled workers would boost overall productivity by 1.75 percent, at a cost of around 0.4 percent of GDP annually over the next five years. With higher spending raising GDP over the medium term due to higher productivity and labor supply, these policies would lower fiscal reserves only by 1.1 percentage points of GDP by 2024

Other

31. ***We take note that staff highlights certain sustainability issues, such as the introduction of a carbon tax, the issuance of Green Bonds for investment in***

environmentally-friendly projects, or the heightened relevance of Green Finance. In order to better understand staff's work on these topics in the case of Hong Kong SAR, we would welcome additional comments (including authorities' views on these policies).

- Currently, the Hong Kong SAR government has no plan to launch a carbon tax. Nevertheless, the authorities have put in place a number of climate change initiatives in order to achieve the goals of the Paris Agreement, which applies to the Hong Kong SAR. These include carbon intensity target of 65 to 70 percent by 2030 compared to 2005, which is equivalent to absolute reduction of 26 to 36 percent and a reduction of 3.3 to 3.8 tonnes on a per capita basis. Hong Kong SAR's carbon emissions have been decreasing since 2014.
- To promote sustainable and green finance, the HKMA has introduced three measures to encourage banks and the financial industry to factor in climate-related considerations in their business framework such as corporate governance, risk management and investment decisions. These measures include: (i) developing a common framework consisting of guiding principles for assessing the "greenness" of individual banks, and setting tangible deliverables to encourage banks meeting targets on green finance and implementation of climate-related measures, (ii) adopting investment principles with priority given to green and ESG (environmental, social and governance) asset classes in managing the investment portfolio of the Exchange Fund by the HKMA; and (iii) establishing the Centre for Green Finance under the HKMA Infrastructure Financing Facilitation Office (IFFO), serving as a platform for technical support and experience sharing to promote green developments in the banking and finance industry.
- Meanwhile, the Securities and Futures Commission (SFC), the regulator of the securities industry, has push forward its Strategic Framework for Green Finance, by enhancing listed companies' reporting of climate-related disclosure, encouraging asset managers to adopt principles of green investment, facilitating the origination of green-related investment products, and increasing investor awareness in green finance and responsible investment.
- The Government Green Bond Program was established in 2018/19 with a view to promoting the development of green finance in Hong Kong SAR by encouraging issuers to arrange financing for their green projects through our capital markets. Under this program, the government issued its first 5-year Green Bond in May 2019. The inaugural green bond attracted strong demand from global investors, with a US$4 billion order book which was more than four times the issuance size, priced at a tight spread over US Treasuries at issuance (2.555%, a spread of 32.5 basis points over 5-year US Treasuries), and has been included in several major global green bond indices.