Economic Research

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Hong Kong SAR of China: Country Risk Insights

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In a nutshell

- Hong Kong has been ranked as the world's second most competitive economy. It is an important gateway to the world's largest market, mainland China. With a competitive advantage in finance, it has very flexible goods, factor and asset markets. Economic growth remains resilient. In 2014, the economy grew 2.5%, and average growth during the first three quarters of 2015 was also 2.5%. Against a backdrop of global economic and financial uncertainties, growth volatility has been high because the economy is small and very open. Its growth momentum will likely weaken further as growth in mainland China continues to struggle. While there will be impact from tighter liquidity conditions arising from monetary policy normalisation in the United States (US), it would likely be outweighed by the benefits of a stronger US economy. The Hong Kong economy would likely remain resilient on account of its competitiveness and continued proactive and credible economic management.

- Hong Kong's track record on fiscal prudence continues to be impressive. The government had even managed to register a small surplus during the Global Financial Crisis (GFC) years (2008–2009). For FY2014/15, it achieved a primary surplus of 3.6% of gross domestic product (GDP). Thanks to sustained fiscal discipline, it has accumulated sizeable fiscal reserves. As at end-FY2014/15, fiscal reserves reached 36.1% of GDP, equivalent to about 23 months of government expenditure. While the Hong Kong government is a net creditor, Hong Kong dollar (HKD) debt instruments have been issued mostly for the purpose of banking sector liquidity management and local bond market development. As at end-FY2014/15, government debt and government-guaranteed debt stood at 0.2% and 6.9% of fiscal reserves, respectively.

- Hong Kong's external balance sheet remains strong. It continues to churn out current account (CA) surpluses, thanks largely to services exports. Risks coming from potential volatile capital flows are expected to be limited because of Hong Kong's sizeable financial buffers. As of end-June 2015, foreign exchange reserves reached USD340.8 billion. The monetary authority continues to be proactive in its supervision and regulation of the financial sector, and this should stand Hong Kong in good stead. In addition, the territory is a net creditor. As of end-2014, its net international investment position (NIIP) stood at around 284% of GDP. Meanwhile, public sector external debt is low. The general government and monetary authority had external liabilities equivalent to 0.8% and 0.1% of GDP, respectively, at end-2Q2015.

- Meanwhile, Hong Kong faces rising risks from the property market and its high exposure to mainland China. Over the past five years, negative real interest rates and strong demand from mainland China have caused Hong Kong's real estate prices to rise more than 100%. In the first seven months of 2015 alone, private property prices increased 19% year-on-year (y-o-y). Home prices have decoupled from local household earnings and price-to-income and price-to-rent ratios have reached all-time highs. There will be impact from the US Federal Reserve's interest rate hike, which will cause domestic liquidity conditions to tighten. While it is likely to lead to asset price correction, the main risk will come from a disorderly correction of property prices. As it is, the property market already has to contend with slower economic growth, rising home supply and declining purchasing power of mainlanders.

- Mainland China-related lending by authorised institutions (AI) continued to expand in 2014, rising 19.2% from HKD2,616 billion in 2013. At end-June 2015, mainland-related lending represented 15.9% of AIs' total assets compared with 15.4% at end-2014. With mainland economic growth continuing to slow, rising mainland-related lending is a concern as the debt-servicing capabilities of borrowers are expected to deteriorate. Meanwhile, Hong Kong, being a gateway between the mainland and the rest of the world, is and will continue to be affected by slower mainland growth. In fact, China is an important force driving Hong Kong's trend growth. The territory's integration into the Chinese economy means that it will be affected by economic, social and political developments on the mainland.

Table 1: Selected economic indicators

	2010	2011	2012	2013	2014
Real GDP (%)	7.1	4.9	1.5	3.1	2.5
Headline CPI inflation (%)	2.4	5.3	4.1	4.3	4.4
Underlying CPI inflation (%)*	1.7	5.3	4.7	4.0	3.5
Primary surplus (% GDP)**	4.1	3.8	3.1	1.0	3.6
Government debt (% GDP)**	0.6	0.6	0.5	0.5	0.1
Current account balance (% GDP)	7.0	5.6	1.6	1.5	1.9
Net international investment position (% GDP)	291.1	285.5	274.5	274.8	283.7
Foreign exchange reserves (USD billion)	268.7	285.4	317.4	311.2	328.5
Unemployment rate (%)	4.3	3.4	3.3	3.4	3.3

Source: Census and Statistics Department, MARC Economic Research
*Note: * After netting out the effects of government's one-off relief measures.*
*** Fiscal year runs from April to March. 2014, for example, refers to FY2014/15.*

Key Strengths

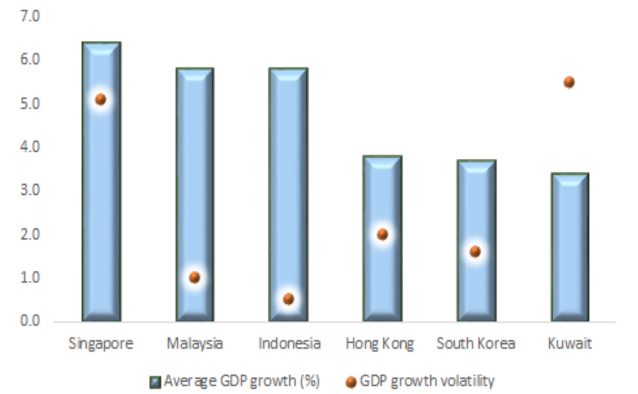
Resilient and highly competitive economy

Hong Kong, a service-based economy with a competitive advantage in finance, is an important gateway to the world's largest market, mainland China. It has very flexible goods, factor and asset markets, and has been ranked as the world's second most competitive economy. Economic growth remains resilient. In 2014, the Hong Kong economy grew 2.5%. Average growth during the first three quarters of 2015 was also 2.5%. Over the 2010-2014 period, the economy grew 3.8% per annum on average. Growth volatility has been high because of its highly open economy. In addition, it is a small economy, and as such is heavily influenced by global developments. With global economic and financial uncertainties continuing, Hong Kong faces stronger economic headwinds when compared to some of its regional neighbours with larger and less open economies.

The results of an International Monetary Fund (IMF) study show that mainland China is a more important force driving Hong Kong's trend growth, while the US is a dominant force as a driver of cyclical fluctuations. Considering the former's ongoing economic slowdown, it is not surprising that Hong Kong's GDP growth post-GFC has been on a downtrend.

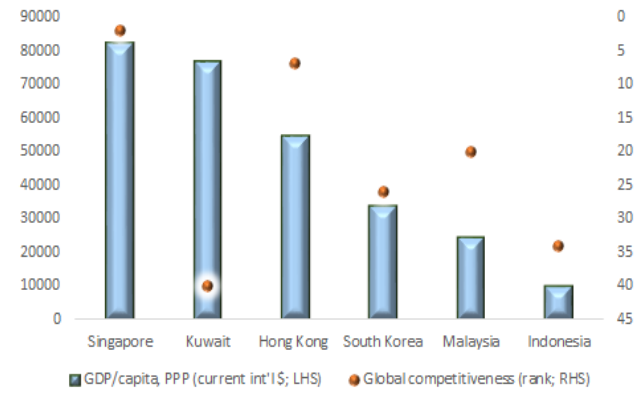
Hong Kong's growth momentum will likely weaken further as growth in mainland China continues to struggle. Going forward, uncertainties related to the US interest rate hike and the weaker spending power of inbound tourists will continue to impact domestic consumption and investment sentiment. However, MARC expects the Hong Kong economy to remain resilient on account of its competitiveness and continued proactive and credible economic management. Meanwhile, the impact of tighter liquidity conditions in Hong Kong due to monetary policy normalisation in the US would likely be outweighed by the benefits of a stronger US economy.

Chart 1: GDP growth – average and volatility (2010-2014)



Source: World Bank, IMF, MARC Economic Research

Chart 2: GDP per capita and global competitiveness



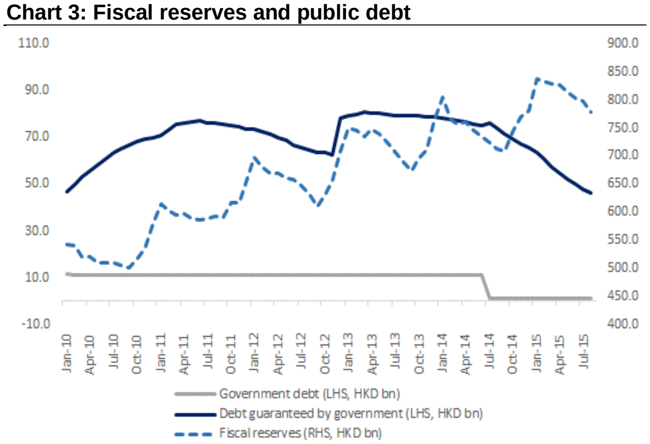
Source: World Bank, IMF, WEF, MARC Economic Research
Note: Kuwait's per capita GDP data is from 2013

Strong fiscal performance and position

Hong Kong's track record on fiscal prudence continues to be impressive, and as such it remains fiscally sustainable. Post-Asian Financial Crisis (AFC), Hong Kong has achieved significantly more years of fiscal surpluses than of deficits. The government had even managed to register a small surplus during the GFC years (2008–09). For FY2014/15, the primary surplus stood at 3.6% of GDP. Sustained fiscal discipline has led to a sizeable accumulation of fiscal reserves. As at end-FY2014/15, fiscal reserves reached a sizeable HKD828.5 billion, equivalent to 36.1% of GDP and about 23 months of government expenditure.

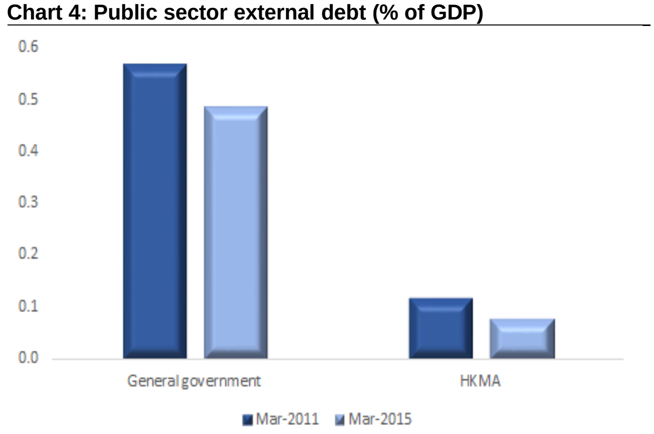
Having sizeable fiscal reserves, the Hong Kong government is a net creditor. It also has no fiscal-related debt. Debt instruments denominated in HKD, however, have been issued mostly for the purposes of banking sector liquidity management and local bond market development. As at end-FY2014/15, government debt and government-guaranteed debt stood at 0.1% and 2.5% of GDP, respectively. As a percentage of fiscal reserves, they stood at 0.2% and 6.9%, respectively. General government external debt is also negligibly small, and remains on a downtrend as a percentage of GDP. At end-FY2014/15, it stood at 0.5% of GDP. With public debt relative to GDP low, the Hong Kong government does not face any debt sustainability issues.

Chart 3: Fiscal reserves and public debt



Source: CEIC, MARC Economic Research

Chart 4: Public sector external debt (% of GDP)



Source: CEIC, MARC Economic Research

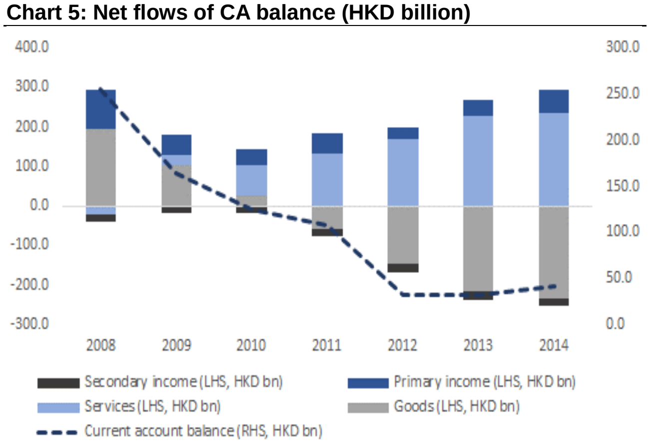
Sturdy external position

Hong Kong's CA balance remained in surplus in 2014 at HKD42.2 billion, equivalent to 1.9% of GDP. The latest data show that it recorded a surplus equivalent to 7.9% of GDP in 3Q2015, compared with a surplus equivalent to 6.0% of GDP in the same quarter last year. Services exports continue to keep Hong Kong's CA balances positive. Hong Kong's services exports-to-GDP ratio, at 36.5% in 2014, is significant by international standards.

As more than half of Hong Kong's exports (1H2015: 53.5%) end up in mainland China, slowing economic growth in the latter will have a negative economic impact on the former. However, US demand for Hong Kong's financial services exports could help cushion some of that expected impact coming from a slowdown in China. This is because US demand actually accounts for a larger share of the total compared to demand from mainland China. Data from IMF research show that in 2012, US demand accounted for 33%, whereas the mainland's share was a mere 4%.

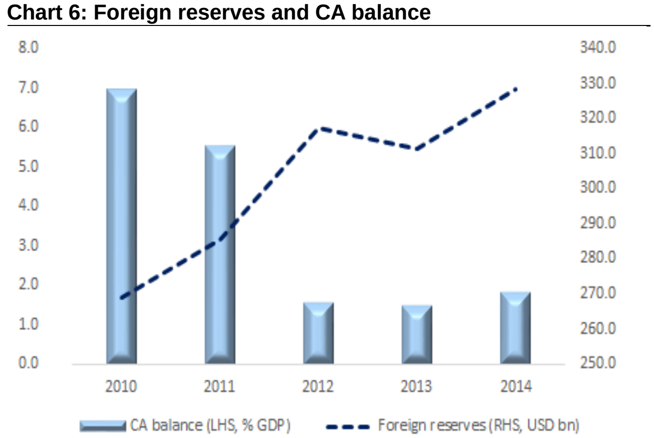
Hong Kong's persistent CA surpluses over the years have generated huge foreign exchange reserves that continue to keep its external position strong. As of end-June 2015, it reached USD340.8 billion. There should be limited risks coming from potential volatile capital flows because of the territory's sizeable buffer of financial resources, as well as the monetary authority's proactive supervision and regulation of the financial sector. Hong Kong is a net creditor. As of end-2014, its NIIP stood at around 284% of GDP. As for external debt, the general government and monetary authority had liabilities equivalent to 0.8% and 0.1% of GDP, respectively, as of end-2Q2015.

Chart 5: Net flows of CA balance (HKD billion)



Source: Census and Statistics Department, MARC Economic Research

Chart 6: Foreign reserves and CA balance



Source: HKMA, MARC Economic Research

Major Risks

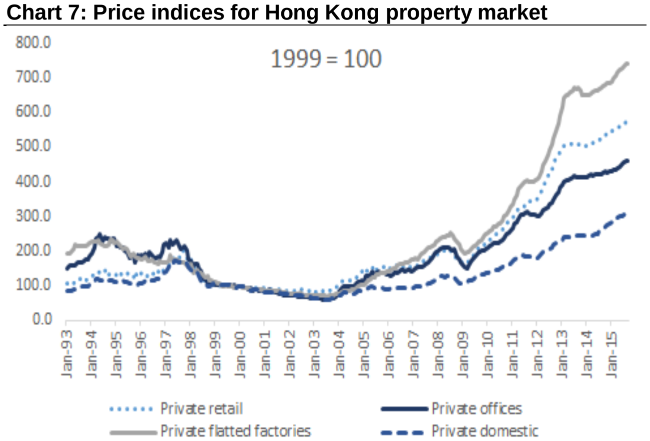
Property market risk

The property market in Hong Kong remains a large risk. Negative real interest rates and solid demand from mainland China have led to real estate prices increasing more than 100% over the past five years. And in the first seven months of 2015, private property prices rose 19% y-o-y.

The divergence in monetary policies of the major developed economies is expected to have a material impact on global fund flows and liquidity conditions. The US has started its interest rate hike cycle, and Hong Kong, having no independent monetary policy because of its currency board arrangement with the USD as an anchor currency, has followed suit. As such, domestic liquidity conditions will tighten and will likely lead to asset price correction. The main risk here comes from a disorderly correction of property prices. Hong Kong has among the worse affordability levels. Home prices have decoupled from local household earnings due to local and global investment demand pushing them higher, and price-to-income and price-to-rent ratios have reached all-time highs.

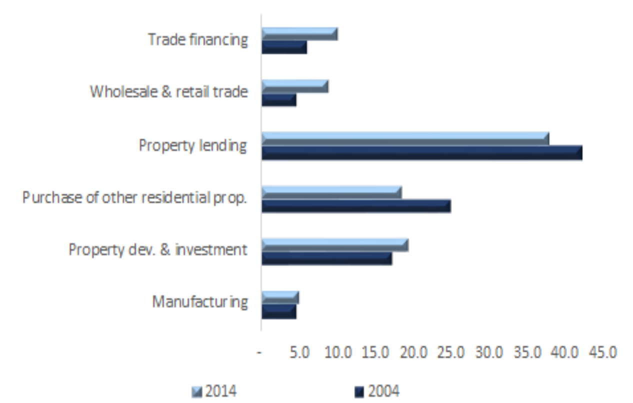
The property market has to also contend with an economic slowdown, rising home supply and declining purchasing power of mainlanders. Factors contributing toward high property prices have started diminishing, thus raising risks in the property market. There have been recent examples of both the primary and secondary markets experiencing falling prices. Notwithstanding these concerns, IMF stress tests suggest that banks should be able to absorb a significant realisation of risks.

Chart 7: Price indices for Hong Kong property market



Source: Rating & Valuation Department, MARC Economic Research

Chart 8: Domestic loans by economic sector (% of total)



Source: HKMA, MARC Economic Research

Highly exposed to mainland China

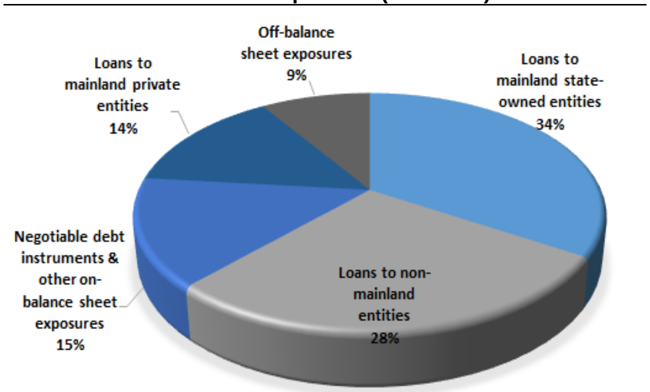
Mainland China-related lending by AIs continued to expand in 2014, rising 19.2% from HKD2,616 billion in 2013. Locally incorporated AIs have the biggest share at 40.1% of the total, while lending by their mainland-based banking subsidiaries make up 16.8%. Meanwhile, lending by overseas-incorporated AIs make up the balance of 43.1%. By type of borrower, state-owned entities are the biggest borrowers, taking up 45.9% of total mainland-related lending. Mainland private entities take up 18.1% while non-mainland entities take up the balance of 36.0%.

As at end-June 2015, mainland-related lending represented 15.9% of banks' total assets compared with 15.4% at end-2014. With mainland economic growth having already slowed significantly, rising mainland-related lending is a concern as any worsening of the Chinese economy would further impact the debt-servicing capabilities of borrowers.

Meanwhile, Hong Kong's position as a gateway between the mainland and the rest of the world also means that its economy will be affected by slower growth in the former. This is an important concern because China is a significant force driving Hong Kong's trend growth. The latter's integration into the Chinese economy means that there will be material impact from economic, social and political developments on the mainland.

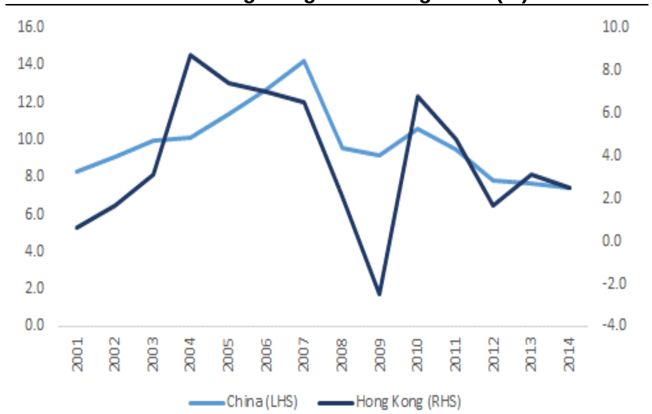
Growth momentum in China is still fading as investment and manufacturing continue to weaken due to overcapacity in certain sectors and insufficient global demand. The IMF forecasts Chinese economic growth to slow down further in 2016 to 6.3% from a 6.9% expansion in 2015. Meanwhile, the Organisation for Economic Co-operation and Development (OECD) projects China's growth to decline gradually to 6.2% by 2017. Against such a backdrop, monetary tightening would be premature for Hong Kong. However, given Hong Kong's currency board arrangement, its interest rate hike cycle, which follows that of the US, has already started.

Chart 9: Mainland-related exposures (% of total)



Source: HKMA, MARC Economic Research

Chart 10: China vs Hong Kong real GDP growth (%)



Source: World Bank, MARC Economic Research

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