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Country Risk Monitor

Hong Kong SAR of China

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In a nutshell

- Hong Kong Special Administrative Regions (SAR) of China is a relatively rich country. Its high per capita gross domestic product (GDP) reflects, among other things, strong economic fundamentals, high quality of governance and institutions, productivity, as well as international competitiveness. This makes it generally better able to withstand unexpected economic, financial and political shocks. With its integration into China, it has transformed itself into a service-based economy with a competitive advantage in finance. The International Institute for Management Development's (IMD) World Competitiveness Centre ranked it the world's most competitive economy in 2016. Notwithstanding Hong Kong's competitive and resilient economy, it faces economic, financial and political risks as a result of its exposure to the mainland. Monetary policy normalisation in the United States (US) has not helped. While studies have shown that the US is a dominant force driving Hong Kong's cyclical fluctuations, it is mainland China that drives the island territory's trend growth.

- Hong Kong's track record on fiscal prudence continues to be impressive. It has, as a result, managed to rack up a sizeable amount of fiscal reserves. It also has no fiscal-related debt. While it has issued HKD-denominated debt instruments, the debt was mostly related to banking sector liquidity management and local bond market development. Meanwhile, general government external debt stood at just HKD18.2 billion (0.8% of GDP) at end-FY2015/16. However, with the Hong Kong economy maturing against a backdrop of rising global uncertainties, there are fiscal risks ahead. Government expenditure continues to rise, notwithstanding relatively slower GDP growth in recent years. With an ageing population, the island territory could be facing a structural fiscal deficit within a decade. These are clearly concerns going forward considering that the economy is both small and very open, and the government continuing its dependence on a narrow tax base.

- Hong Kong's external balance sheet remains strong. At end-2015, its net external financial assets reached an equivalent of 316.6% of GDP. And as a result of persistent current account (CA) surpluses, it has accumulated a large amount of foreign exchange reserves (October 2016: USD383.1 billion). Hong Kong's vulnerabilities in the international investment position are therefore low on account of its large net external financial assets and foreign exchange reserves. Notwithstanding its strong external balance sheet, Hong Kong faces many sources of external vulnerability. A case in point: its status as a proxy for China's economic health has sometimes meant increased pressure on the exchange rate link (ERL) as investors make bets against the mainland. Concerns have been raised about the viability of the ERL against such a backdrop, even though it has worked well to keep Hong Kong's external position broadly in balance.

- Hong Kong faces rising risks from the property market, which has remained on an upward trend since the Global Financial Crisis (GFC). The territory's macroeconomic fundamentals – viz. real GDP per capita, real domestic credit and land supply – explain very well why it has the world's least affordable property market. In the aftermath of the GFC, property market indices rose in double digits until 2013. Since then, the pace of increase has moderated and then, from around the beginning of 2016, property prices started falling and alarms have been sounded. The interest rate upcycle could cause the property market to lose further momentum. It will also likely increase debt service ratios and cause deterioration of bank asset quality. According to the UBS Global Real Estate Bubble Index 2016 report, the Hong Kong housing market is already in bubble-risk territory, with unsustainable price-to-income and price-to-rent ratios of 18.5 and 34.0, respectively.

- Hong Kong is widely exposed to China on many fronts – economic, financial and political – as a result of integration. While it has benefitted from China's economic growth, it has also become increasingly susceptible to headwinds from across the border. For example, China's struggling trade has hurt both output and jobs in Hong Kong, with knock-on effects on consumer demand. The deep economic and financial linkages imply material risks related to mainland-related lending, especially with China facing mounting risk of excessive credit. With total mainland-related lending of Hong Kong banks standing at 15.6% of total assets as of end-June 2016, this is a concern. As it is, the classified loan ratio of mainland-related lending has already started deteriorating. On the political front, there are fears that worsening political polarisation could bog down policymaking as Beijing is unlikely to back away from confronting the pro-independence groups.

Table 1: Selected economic indicators

	2015	2014	2013	2012	2011
Real GDP growth (%)	2.4	2.7	3.1	1.5	4.9
Headline Composite CPI inflation (%)	3.0	4.4	4.3	4.1	5.3
*Underlying Composite CPI inflation (%)**	2.5	3.5	4.0	4.7	5.3
*Primary surplus (% GDP)***	0.6	3.6	1.0	3.1	3.8
*Government debt (% GDP)***	0.1	0.1	0.5	0.5	0.6
Current account balance (% of GDP)	3.1	1.3	1.5	1.6	5.6
Net international investment position (% of GDP)	316.6	298.9	274.9	274.5	285.5
Gross official reserves (USD billion)	358.8	328.5	311.2	317.4	285.4
Unemployment rate (%)	3.3	3.3	3.4	3.3	3.4

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

Key Strengths

Competitive and resilient economy

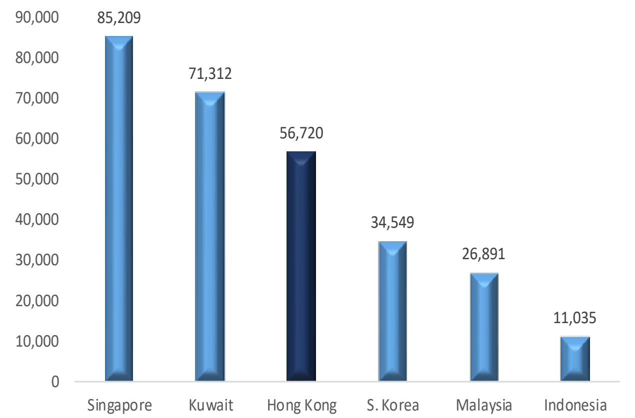
Hong Kong is a relatively rich country, with a per capita GDP on a purchasing power parity basis of 56,719.50 international dollars in 2015. Economies with high per capita GDP are generally better able to withstand unexpected economic, financial and political shocks. It reflects among other things, strong economic fundamentals, high quality of governance and institutions, productivity, as well as international competitiveness.

With its integration into the large hinterland that is China, Hong Kong has transformed itself into a service-based economy with a competitive advantage in finance. It was ranked the world's most competitive economy in 2016 by the IMD's World Competitiveness Centre. It is also highly ranked at number nine out of 138 countries in the World Economic Forum's Global Competitiveness Report 2016-2017.

Thanks to strong economic fundamentals, high quality of governance and institutions, productivity, as well as international competitiveness, the economy remains resilient. However, growth volatility has been generally high because of its small and very open economy. Over the 2011-2015 period, for example, Hong Kong's GDP growth volatility was 1.3%, compared to Malaysia's 0.5%. Private consumption, at 66% of GDP (2015), is a key driver of GDP growth as the trade sector has been affected by muted global trade.

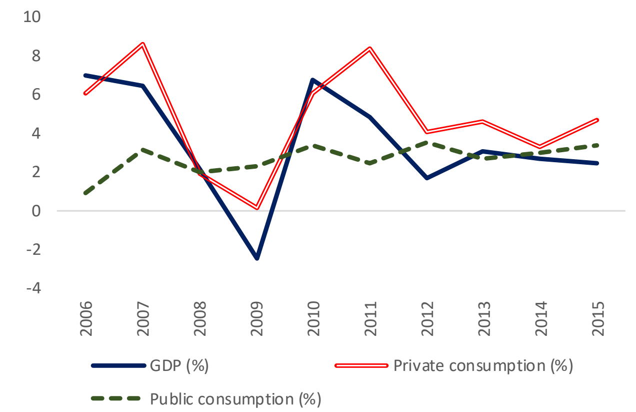
The Hong Kong economy faces a number of risks, the largest of which comes from its exposure – economic, financial, political – to mainland China, whose economy continues to struggle as it rebalances. Monetary policy normalisation in the US has not helped. A faster-than-expected US Fed interest rate hike could hurt private consumption because of the high current stock of household debt. While studies have shown that the US is a dominant force driving Hong Kong's cyclical fluctuations, it is mainland China that drives the island territory's trend growth.

Chart 1: GDP per capita (PPP, current international $, 2015)



Source: World Bank, MARC Economic Research

Chart 2: Hong Kong: GDP and selected components (% y-o-y)



Source: Census and Statistics Department, MARC Economic Research

Strong fiscal performance and position

Hong Kong has a solid fiscal position, thanks to its impressive track record on fiscal prudence. As a result of its strong fiscal performance, Hong Kong has managed to rack up a sizeable amount of fiscal reserves, an important buffer during economic downturns. The reserves are particularly important as Hong Kong has no independent monetary policy because of its ERL to the USD. At end-FY2015/16, fiscal reserves reached a sizeable HKD842.9 billion, equivalent to 34.9% of GDP.

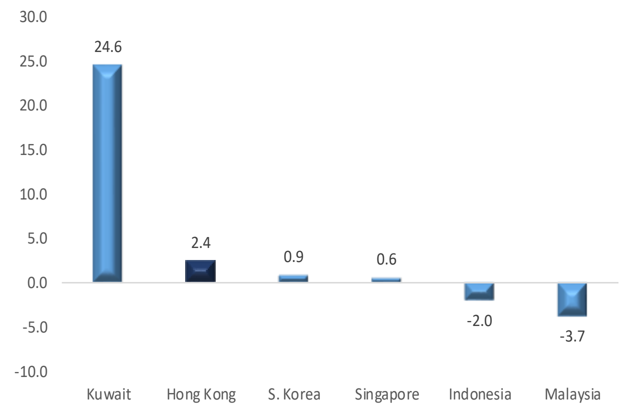
Thanks to its strong fiscal performance, the government has no fiscal-related debt. It has, however, issued HKD-denominated debt instruments mostly for the purposes of banking sector liquidity management and local bond market development. Government debt and government-guaranteed debt at end-FY2015/16 stood at 0.1% and 1.4% of GDP, respectively. General government external debt is also negligibly small. At end-FY2015/16, it stood at just HKD18.2 billion, or about 0.8% of GDP.

There are, however, new fiscal challenges ahead for the maturing Hong Kong economy, for example the island territory's ageing population. According to the results of most scenarios tested by the government, Hong Kong risks facing a structural fiscal deficit within a decade because of its ageing population.

With the Hong Kong economy being both small and very open, and the government continuing to depend on a narrow tax base, there are clearly concerns ahead. And notwithstanding relatively slower GDP growth in recent years compared to the pre-GFC years, government expenditure continues to rise.

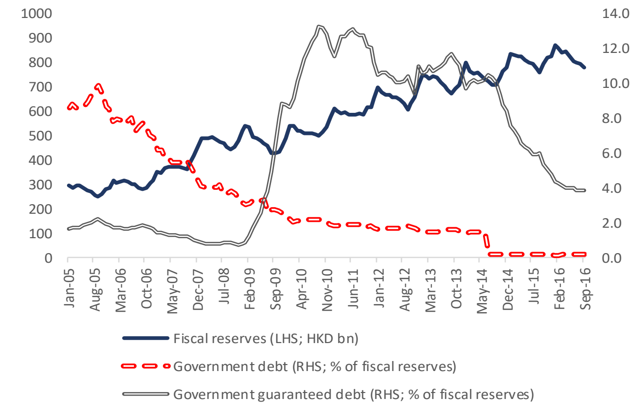
Going forward, proactive efforts to contain expenditure growth, safeguard the revenue base, save for the future and manage government assets will be key to resolving the anticipated structural deficit or to defer its onset. We see efforts aimed at striking a balance between supporting economic growth and meeting inter-generational needs become increasingly important in the years ahead.

Chart 3: Fiscal balance (% GDP; average for 2011-2015)



Source: CEIC, MARC Economic Research

Chart 4: Hong Kong: Fiscal reserves and debt



Source: CEIC, MARC Economic Research

Sturdy external position

Hong Kong has a large net external creditor position. At end-2015, its net external financial assets reached an equivalent of 316.6% of GDP. Two factors explain the large size of Hong Kong's net external financial assets: accumulated trade balance and investment income.

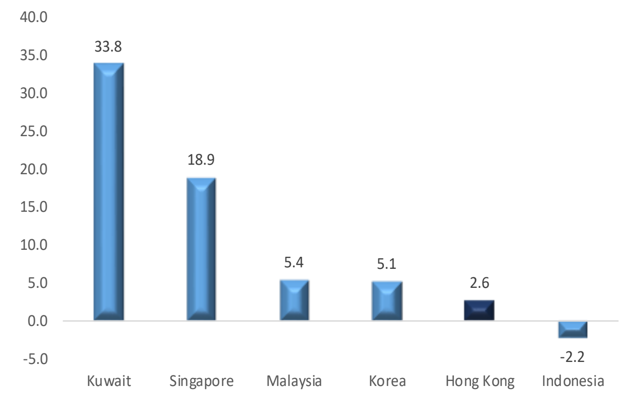
The territory has persistently churned out CA surpluses. In 2015, it registered a surplus equivalent to 3.1% of GDP (2014: 1.3%), thanks largely to the improvement of its goods balance. As a result of persistent CA surpluses, Hong Kong's accumulation of foreign exchange reserves at end-October 2016 reached USD383.1 billion. With large net external financial assets and foreign exchange reserves, Hong Kong's vulnerabilities in the international investment position are therefore low.

Hong Kong's CA surplus has likely stabilised after falling to a recent low of 1.5% of GDP in 2013. As China struggles with its economic rebalancing, it is unlikely that the territory's CA surpluses will return to the relatively high levels seen during the pre-crisis years. Rising domestic demand on account of sustained property price increases has also compressed the CA surplus. It should improve further as global demand recovers, with US demand for financial services exports providing some support.

Notwithstanding its strong external position, Hong Kong faces many sources of external vulnerability. A case in point: as it becomes more integrated into the mainland, its status as a proxy for China's economic health has sometimes meant increased pressure on the ERL as investors make bets against the mainland.

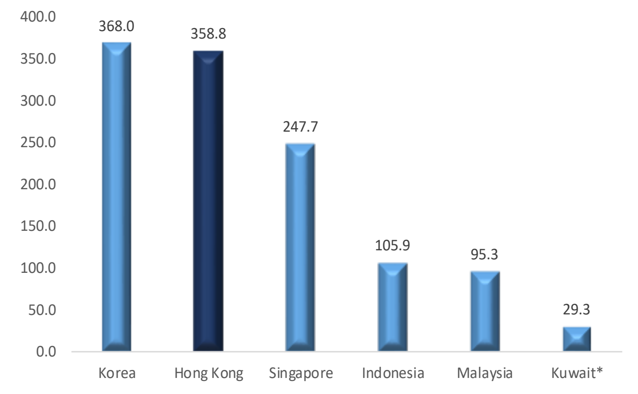
There have been concerns regarding the ERL's viability as Hong Kong integrates further into the mainland. It is important to note that the exchange rate system has worked well to keep the external position broadly in balance. As such, it is an anchor of stability for the small and very open economy with a globally integrated financial services industry. The ERL should remain safe at least over the short to medium term, thanks in part to the Hong Kong Monetary Authority's (HKMA) strong war chest of reserves.

Chart 5: CA balance (% GDP; average for 2011-2015)



Source: CEIC, MARC Economic Research

Chart 6: Foreign exchange reserves (USD billion; 2015)



Source: CEIC, MARC Economic Research
** Does not include external assets held by the Kuwait Investment Authority*

Major Risks

Rising property market risk

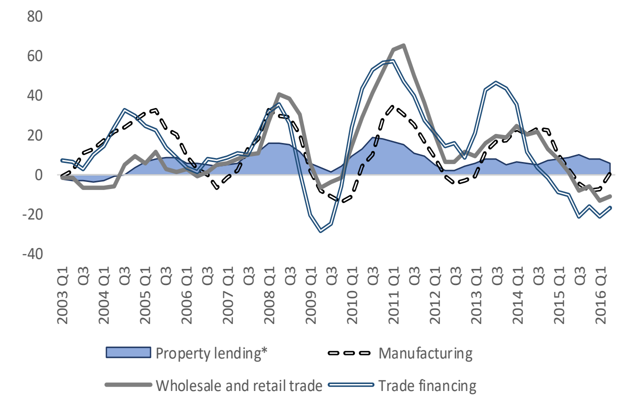
Notwithstanding occasional speed bumps, the Hong Kong property market has remained on an upward trend since the GFC. Hong Kong's macroeconomic fundamentals – viz. real GDP per capita, real domestic credit and land supply – explain very well why the territory has the world's least affordable property market. As a result of both local and global investment demand, home prices have decoupled from local household earnings.

In the immediate aftermath of the GFC, property market indices rose more than 20%. It is important to note that double digit increases in the indices had continued until 2013. Since then, the pace of property price increases had moderated, and from around the beginning of 2016, fallen into negative territory. The market correction in 2016 was somewhat significant. For example, the retail property market index fell around 10% y-o-y, while the offices property market index fell around 9% for three consecutive months in the third quarter.

While the market has not exactly fallen into bear market territory, it is nevertheless disconcerting and alarms have been sounded. A faster-than-expected US Fed interest rate hike will be bad news for the property market. The interest rate upcycle will possibly cause the property market to lose further momentum, though much will also depend on how the dynamics of the property demand-supply imbalance evolve. It will also likely increase debt service ratios and cause deterioration of bank asset quality.

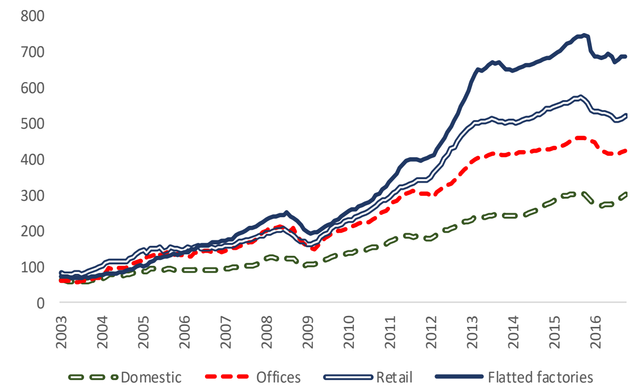
According to the UBS Global Real Estate Bubble Index 2016 report, the housing market is already in bubble-risk territory, with unsustainable price-to-income and price-to-rent ratios of 18.5 and 34.0, respectively. And with inflows of mainland money distorting the property market, a disorderly property market correction on the mainland could cause a knee-jerk reaction in Hong Kong. The small territory's integration into China has thus enhanced cross-border contagion risks.

Chart 7: Hong Kong: Loans by sector (% y-o-y)



Source: HKMA, MARC Economic Research
** Includes property development & investment and purchase of private residential properties.*

Chart 8: Hong Kong: Property price indices (1999 = 100)



Source: Rating and Valuation Department, MARC Economic Research

High exposure to mainland China

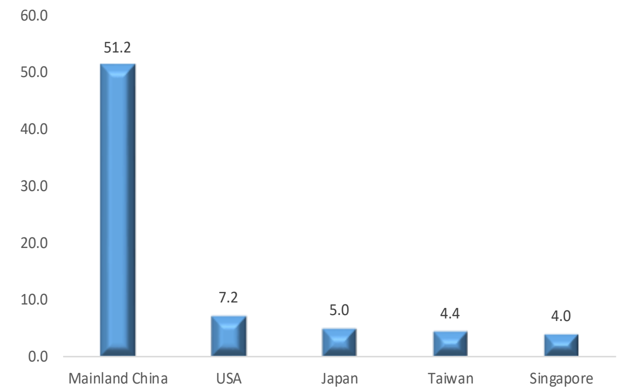
Hong Kong is widely exposed to the mainland on many fronts – economic, financial and political. Going forward, the island territory's economic fortunes will for better or for worse become even more closely tied to developments over the border. For example, an analysis of Hong Kong's and China's quarterly GDP growth data over the March 2005–December 2010 period and the March 2011–September 2016 period shows the correlation coefficient rising from +0.75 to +0.77.

There is no doubt that Hong Kong has benefitted substantially from the boom in Chinese trade. But with China's trade struggling against a backdrop of muted global trade, Hong Kong's trade performance has suffered. This has hurt both output and jobs, with knock-on effects on consumer demand. On top of that, the Chinese economy has been affected by ongoing economic rebalancing, as well as a housing inventory and debt overhang. Hong Kong's external position has also been affected, though it remains strong.

The deep economic and financial linkages imply material risks related to mainland-related lending. This is especially more so as China faces mounting risk of excessive credit, as indicated by its rising credit-to-GDP ratio. At end-June 2016, total mainland-related lending of Hong Kong banks stood at HKD3,443 billion, equivalent to 15.6% of total assets of the sector. The classified loan ratio of mainland-related lending has deteriorated. For example, the classified loan ratio of mainland-related lending of retail banks rose to 0.92% at end-June 2016, compared to 0.78% at end-December 2015

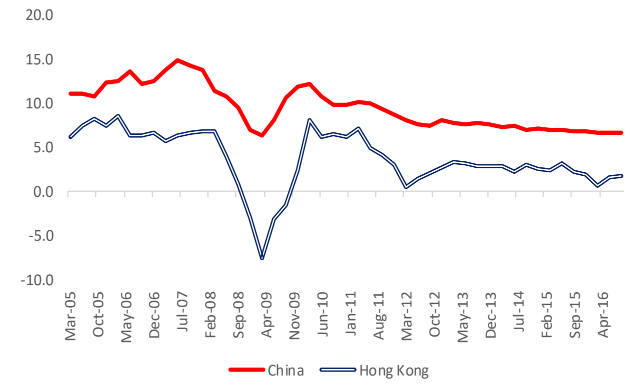
On the political front, it is unlikely that Beijing will back away from confronting the pro-independence groups. There are already fears that worsening political polarisation could bog down policymaking. On November 15, Hong Kong's High Court ruled that two pro-democracy lawmakers have been disqualified from the Legislative Council (LegCo). This means the pair would be unable to carry out their duties as legislators.

Chart 9: Hong Kong: Top 5 trading partners (% share of total trade; 2015)



Source: Trade and Industry Department, MARC Economic Research

Chart 10: Hong Kong and China: GDP growth (% y-o-y)



Source: World Bank, MARC Economic Research

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