AMRO Annual Consultation Report

Hong Kong, China - 2022

ASEAN+3 Macroeconomic Research Office (AMRO)

December 2022

Acknowledgments

1. This Annual Consultation Report on Hong Kong, China has been prepared in accordance with the functions of AMRO to monitor, assess and report on its members' macroeconomic status and financial soundness, to identify relevant risks and vulnerabilities, and to assist them in the timely formulation of policy to mitigate such risks (Article 3 (a) and (b) of the AMRO Agreement).
2. This Report is drafted on the basis of the Annual Consultation of AMRO with Hong Kong, China from 1 to 17 August 2022 (Article 5 (b) of the AMRO Agreement). The AMRO Mission team was headed by Dr Jae Young Lee, Group Head and Lead Economist. Members include Dr Fan Zhai, Senior Economist and Desk Economist for Hong Kong, China; Mr Xu (Kimi) Jiang, Economist; Mr Suan Yong Foo, Senior Economist; Dr Siang Leng Wong, Senior Financial Specialist; and Mr Chiang Yong (Edmond) Choo, Associate Economist. AMRO Director Dr Kouqing Li and Chief Economist Dr Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Hong Kong for 2022 was peer reviewed by Dr Jinho Choi, Deputy Group Head and Senior Economist; and Ms Laura Grace Gabriella, Associate Economist; and approved by Dr Hoe Ee Khor, AMRO Chief Economist.
3. The analysis in this Report is based on information available up to 23 September 2022.
4. By making any designation of or reference to a particular territory or geographical area, or by using the term "member" or "country" in this Report, AMRO does not intend to make any judgments as to the legal or other status of any territory or area.
5. On behalf of AMRO, the Mission team wishes to thank the Hong Kong, China authorities for their comments on this Report, as well as their excellent arrangements and warm engagement during our consultation.

Table of Contents

Executive Summary

1. Economic recovery in Hong Kong, China[1] was briefly interrupted by the outbreak of the fifth wave of the COVID-19 pandemic in H1 2022. GDP growth of 6.3 percent in 2021 was followed by a 2.6 percent (year-on-year) contraction in H1 2022. Soaring new infections and stringent social distancing measures weighed heavily on economic activities and sentiment in Q1 2022, while COVID-19 related regional logistical disruptions depressed exports in Q2 2022.

2. The recovery will face strong headwinds. Domestic demand rebounded in Q2 2022 on strong policy support and subsiding infections. However, the economy will continue to face strong internal and external headwinds, and the momentum of the economic recovery will in part depend on the pace of boundary control easing. GDP is expected to contract by 2.5 percent in 2022 before recovering to 4.3 percent growth in 2023.

3. Labor market conditions deteriorated in early 2022 before improving gradually in recent months. The seasonally adjusted unemployment rate increased to 5.4 percent in February-April, then slid to 4.1 percent in June-August. Total employment dropped sharply from a peak of 3.9 million in 2018 to less than 3.6 million in H1 2022 and saw signs of stabilization thereafter.

4. Inflation rose modestly, primarily due to rising import prices. Headline CPI inflation was unchanged at 1.6 percent in the first eight months of 2022, compared with 2021. After netting out all one-off government relief measures, inflation accelerated from 0.6 percent in 2021 to 1.7 percent in the first eight months of 2022. Food inflation contributed the most to the headline CPI inflation in 2022. Price pressures will likely rise, owing to a gradual pickup of the economy and a pass-through of imported inflation. Headline CPI is projected to rise by 2.0 percent in 2022 and 2.3 percent in 2023.

5. The overall external position has stayed strong, underpinned by a sizable current account surplus and ample foreign reserves. Following a robust performance in 2021, the value of Hong Kong's merchandise exports contracted by 1.0 percent (yoy) in the first seven months of 2022. Supported by its strong services and primary income surpluses, Hong Kong maintained a large current account surplus in 2021 and H1 2022. However, reflecting outflows from the HKD and the triggering of the weak-side Convertibility Undertaking (CU), foreign reserves decreased from USD497 billion at the beginning of 2022 to USD432 billion at the end of August, albeit still ample and sufficient to cover about 39 months of retained imports.

6. Domestic financial and credit conditions have tightened moderately in recent months. Credit growth moderated in 2022, mainly due to weak economic growth. The overall credit risk of banks has increased but remains contained under the prevailing COVID-19 relief measures. Volatilities in financial markets have heightened as Hong Kong dollar interest rates have been rising in tandem with U.S. interest rates. The residential property market has softened somewhat, with the various segments displaying signs of downward pressure.

7. Overall, risks have become more heightened since the turn of the year:

- The spread of new and more virulent variants of the COVID-19 virus could prolong the pandemic, slow Hong Kong's boundary reopening, and derail the economic recovery.
- A sharper-than-expected US monetary policy tightening would lead to a much tighter domestic financial condition and dampen the recovery.

[1] Hong Kong, China will be referred to as Hong Kong hereafter.

- If the U.S. and Europe were to go into recession, this could likely weaken Hong Kong's already feeble economic recovery in the short term.
- A significant slowdown of mainland China's economic growth would also derail Hong Kong's economic recovery.
- A sharp downshift in Hong Kong's property market, should it happen, would weigh on economic growth. But the likelihood of such an event is assessed to be low and the associated risks have been mitigated in part by the macroprudential measures in place.
- In the medium term, further escalation of China-U.S. tensions could dampen business and financial market sentiments, and undermine Hong Kong's role as an international financial and business center.
- Population ageing and climate change pose challenges to Hong Kong's economic growth and fiscal robustness in the long run.

8. In view of these multiple near- and medium-term risks, fiscal support for businesses and households should continue and can be more targeted to ensure that the economic recovery is sustained and broad-based. The FY2022 budget deployed timely and effective fiscal measures to support the economy while buttressing long-term growth. The support should be continued until there are clear signs of a sustained and broad-based economic recovery. At the same time, as the impacts of COVID-19 have been uneven across sectors and income inequality has been rising during the pandemic, the fiscal measures should be more targeted to support the vulnerable sectors and households.

9. The banks should continue to manage risks prudently to enhance their resilience to shocks. The high levels of Tier 1 capital and liquidity ratios for banks should be maintained. Larger banks, particularly those with loan loss reserves lower than non-performing loans, should seek to increase their provisioning to better cushion against stresses. Credit relief measures should be allowed to lapse as the economy starts to emerge from the pandemic.

10. The authorities are encouraged to strengthen fiscal buffers and the macroprudential framework to ensure long-term resilience. Looking ahead, the government should explore options to increase fiscal revenue from more stable sources to match the trend rise in spending for key areas such as health and social welfare due to aging population, as well as capital expenditures. The coordination of macroprudential policies should be enhanced to improve the soundness of the property market. A formal framework could be put together to facilitate surveillance and policy making, in particular demand-side measures, given that such policies now reside in different government agencies.

11. In the long term, Hong Kong should continue efforts to enhance its long-term growth potential, diversify economic bases and foster social inclusiveness by:

- Strengthening the social safety net and providing greater support for small and medium enterprises to promote more inclusive growth.
- Deepening integration between mainland China and the rest of the world through stronger institutional arrangements. Hong Kong's role as mainland China's super-connector could be strengthened through deeper financial linkages and Greater Bay Area collaboration.
- Continuing to nurture new growth engines in areas such as financial technology and green finance.
- Achieving high-technology aspirations by leveraging regional manufacturing prowess and Hong Kong's role as a node in the regional value chain and an intellectual property hub.

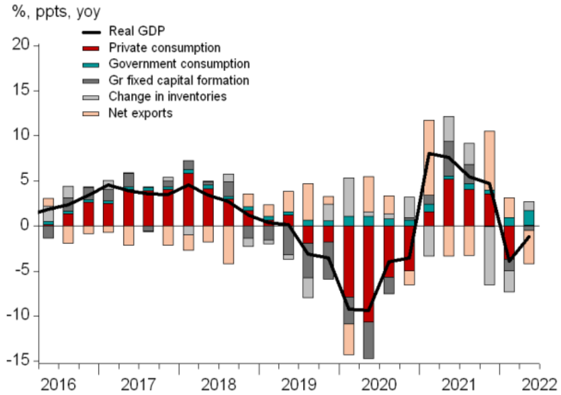
A. Recent Developments and Outlook

A.1. Real Sector Developments and Outlook

1. Hong Kong's economy rebounded markedly in 2021 from a two-year recession, underpinned by effective containment of the COVID-19 infection, solid global recovery, and strong fiscal and financial policy responses to the pandemic. Real GDP grew by 6.3 percent in 2021 with private and public consumption expanding by 5.4 percent and 4.6 percent, respectively. Fixed investment rose 9.8 percent, spurred by improved business sentiment and public investment projects. Exports and imports surged nearly 20 percent, with net exports contributing 2.1 percentage points to GDP growth.

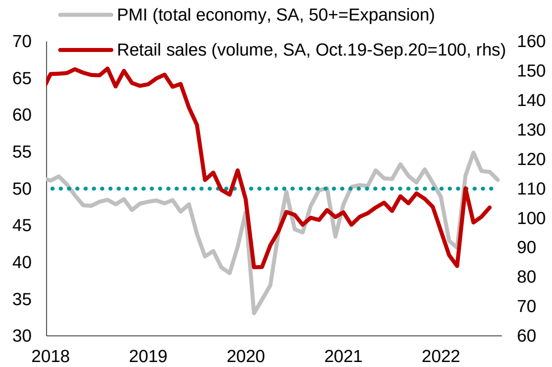
2. Although the fifth wave of COVID-19 briefly disrupted economic activity in H1 2022, a gradual recovery has been underway since the second quarter as the infections subsided. Soaring new infections and stringent social-distancing measures initially weighed heavily on economic activities and sentiment. Real GDP fell by 3.9 percent (year on year) in Q1 2022. The weakening has been severe, with pronounced contraction of all demand components except government spending (Figure 1). The COVID-related restrictions hit contact-intensive sectors hard in Q1 2022, further exacerbating the unevenness of the economic recovery. In Q2 2022, domestic demand improved on the back of strong policy support, but regional logistical disruptions related to COVID-19 depressed export activities, leading to a 1.3 percent (yoy) drop in GDP. Indicators such as retail sales and Purchasing Managers' Index (PMI) suggest that recovery in domestic demand and production might continue in Q3 2022 (Figure 2). Although the latest adjustments in late September to quarantine and testing arrangements for inbound visitors should support the travel industry, boundary controls are still largely in place. As a result, the recovery will likely be gradual and moderate.

Figure 1. GDP Growth by Expenditure (percentage point contribution)



Source: Census & Statistics Department (C&SD); Haver Analytics

Figure 2. PMI and Retail Sales



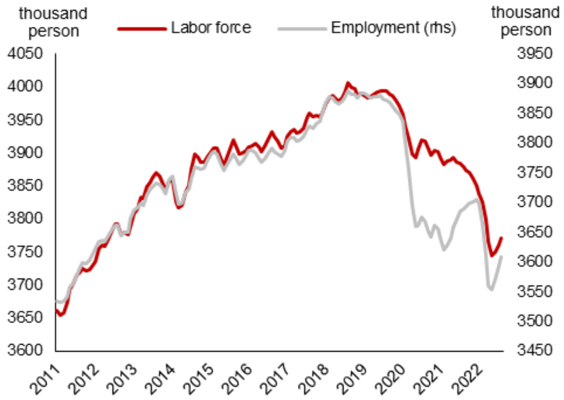
Source: C&SD; Haver Analytics

3. Labor market conditions, which had improved gradually in 2021, deteriorated in early 2022 before improving again in recent months. The seasonally adjusted unemployment rate fell to 3.9 percent in November 2021-January 2022 from a peak of 7.2 percent in December 2020-February 2021. However, the unemployment rate increased rapidly to 5.4 percent in February-April 2022, and then fell back to 4.1 percent in June – August. Total employment dropped from a peak of 3.88 million in 2018 to 3.57 million in Q2 2022, before inching up to 3.61 million in June - August. Current total employment is similar to what it was a decade ago, reflecting the combined impacts of structural factors such as population ageing and the cyclical shocks caused by the pandemic (Figure 3).

4. Inflation rose modestly, primarily due to rising import prices. Headline CPI rose by 1.6 percent in 2021, mainly due to the low base effect created by the government's sizable one-off relief measures, such as subsidies on electricity charges and public housing rental waivers. After netting out all one-off relief measures, the underlying inflation rate averaged only 0.6 percent in 2021. COVID-19 related supply chain disruptions for imported fresh foods pushed up local food prices - including both basic food as well as meals out and takeaway food - by 3.9 percent in the first eight months of 2022, contributing the most to the headline CPI inflation of 1.6 percent over the same period. Increases in unit labor costs remained subdued due to the lagged and uneven labor market recovery. The housing rental component, which accounts for 37 percent of the composite CPI basket, continued to decrease in recent quarters and helped to contain overall inflationary pressures (Figure 4).

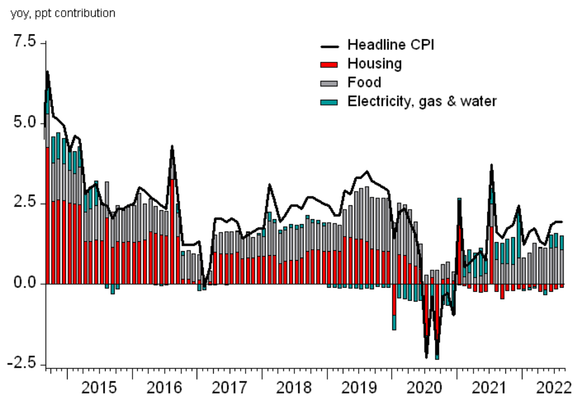
5. Overall, GDP is forecast to contract by 2.5 percent in 2022, owing to the severe fifth wave of COVID-19 and weaker global economic prospects. Following the retreat of infections, domestic demand improved somewhat on the back of strong fiscal support and easing of social-distancing curbs. However, the momentum of economic recovery in Hong Kong will depend in part on the pace of boundary control easing. Assuming that international borders fully reopen in Q4 2022, Hong Kong's economy is expected to rebound strongly by 3.9 percent in 2023, supported by further recovery of businesses, improvement of labor market conditions, and resumption of tourism activities. Price pressures are also likely to rise in the rest of 2022 and in 2023, owing to the strengthening economy and a pass-through of imported inflation. Headline inflation is forecast to rise moderately to 2.0 percent in 2022 and 2.3 percent in 2023.

Figure 3. Total Employment and Labor Force (3-month average, NSA)



Source: C&SD; Haver Analytics

Figure 4. Contribution to Headline Inflation



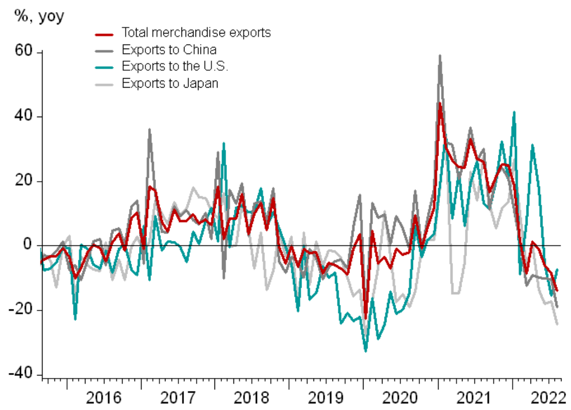
Source: C&SD; Haver Analytics; AMRO calculations

A.2. External Sector and the Balance of Payments

6. Hong Kong's external position remains strong, underpinned by sizable current account surplus and ample foreign reserves, although volatility in capital flows has heightened amid global monetary policy tightening. Following a robust performance in 2021, merchandise exports contracted by 1.0 percent in value (yoy) in the first seven months of 2022, largely reflecting the impact of COVID-19 outbreaks in Hong Kong, Shenzhen and

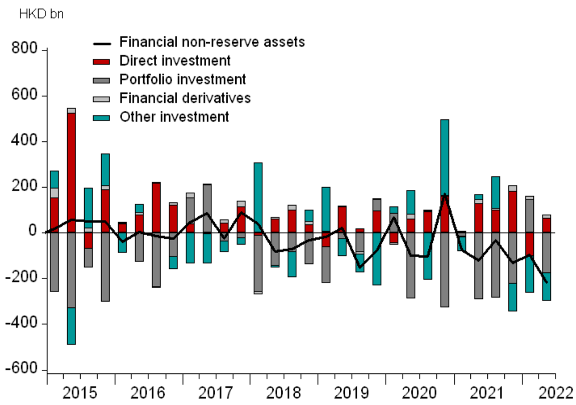
Shanghai, and regional logistical disruptions caused by the lockdown (Figure 5). Supported by its strong services and primary income surpluses, Hong Kong maintained a current account surplus in 2021 and H1 2022. On the other hand, the deficit in the financial and capital account widened significantly in 2021 as risk-off sentiment resulted in outflows of portfolio investments, part of which are attributable to residents' purchase of non-resident firms' shares listed in Hong Kong. In H1 2022, although the net outflows of portfolio investment and FDI were modest, a larger outflow of "other investment" led to expansion of the deficit in the financial and capital account (Figure 6). As a result, Hong Kong's foreign reserves decreased from USD497 billion at the beginning of 2022 to USD432 billion at the end of August.

Figure 5. Merchandise Exports by Region



Source: C&SD; Haver Analytics

Figure 6. Balance of Payment: Financial Account

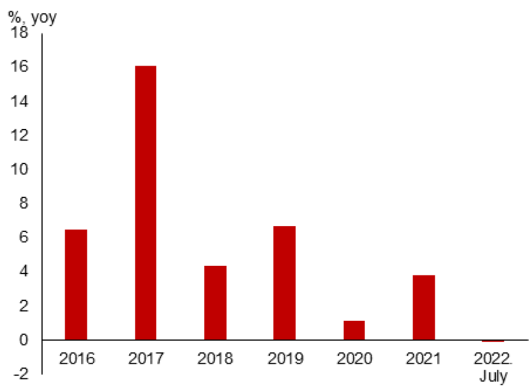


Source: C&SD; Haver Analytics

A.3. Monetary Conditions and the Financial Sector

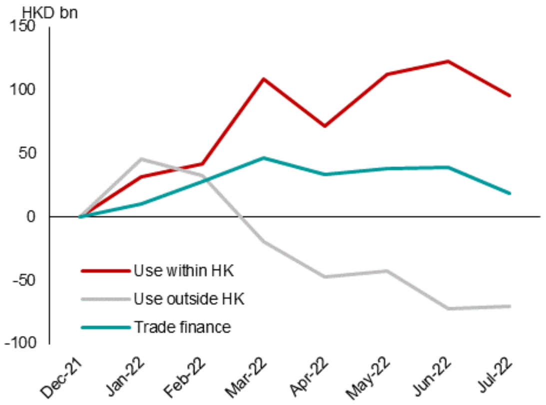
7. Credit growth moderated, mainly due to weaker economic growth. Total outstanding credit grew by 3.8 percent in 2021, after a moderate growth of 1.2 percent in 2020 (Figure 7). However, in the first seven months of 2022, credit grew only 0.4 percent from end-2021, lower than the 4.3 percent recorded in the same period in 2021, likely due to weak demand arising from the Omicron wave. The more modest credit growth was largely driven by reduced credit for use outside Hong Kong (Figure 8), which fell 2.2 percent from end-2021 to July 2022. Considering the weakness of the economy and increasingly tighter funding conditions, the moderate credit growth is expected to continue for the whole of 2022.

Figure 7. Outstanding Bank Loans



Source: Hong Kong Monetary Authority (HKMA); Haver Analytics

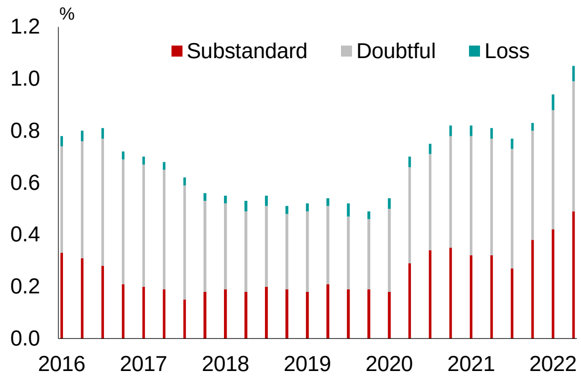
Figure 8. Accumulated Monthly Changes in Bank Loans by Use in 2022



Source: HKMA; Haver Analytics

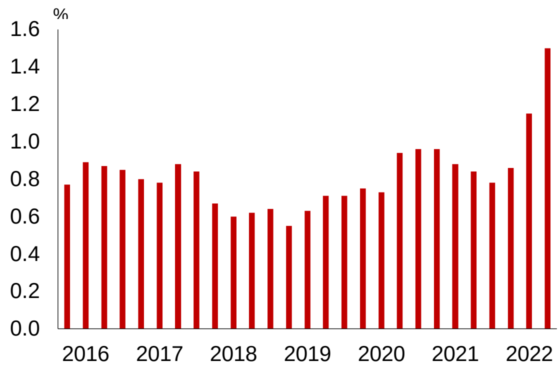
8. Banks' overall credit risk has increased but remains contained so far with COVID-19 relief measures still in place. As the negative impacts of the containment measures weigh on borrowers' repayment ability, the overall non-performing loan (NPL) ratio of the banking sector rose from 0.86 percent in Q2 2021 to 1.10 percent in Q2 2022 (Figure 9). In particular, the NPL of mainland-related loans deteriorated at a faster pace, from 0.84 percent in Q2 2021 to 1.50 percent in Q2 2022 (Figure 10). That said, the overall asset quality of Hong Kong's banking sector remains sound by historical and international standards. A suite of credit relief schemes rolled out by banks, such as a Pre-approved Principal Payment Holiday Scheme for corporates, extension of the tenor of corporate and personal loans, conversion of trade financing lines to temporary overdraft facilities, and different relief initiatives for personal customers, have helped to support corporates and individuals that faced temporary cash-flow pressures amid the pandemic. This has partly contributed to the relatively small increase in NPLs in Hong Kong banks.[2] As of May 2022, banks had granted 139,000 corporate borrowers and 92,000 individual borrowers, credit relief of about HKD1,050 billion and HKD61 billion respectively.[3]

Figure 9. NPL Ratios of Banking Sector



Source: HKMA; Haver Analytics

Figure 10. NPL Ratio of Mainland-related Loans

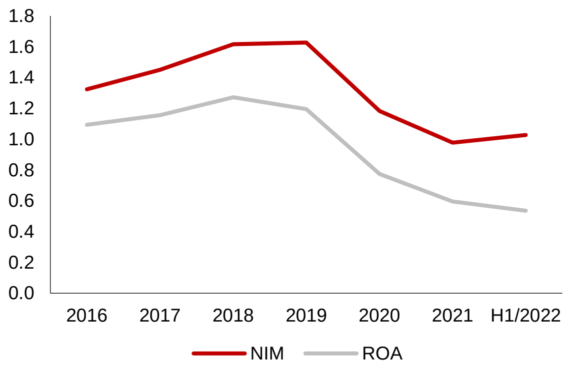


Source: HKMA; Haver Analytics

9. Banks' capital and liquidity positions remain strong, providing an ample cushion against shocks despite lower profitability. As of H1 2022, the banking sector's return on assets fell to 0.54% compared with 0.69% in H1 2021 (Figure 11). However, the banking sector's total and Tier 1 capital adequacy ratios (CARs) stood at 19.8 percent and 17.7 percent respectively in Q2 2022, well above the requirements set by the Hong Kong Monetary Authority (HKMA) (Figure 12). The banking sector's major liquidity ratios were also well above the statutory requirements, with the quarterly average liquidity coverage ratio ("LCR") of category 1 institutions at 154.9% in Q2 2022.

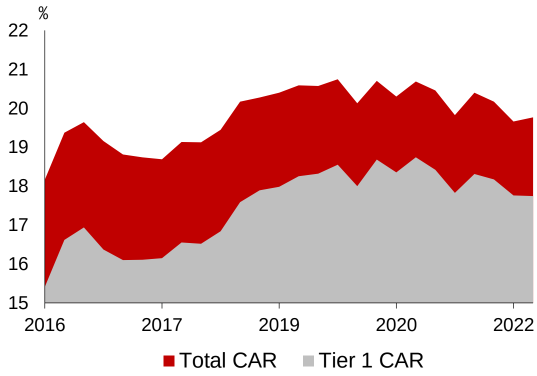
[2] The relief measures are expected to have a rather moderate impact on NPLs as the HKMA has not relaxed the loan classification standards despite the relief measures. In addition, the amount of outstanding loans covered by the relief measures is no more than HKD100 billion, which is less than 1 percent of the total loans of the banking sector at the current juncture. There have also been signs of reduced demand for such relief measures. For instance, the participation rate of the Pre-approved Principal Payment Holiday Scheme has declined substantially from 16 percent, when the scheme was first launched in May 2020, to 2.3 percent in August 2022.
[3] HKMA. 2022. "Riding Out the COVID-19 Challenge." https://www.hkma.gov.hk/eng/key-functions/banking/banking-regulatory-and-supervisory-regime/riding-out-the-covid-19-challenge/.

Figure 11. Net Interest Margin (NIM) and Return on Assets (ROA) of Banking Sector



Source: HKMA

Figure 12. Capital Adequacy Ratios

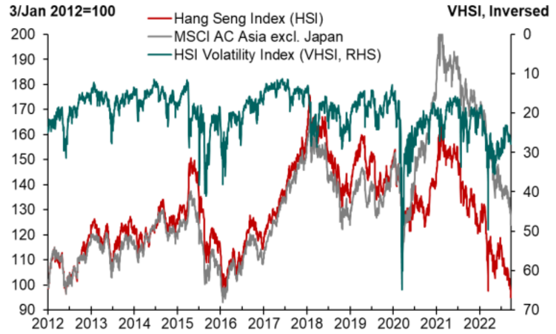


Source: HKMA; Haver Analytics

10. **Volatilities in the financial market remain heightened as Hong Kong dollar interest rates increase gradually in tandem with rising U.S. interest rates, given that Hong Kong dollar is pegged to the U.S. dollar.** The Hang Seng Index has fallen by 19.1 percent year to date in 2022 as of mid-September, in tandem with the broader Asian market (Figure 13), primarily due to the economic slowdown in mainland China, the United States Federal Reserve's aggressive monetary tightening, and heightened geopolitical risks. The spreads between the London Interbank Offered Rate (LIBOR) and the Hong Kong Interbank Offered Rate (HIBOR) widened during March to mid-July 2022 but have narrowed more recently. Carry trades have pushed the USD/HKD exchange rate toward the weak side of the convertibility undertaking (CU) band (Figure 14). This has prompted the HKMA to buy Hong Kong dollars in the foreign exchange market totaling HKD213 billion since May 2022. As a result, the aggregate balance declined to HKD125 billion in mid-August from HKD338 billion in May (Figure 15), pushing up HIBOR rates, which would in turn add pressure on the prime rate and lead to higher funding costs for households and corporates (Figure 16). Despite the triggering of the weak-side CU, the Linked Exchange Rate System (LERS), which underpins Hong Kong's overall financial and external stability, remains robust, supported by ample foreign and fiscal reserves and the automatic interest rate adjustment mechanism.[4]

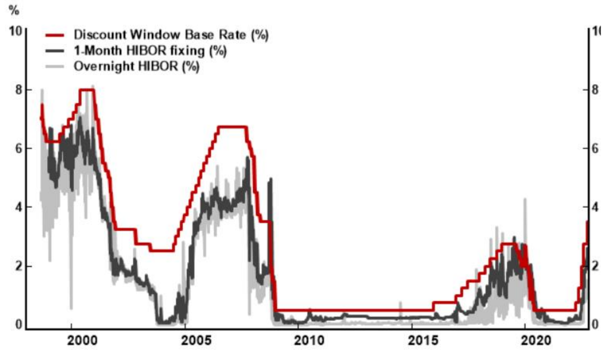
[4] The HKD is managed by the LERS. According to the LERS, the HKMA provides Convertibility Undertakings (CUs), under which the HKMA commits to sell HKD upon request by banks at the strong-side CU of HKD7.75 per USD, and to buy HKD upon request by banks at the weak-side CU of HKD7.85 per USD. Taking the triggering of weak-side CU as an example, the HKMA's purchase of HKD would reduce HKD liquidity as evidenced by the decline in the Aggregate Balance. With reduced liquidity in the market, domestic HKD interest rates would move up, pushing the HKD away from the weak-side CU to stay within the Convertibility Zone.

Figure 13. Hang Seng Stock Index



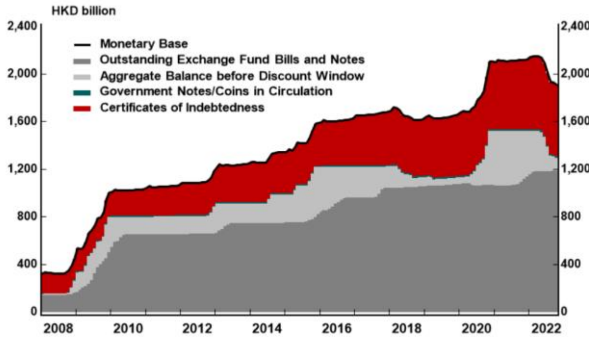
Source: Bloomberg

Figure 14. Policy Rate and Money Market Rates



Source: HKMA; Haver Analytics

Figure 15. Monetary Base



Source: HKMA; Haver Analytics

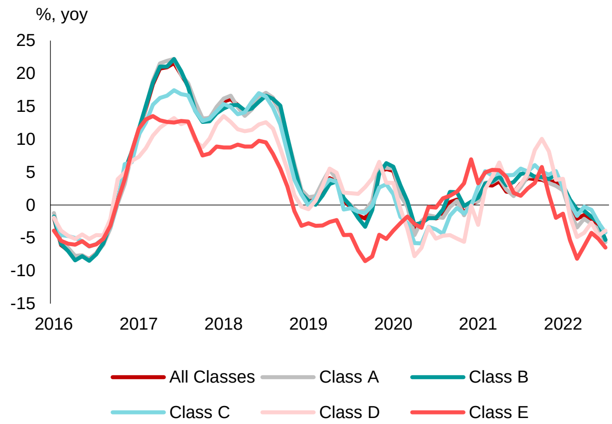
Figure 16. Hong Kong Dollar Exchange Rate and Interest Rate Spread with U.S. Dollar

Source: HKMA; Haver Analytics

11. The residential property market has softened somewhat, with the various segments displaying signs of downward pressure. From January 2017 to June 2021, prices in all segments of the property market rose at varying speeds. Prices of Class A and Class B[5] properties increased the most, by 28 percent and 29 percent, respectively. The prices of other classes of properties grew at 9 to 25 percent during the same period. However, in the past one year until July 2022, signs of market corrections have emerged across the board, with overall private property prices falling 5.4 percent from the previous year (Figure 17). In the same period, transactions saw a broad-based contraction (Figure 18). According to the RICS-Spacious Survey on real-estate professionals, market sentiment has also worsened, with more respondents reporting a likely fall rather than rise in future prices and transactions compared with a year ago.

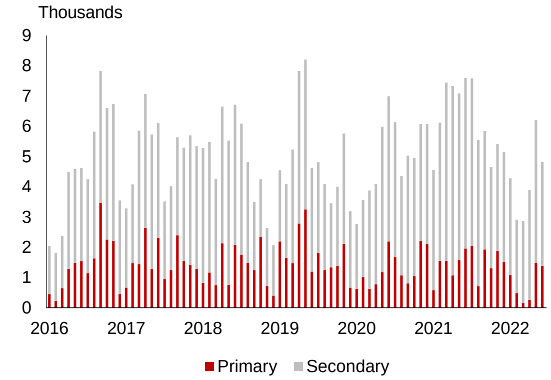
[5] Classes A, B, C, D and E represent saleable areas of less than 40 square meters, 40 to 69.9 sq m, 70 to 99.9 sq m, 100 to 159.9 sq m and 160 sq m or above, respectively.

Figure 17. Residential Property Prices



Source: Rating & Valuation Department; AMRO staff estimates

Figure 18. Number of Residential Property Transactions



Source: Rating and Valuation Department.

A.4. Fiscal Sector

12. The FY2022[6] budget, which provides an overall fiscal deficit of 1.9 percent of GDP, aims to deploy timely and effective fiscal measures to support the economy while buttressing long-term growth. For FY2021, the government recorded a consolidated fiscal surplus of 1.0 percent of GDP, compared to the initially estimated deficit of -3.6 percent of GDP, primarily due to the higher-than-expected revenues from land premium, stamp duties and profits tax as well as contributions from the Housing Reserve and the Future Fund.[7] This expanded the policy space for the government to make all-out efforts to combat the fifth wave of COVID-19 in H1 2022. Accordingly, the FY2022 budget was expansionary with HKD170 billion of counter-cyclical measures, including HKD66 billion for a second round of consumption vouchers, fixed at HKD10,000 per eligible resident, and HKD54 billion for anti-pandemic and other measures targeted at supporting vulnerable sectors and households. Apart from the pandemic measures, the government also set aside funds to enhance Hong Kong's innovation and technology ecosystem and to deepen its integration into the Guangdong-Hong Kong-Macao Greater Bay Area (GBA).

13. The consolidated budget balance is expected to return to a surplus from next fiscal year onwards, that is, FY2023, based on the government's projections. The updated fiscal outlook in September 2022 suggests that the consolidated fiscal deficit in FY2022 would likely exceed HKD100 billion, compared to HKD56.3 billion announced in 2022 February Budget Speech.[8] As a result, the government will run fiscal deficits in three out of the recent four fiscal years. The fiscal balance is projected to return to a surplus in FY2023, supported by new tax measures and revenue sources,[9] as well as reduced anti-epidemic spending

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[6] For Hong Kong, fiscal year runs from April 1 to March 31 next year.

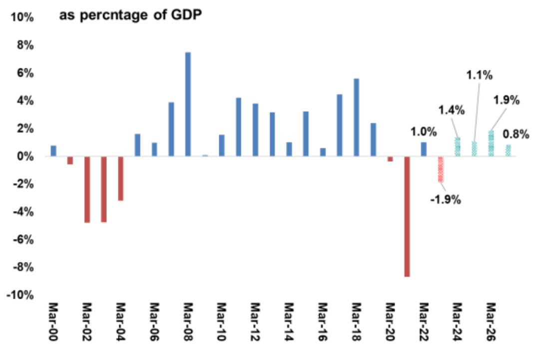
[7] The government has started to take out accrued investment returns from the Future Fund and money in the housing reserves to shore up its fiscal accounts. These contributions were not recorded in the fiscal reserves as their valuation follows a cash-based approach rather than a mark-to-market method. From the accrued investment returns of Future Fund, the government brought back HKD25 billion in FY2021 and estimates to bring back another HKD49 billion to the revenue account in FY2022. From the housing reserves, the government brought back HKD23 billion in FY2021 and plans another bringing back of HKD24 billion in FY2022, which would mark the end of its bringing back of the housing reserves.

[8] https://www.fso.gov.hk/eng/blog/blog20220918.htm

[9] In the FY2022 budget, the government announced a progressive rating system for domestic properties. The lowest tier of properties will be subjected to a 5 percent rate, while the two higher tiers must pay rates of 8 percent and 12 percent, respectively starting from Q4 of FY 2024. The government will also consider the introduction of minimum top-up taxation for multinational enterprises to safeguard Hong Kong's taxing rights under the implementation of the global minimum tax. The Government will review its plan with reference to the implementation targets of other jurisdictions.

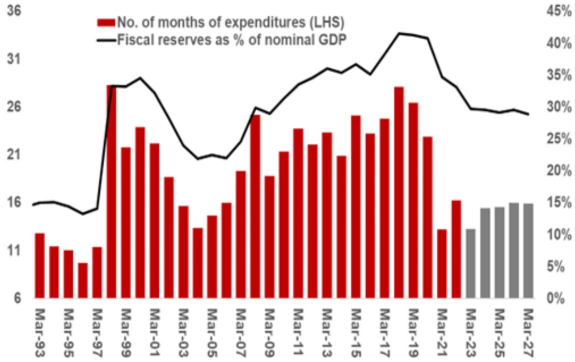
related to COVID-19 (Figure 19). Over the medium term, fiscal reserves are projected to be around 30 percent of GDP during FY2023 - FY2025, down from the current 33.4 percent. These reserves would be sufficient to cover 13-16 months of government spending (Figure 20).

Figure 19. Consolidated Fiscal Balance and Government Budget Projections



Source: Financial Services and the Treasury Bureau; CEIC
Note: Bars in teal denote the government's medium-range forecasts announced in the 2022 February Budget Speech.

Figure 20. Fiscal Reserves Projected by Government

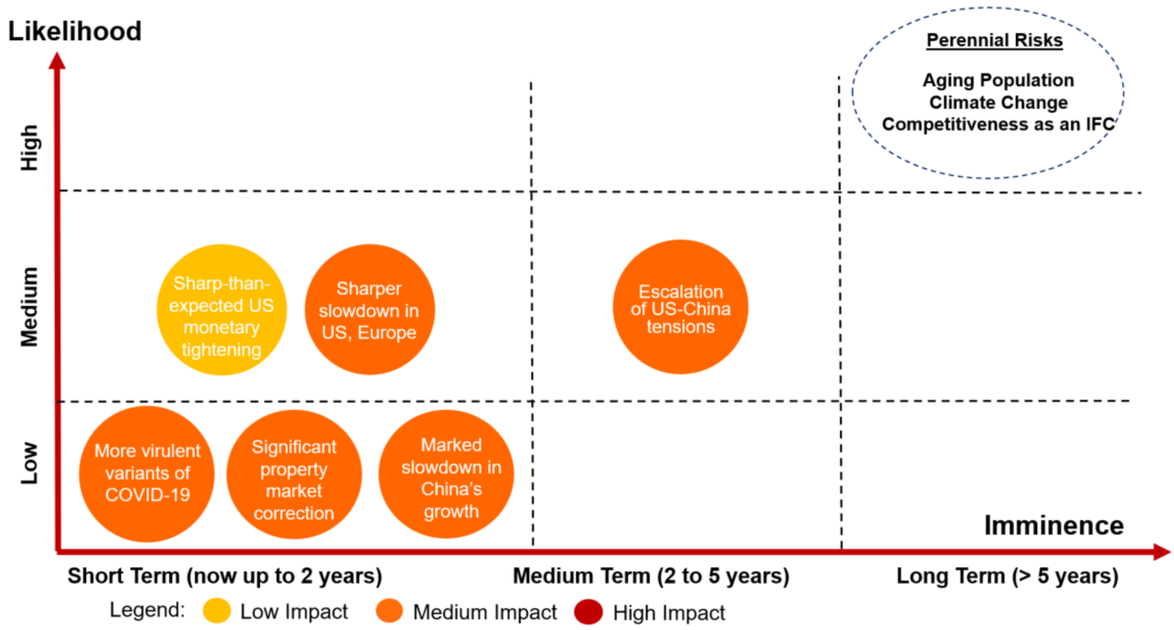


Source: Financial Services and the Treasury Bureau; CEIC
Note: Bars in grey denote the government's medium-range forecasts announced in the 2022 February Budget Speech.

B. Risks, Vulnerabilities and Challenges

14. Uncertainties surrounding Hong Kong's economic outlook remain substantial and downside risks are pronounced in the short term. (Figure 21)**.** Recurrent outbreaks of COVID-19, a sharper-than-expected U.S. monetary policy tightening, economic slowdown in the U.S., Europe and mainland China, as well as a sharp downshift of Hong Kong's property market can all dampen Hong Kong's economic growth in the near term. In addition, China-U.S. tensions, the aging population, and climate change pose significant challenges to Hong Kong's economic future in the medium to long term.

Figure 21. Risk Map for Hong Kong



Source: AMRO staff

B.1. Near-term Risks to the Macro Outlook

15. The spread of new and more virulent variants of the COVID-19 virus could prolong the pandemic, slow Hong Kong's boundary reopening, and thus derail the economic recovery. In the event of a more virulent variant outbreak, social-distancing measures will likely be tightened, disrupting mobility, while travel and logistical restrictions could disrupt Hong Kong's international trade with major trading partners. In such a scenario, dim economic prospects and weak sentiment would also weigh on private investment.

16. A sharper-than-expected US monetary policy tightening would lead to a much tighter domestic financial condition. Hong Kong's robust exchange rate system, sound financial sector and ample banking liquidity have helped the economy to weather the Fed's rate hikes well so far in 2022. However, persistently elevated inflationary pressures may prompt central banks in the U.S. and other advanced economies to tighten monetary policy even more sharply. Given the monetary policy implications under the Hong Kong's linked exchange rate system, which is pegged to the U.S. dollar, higher U.S. interest rates would translate into higher local interest rates, which would further dampen the already weak domestic investment and consumption. Moreover, the U.S. rate hikes and the U.S. dollar's appreciation may prompt investors to take a dimmer view of the region's growth prospects, which could in turn cause significant volatility in regional financial markets, including Hong Kong.

17. If the U.S. and Europe were to go into recession, Hong Kong's economic recovery would likely weaken in the short term. High global inflation and aggressive monetary tightening, coupled with persistent supply disruptions and elevated geopolitical uncertainties, have increased the likelihood of a recession in the U.S. and Europe. Given Hong Kong's high economic and financial linkages with the U.S. and Europe, their recessions would likely have adverse impacts on Hong Kong's economy, softening the nascent recovery.

18. A significant slowdown of mainland China's economic growth would also derail Hong Kong's weak economic recovery. Hong Kong's business cycle has become increasingly synchronized with that of the mainland, and this is expected to become more pronounced over time as the Hong Kong economy integrates further with the mainland economy through GBA developments and strengthening cross-border financial linkages.[10] These close links will pose a downside risk to Hong Kong should mainland China's economic growth slow down significantly.

19. A sharp downshift in Hong Kong's property market, should it happen, could weigh on the broader economy. Housing prices have increased rapidly in the past few years, but have softened since Q4 2021. A sharp downturn in the property market could occur if mortgage rates were to increase sharply or if any other adverse developments - such as large outflows of professionals - emerge in the domestic or external environments. A sharp property downturn would negatively affect the broader economy through the wealth effect and balance sheet channels, likely dampening both consumption and business activities. However, such risks could be mitigated in part by the eight rounds of macroprudential measures between 2009 to 2017, which have strengthened the resilience of both banks and households to interest rate shocks; and by the strong household balance sheet on aggregate, as more than half of private housing apartments did not have any outstanding mortgages as at the end of 2021. (*See Selected Issue 1, Could Downside Risks Tilt the Residential Property Market over the Cliff?)*

B.2. Longer-term Challenges and Vulnerabilities

20. In the medium term, a further escalation of China-U.S. tensions could dampen business and financial market sentiments and may undermine Hong Kong's role as an international financial and business center. A further rise in China-U.S. tensions could heighten risks related to greater decoupling in trade investment and technology between the world's two largest economies, posing greater challenges for Hong Kong, which is an important intermediary in global trade and investment. Moreover, the ongoing Russian-Ukrainian war and the subsequent sanctions imposed on Russia have highlighted the rising threat of financial fragmentation amid heightened geopolitical tensions. Hong Kong's financial system has withstood well the recent geopolitical challenges and it continues to be a globally competitive international financial center. However, if the China-U.S. tensions escalate and persist over an extended period, Hong Kong's status as an international financial center could be threatened.

[10] See He, Liao and Wu, 2015, "Hong Kong's Growth Synchronization with China and the U.S.: A Trend and Cycle Analysis", IMF Working Paper, 15/82.

21. Population aging and climate change pose challenges to Hong Kong's economic growth and fiscal robustness in the long run. The quickening pace of population aging in Hong Kong has been a major cause behind the recent contraction of its resident population and labor force. Should the current trend continue, it could exert a major drag on economic growth. Population aging will also increase the fiscal burden, given the need to increase health care and other social services for the elderly, and rising pension bills. In addition, climate change could harm the economy through both direct physical risks and indirect transition risks. With its islands and high population density, Hong Kong is prone to the negative effects of rising sea levels, heat waves, tropical typhoons and other types of extreme weather. Public expenditure on climate change adaptation is expected to go up significantly.

Authorities' Views

22. The impact of China-U.S. tensions on Hong Kong's role as an international financial center is a complex issue. While the evolving China-U.S. relations will inevitably add uncertainties to the global and local economic outlooks and the financial markets, Hong Kong's wide-ranging institutional strengths have remained intact. The city is still the premium gateway for multinational companies to tap the vast business opportunities in the mainland Chinese market and for mainland financial institutions and corporates to establish and expand their international presence. In addition, Hong Kong has been playing an increasingly significant role in managing the assets and wealth of mainland corporates and households. The authorities are also pressing ahead with initiatives in areas such as green finance and fintech to strengthen Hong Kong's role as an international financial center.

23. Hong Kong's financial system has demonstrated resilience and stability despite different challenges in recent years. In September 2022, the Global Financial Centers Index again ranked Hong Kong as one of the top financial centers in Asia and fourth in the world. Hong Kong's stock market raised more than USD42.6 billion through almost 100 company listings in 2021, making it one of the world's leading platforms for fundraising via initial public offerings (IPOs). The city also has the world's largest offshore pool of renminbi funds and accounts for more than 70 percent of global offshore renminbi payments.

24. Hong Kong's status as an international financial center is underpinned by its unique strategic position and strong institutional framework. Hong Kong is the ideal gateway between the mainland Chinese and international markets. It offers robust institutional advantages, including a fine tradition of rule of law, a market-oriented and internationalized business environment, robust infrastructure support, internationally aligned regulatory regimes, a full range of financial products, and the free flow of information and capital. Furthermore, the city is set to benefit from the vast opportunities arising from its increasing collaboration with the mainland, which aligns with the overall national economic development agenda. These advantages will continue to propel the development of Hong Kong's financial sector.

25. Hong Kong authorities are committed to enhancing the city's status as an international financial center. The government has plans to take concrete steps to strengthen Hong Kong's status as a global offshore renminbi business hub, an international asset management center and a risk management center, and to deepen and widen the mutual access between the financial markets of Hong Kong and the mainland. This will enable Hong Kong to continue to improve its competitiveness and strategic significance in connecting the mainland Chinese and international financial markets.

C. Policy Discussions and Recommendations

C.1. Calibrating Fiscal Policies to Support Economic Recovery

26. Hong Kong's firm fiscal support for businesses and households should continue and can be more targeted to ensure that the economic recovery is sustained and broad-based. The fiscal space created by revenue outperformance in FY2021 and past accumulation of fiscal reserves have enabled the government to roll out counter-cyclical measures totaling HKD170 billion and a HKD43 billion Employment Support Scheme[11] in FY2022. These fiscal support measures are timely and commendable, as the economy has been hit hard by the Omicron wave. The support should continue until there are clear signs of a sustained and broad-based economic recovery. At the same time, as the impacts of COVID-19 have been uneven across sectors and income inequality has been rising during the pandemic, the fiscal measures should be more targeted to support the vulnerable sectors and households.

C.2. Safeguarding Financial Stability

27. The capital and liquidity ratios of banks should be monitored and maintained at the current high levels. Capital buffers in the banking sector risk being drawn down rapidly should asset quality deteriorate sharply in the post-pandemic period when the debt relief programs and the regulatory forbearance are terminated. Hence, banks should continue to maintain high Tier 1 capital ratios, reduce cash dividend payouts and give out stock dividends, in particular when profits are less certain, to counter procyclicality in the system. Larger banks, particularly the ones with loan loss reserves lower than NPLs, should increase their provisioning to better cushion against stresses, such as a significant economic slowdown in mainland China and strains on overstretched property developers. As funding costs tick up, banks are encouraged to continue maintaining their liquidity ratios, and one of the ways is to take on more stable, longer-term funding such as term deposits and interbank funding with longer tenors.

28. Credit relief measures should be allowed to lapse as Hong Kong emerges from the pandemic. The relief measures put in place by the authorities have been effective in supporting businesses and households during the difficult period, and some borrowers have started repayments. However, continued extension of the measures could allow non-viable firms or households to keep rolling over their bad debts, resulting in higher eventual losses. Allowing the credit relief measures to expire or at least encouraging the resumption of partial principal repayment would help reduce debt accumulation. This expiry of credit relief should be phased in while fiscal policy remains supportive to provide uninterrupted help for households and businesses to tide them over economic hardships. An informed and phased approach in exiting credit relief measures would guard against cliff effects in NPLs, particularly if downside risks such as a marked slowdown in growth were to materialize.

C.3. Strengthening Policy Buffers and Framework to Ensure Long-term Resilience

29. The authorities' steadfast commitment to maintaining ample fiscal space is commendable, and adequate fiscal reserves should be maintained. Fiscal reserves remain sufficient, notwithstanding the large drawdowns made over the past few years to cushion the economic downturn and support the recovery. Looking ahead, the government needs to explore options to increase fiscal revenue over the medium term from more stable

[11] The government introduced the 2022 Employment Support Scheme in end-April at a total estimated cost of HKD43 billion to provide eligible employers with three-month wage subsidies from May to July 2022.

sources to match the trend rise in spending on key areas such as health and social welfare, and in capital expenditure. Despite a plan to introduce a progressive rating system and collect more corporate profit taxes from the implementation of the global minimum tax rate for multinational enterprises, the increased revenues might not be sufficient to offset the trend rise in aging-related expenditure in the longer term.[12] To avoid structural fiscal deficits and maintain healthy fiscal reserves, the government might consider broadening the tax base in the long term, such as introducing a value-added tax (VAT). Meanwhile, increasing the use of debt financing for big infrastructure projects should also be considered for fairer sharing of cost across generations, with the added benefit of aiding local bond market development.

30. The macroprudential policy framework should be enhanced to strengthen the risk management of banks against possible shocks originating from improving the soundness of the property market. A formal framework could be put together to facilitate surveillance and policymaking, in particular, for macroprudential and demand-side measures (e.g., debt-servicing ratio, LTV, special stamp duty, and new residential stamp duty) that affect the property market, given that such policies now reside in different government agencies. As mortgage loans with higher interest rates and LTV ratios are extended by developers, which do not fall under the HKMA's ambit, there should be concerted efforts across relevant agencies to ensure such loans are not extended, so as to maintain financial prudence in all borrowers.[13] In addition, a supply-side measures such as a remissible transaction tax[14] or a tax on vacant apartments could be introduced to reduce supply hoarding in the market, bringing prices closer to fundamentals. Such efforts will also be in line with providing affordable housing to meet the needs of the population.

C.4. Enhancing Social Safety Net and Growth Inclusiveness

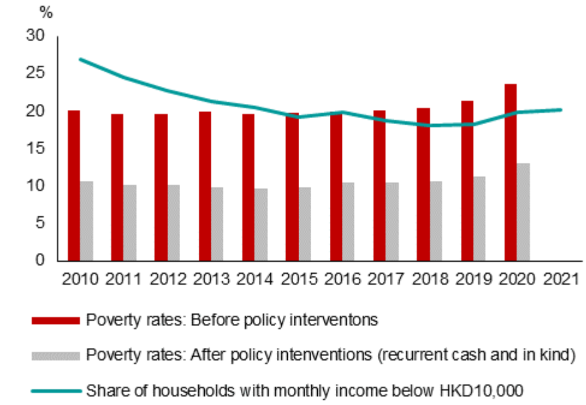
31. The government could play a larger role in strengthening the social safety net. Shocks inflicted by COVID-19 have accentuated Hong Kong's income inequalities (Figure 22) and highlighted the importance of a stronger social safety net to support vulnerable groups of people. The government's social welfare programs, such as the Comprehensive Social Security Assistance (CSSA) Scheme, as well as some cyclical relief measures, have helped cushion the shocks, especially on low-income groups. As global trends such as population aging, digital technology and climate change will likely be challenging and disruptive for certain vulnerable groups, a more integrated and comprehensive social safety net to replace the current ad hoc and fragmented system should be a high priority. In particular, the government may consider extending and converting the current Temporary Unemployment Relief Scheme to a permanent unemployment insurance program to prevent involuntary retrenchment from becoming a long-term unemployment issue. Further investment in public housing would be also critical in providing enough affordable apartments to low-income households and young couples, considering the severe constraints in housing supply.

[12] The estimated increase in revenues from the progressive rating system and the domestic minimum top-up, as announced in the FY2022 Budget, would be about HKD15.76 billion each fiscal year. Comparatively, fiscal expenditure on the elderly has been increasing rapidly. Recurrent expenditure on three major service areas – elderly care, medical and health care, and financial assistance – accounts for an estimated HKD91.9 billion, or 20.8 percent of total government expenditure in 2019-2020, according to an estimate made in a report of the Legislative Council Secretariat's research office, "Government expenditure on the elderly." The estimated amount represents an average annual growth rate of 11.4 percent since the HKD43.3 billion recorded in 2012-2013, higher than the 7.7 percent posted for total government expenditure over the same period.

[13] On the HKMA's part, it introduced risk management measures in May 2017 to govern bank loans to property developers. The measures subject banks to a lower financing gap for construction financing and require them to set aside more capital for loans to developers that have mortgage exposures beyond certain thresholds. The HKMA has also reminded the public to be mindful of risks related to mortgage plans offered by developers. In addition, the Mortgage Insurance Programme enhancements were found to reduce some of the macroprudential measures leakage, with a decline in market share of non-bank mortgages reported in the March 2022 Monetary and Financial Stability Report.

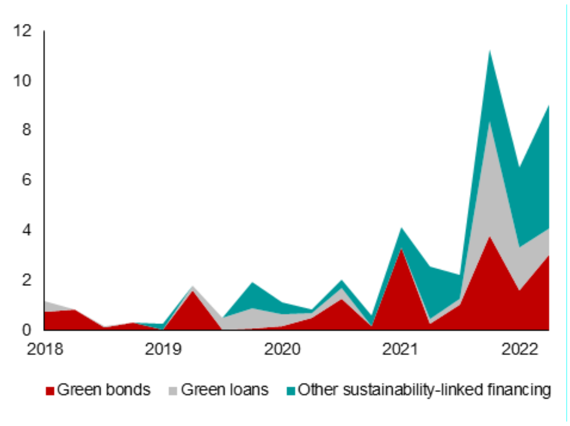
[14] The proposed measure is similar to stamp duties that housing developers in Singapore are required to pay in the form of taxes for acquiring sites, which may be remitted with the sale of all properties in the project.

Figure 22. Poverty Rates



Source: C&SD

Figure 23. Green Bond Issuances and Loans in Hong Kong (In US dollar billions)



Source: International Institute of Finance Sustainability Debt Monitor
Note: Data as of July 2022.

32. Strengthening support for small and medium enterprises (SMEs) will also be important in promoting more inclusive growth. SMEs account for 98 percent of enterprises and 45 percent of workers, and often employ more low-skilled people. Over the past couple of years, the economic downturn has heavily affected SMEs, especially in tourism and retail businesses. Policy support for SME financing has been firm and timely. With SMEs still facing significant challenges in their operations, the authorities announced enhancements in February 2022 to the SME Financing Guarantee Scheme (SFGS), which further alleviated the funding pressure of SMEs in the time of the pandemic.[15] A host of other government measures, such as tax and fee relief and rebates announced in the last three Budgets and cash handouts / consumption vouchers to Hong Kong residents, have also been critical in averting financial distress. Going forward, the government should continue to open up new export markets for SMEs and help improve their business models and products through training and facilitation schemes. *(See Selected Issue 2: SMEs' business and financing conditions: challenges and policy support.)*

C.5. Deepening Integration with Mainland China and the Rest of the World

33. Hong Kong's strategy to act as a super-connector between mainland China and the rest of the world would provide continuous impetus to the economy over the medium to long term. Hong Kong's role in connecting China with the world has evolved over time – apart from being an entrepot for the mainland, Hong Kong has increasingly played a bigger role in financial intermediation since the 2000s, given the city's role as an international financial center with strong institutions and a deep pool of U.S. dollar liquidity. Financial flows between the two economies have increased greatly as investor interest in mainland China grows in tandem with capital liberalization efforts by mainland authorities. Authorities from both sides should continue to deepen financial integration through further development of the Connect schemes and offshore renminbi business. Apart from financial services, further links through trade-related professional services and partnerships in technology with other GBA cities will open up more opportunities and attract investments to high-productivity sectors, thereby

[15] The August 2022 edition of the Survey on the Business Situation of SMEs showed that just 6.5 percent of the surveyed SMEs needed credit or additional credit, down from the 8.2 percent seen in the March edition of the survey.

supporting future growth and talent flow. *(See Selected Issue 3: Hong Kong's Development and Prospects as a Super-connector for Mainland China.)*

34. Greater efforts by Hong Kong to expand its global reach will enhance the city's economic resilience and strengthen its role as a major trade and financial hub in the region and on the global stage. In the face of the challenges of deglobalization, greater geopolitical uncertainty, and reconfiguration of global supply chains, Hong Kong should diversify its economic links to include more markets. This would help local businesses to tap global demand and capitalize on new opportunities. In addition to its existing eight free trade agreements (FTAs), Hong Kong has applied to join the Regional Comprehensive Economic Partnership (RCEP), which is expected to facilitate the city's access to the dynamic regional markets and production networks. *(See Selected Issue 4: Will Hong Kong benefit from joining the RCEP?)*

C.6. Nurturing New Growth Engines

35. The HKMA's commendable Fintech 2025 strategy is progressing well, lending impetus for more efforts to leverage advanced technologies further – including measures by virtual banks to strengthen their value proposition. A Tech Baseline Assessment completed in June has highlighted the receptiveness of commercial banks in adopting both mainstream and novel technologies across different lines of their business operations. In the area of central bank digital currencies (CBDCs), the HKMA has also successfully completed the first cross-border pilot under its multi-CBDC (mBridge) project and studied the prospects of issuing its retail CBDC (e-HKD) through a position paper released in September. With continuous support and collaboration from industry players and other peers, the HKMA should be able to make good progress toward attaining its strategic objectives by 2025. However, virtual banks would need stronger value proposition to thrive alongside conventional banks so as to create more value in providing cost-efficient and inclusive financial services.

36. Across Asia, the commitment is strong to attain national climate change goals and Hong Kong has acted early to establish itself as Asia's green finance hub. Over the last decade, Hong Kong has allocated more than HKD47 billion to various carbon reduction measures, and for the next 15 to 20 years, Hong Kong has committed to investing about HKD240 billion to support a series of actions to combat climate change. Together with mainland China's "dual carbon" goals and rising interest in Asia, the demand for green finance in Hong Kong will likely continue to accelerate. Indeed, green bond issuances and loans in Hong Kong have been growing rapidly (Figure 23). Other than connecting international investors with opportunities in mainland China, Hong Kong is developing a local green classification framework based on the Common Green Taxonomy, identifying an appropriate business model to support the development of Hong Kong as a regional carbon trading centre, and nurturing talent and building capacity in green and sustainable finance.

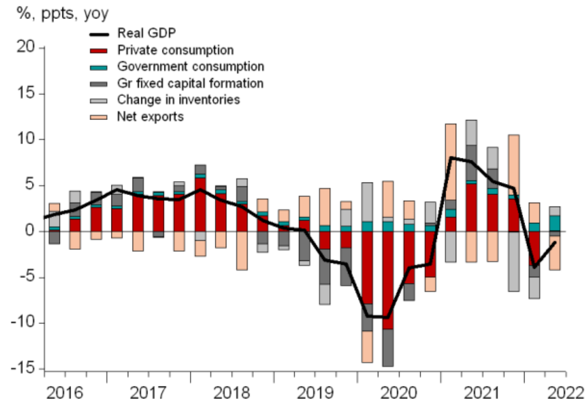
37. Hong Kong can leverage the manufacturing prowess of mainland China and ASEAN, and its connectivity with these economies as a regional value chain and IP hub, to advance its high-technology aspirations. This has the potential to expand Hong Kong's growth engines and enhance economic resilience. The city should also leverage its status as a regional IP trading hub to foster a vibrant high-technology center by connecting investors with innovators. Furthermore, the authorities should continue to attract top talents from across the world, commensurate with increasing investments in research and development facilities and the commercialization of innovative ideas.

Appendices

Appendix 1. Selected Figures for Major Economic Indicators

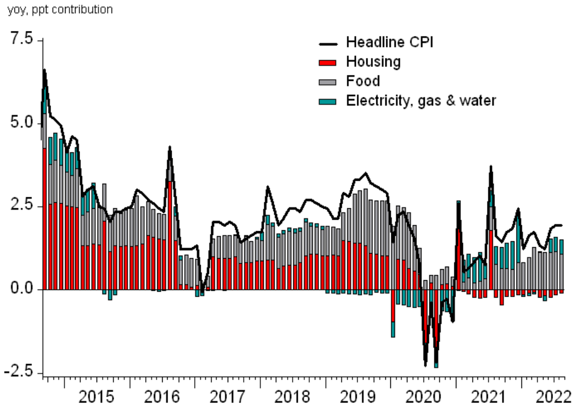
Figure 1.1 Real Sector

Hong Kong's economy contracted in Q1 2022 after a strong recovery in 2021.



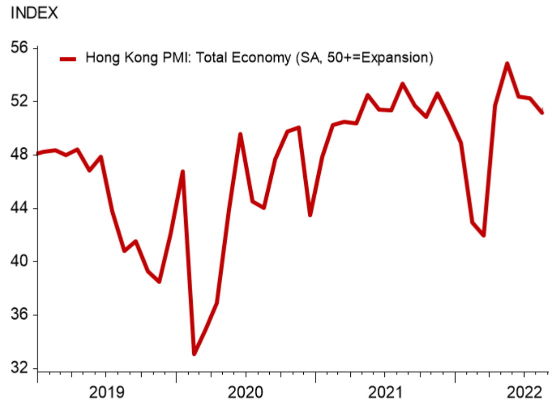
Source: C&SD; Haver Analytics

Inflation rose moderately on rising food prices.



Source: C&SD; Haver Analytics; AMRO calculations

PMI showed signs of economic recovery.

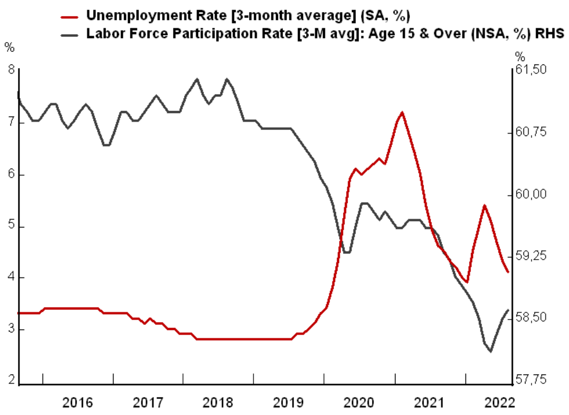


Source: S&P Global; Haver Analytics

Tourist arrivals remained negligible amid strict boundary restrictions.

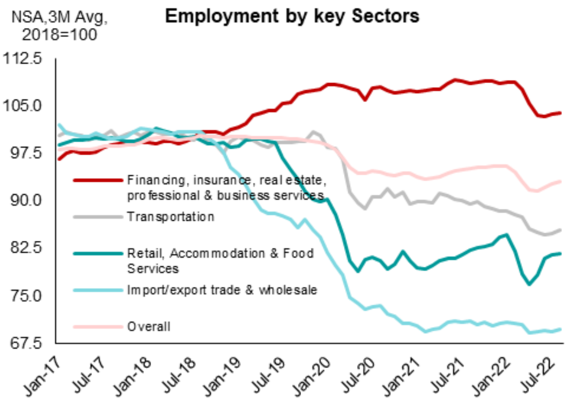
Source: Hong Kong Tourism Board; Haver Analytics

Labor market conditions, which had improved slowly in 2021, deteriorated markedly in Q1 2022.



Source: CEIC; AMRO calculations

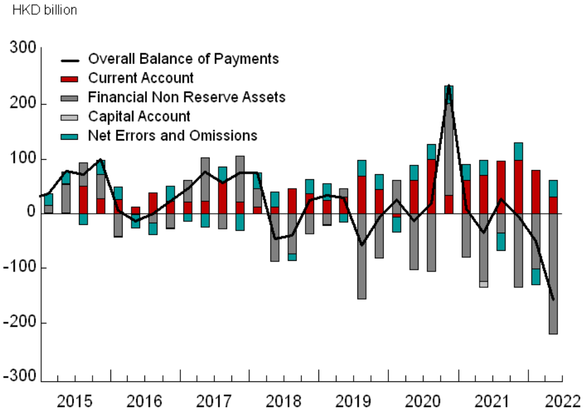
Employment recovery remained uneven across sectors.



Source: C&SD; Haver Analytics

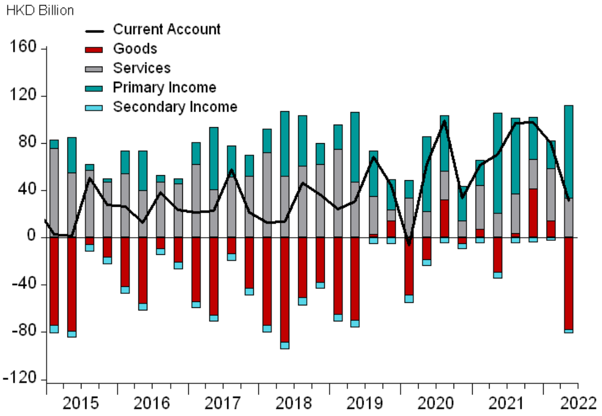
Figure 1.2. External Sector

The external position has remained resilient since the pandemic broke out …



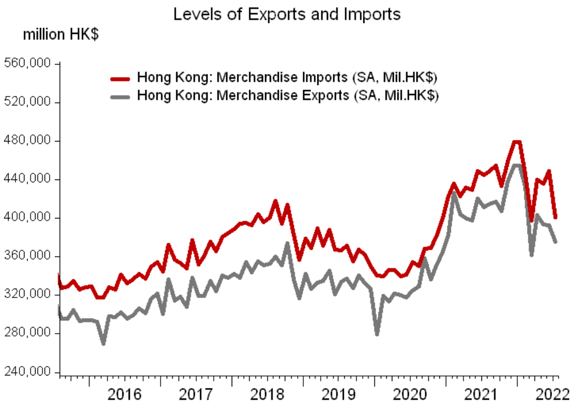
Source: C&SD; Haver Analytics.

…with the surplus in services and primary income outweighing the deficit in goods.



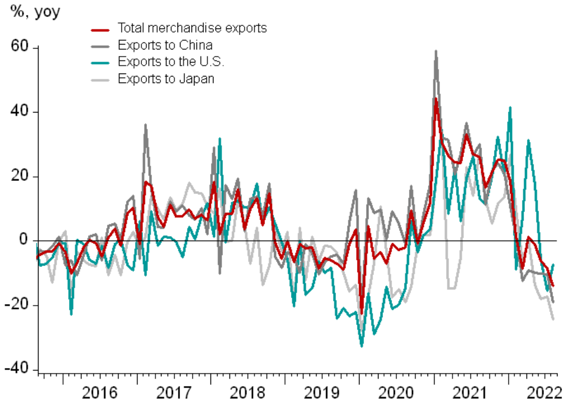
Source: C&SD; Haver Analytics

Exports growth has decelerated sharply in the year to date…



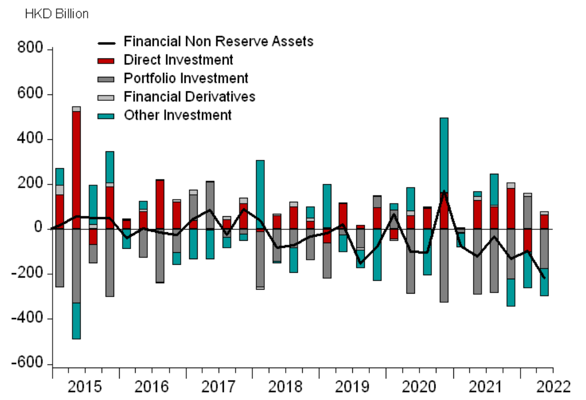
Source: Haver Analytics

… largely reflecting the impact of the local COVID-19 outbreaks and regional logistical disruptions caused by the Shanghai lockdown.



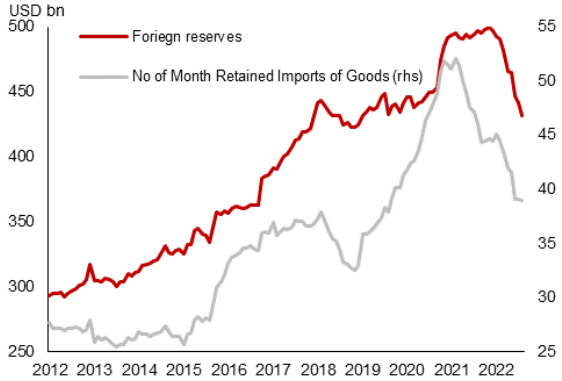
Source: C&SD; Haver Analytics

Volatile capital flows led to moderate deficits in Hong Kong's financial account in recent quarters.



Source: C&SD; Haver Analytics

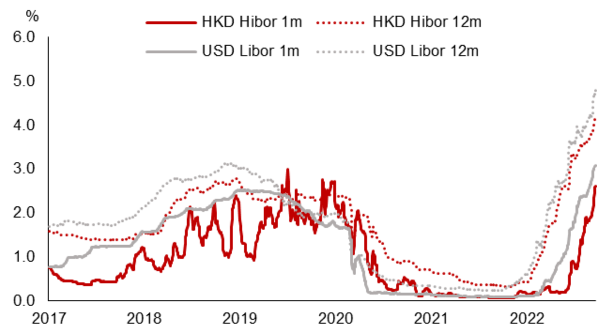
FX reserves remained ample, still covering about 39 months of retained imports.



Source: C&SD; Haver Analytics

Figure 1.3. Monetary and Financial Markets

HKD interest rates have risen in tandem with US rates.



Source: Bloomberg

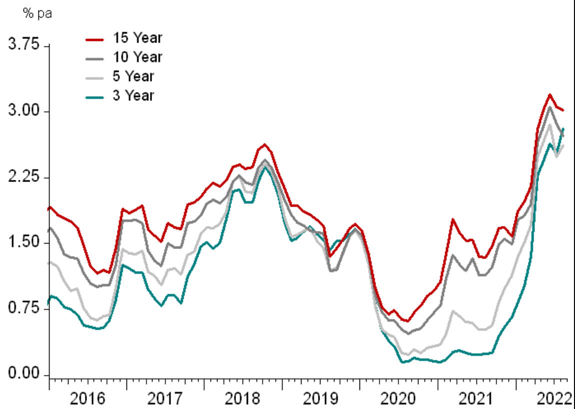
Larger interest rate differentials fostered carry trade, triggering the weak-side CU and HKMA intervention multiple times since May.

Source: Bloomberg

The movement of Hang Seng Index since the start of 2022 has been broadly in line with its peers.

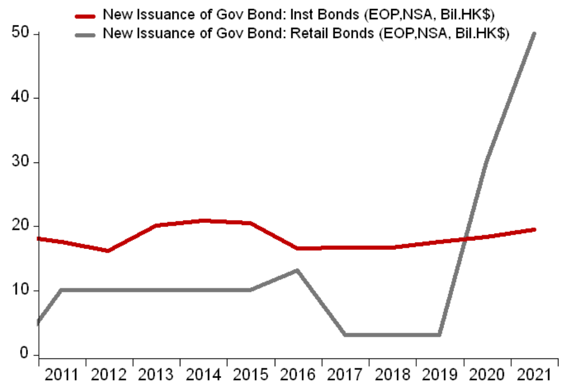
Source: Bloomberg

Yields of Hong Kong government bonds have increased since late 2021 on the back of global monetary tightening.



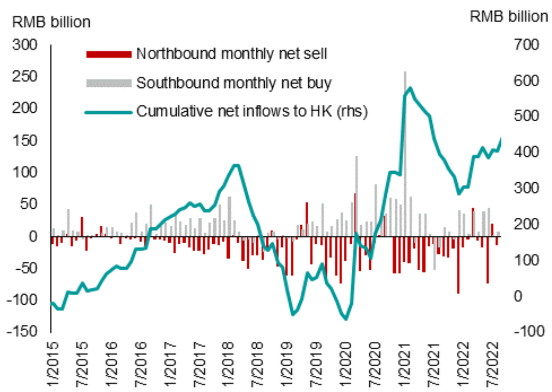
Source: HKMA; Haver Analytics

The government increased bond issuances to retail investors in 2021.



Source: HKMA; Haver Analytics

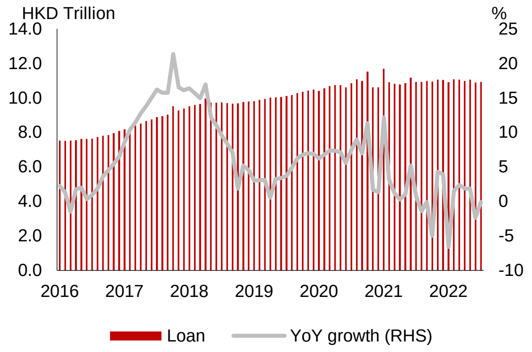
Equity funds posted a net inflow under the Stock Connect schemes in H1 2022.



Source: CEIC; AMRO calculations

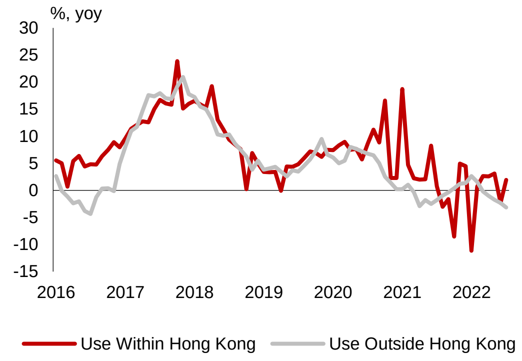
Figure 1.4. Banking and Property Sectors

Overall credit growth was moderate…



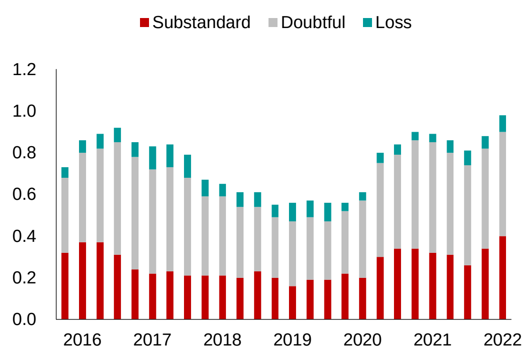
Source: HKMA; AMRO calculations

…across loans of different uses.



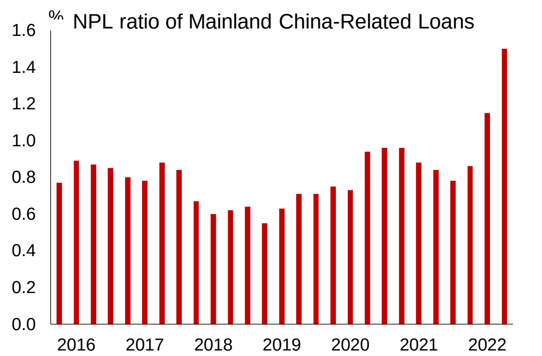
Source: HKMA; AMRO calculations

The overall NPL ratio has risen, …



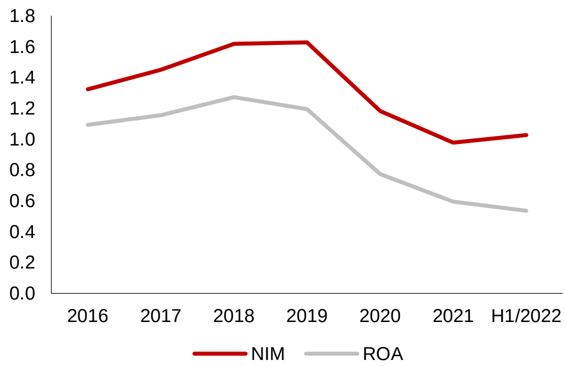
Source: HKMA

……in particular the NPL ratio of mainland-related loans.



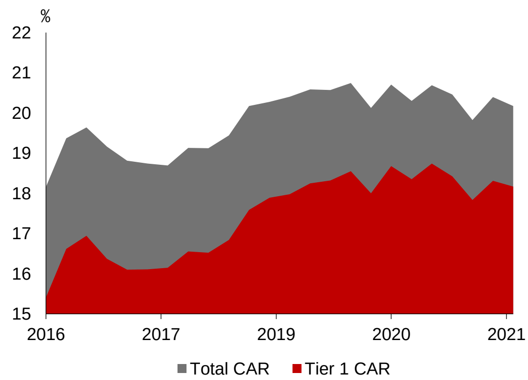
Source: HKMA

Profitability has been compressed in the past few years.



Source: HKMA

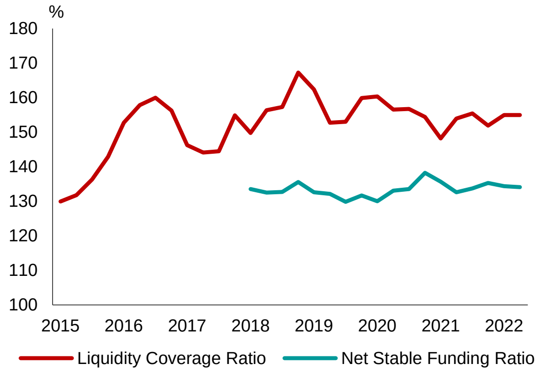
The CAR declined slightly from a year ago.



Source: IMF

Figure 1.5. Banking and Property Sectors (cont'd)

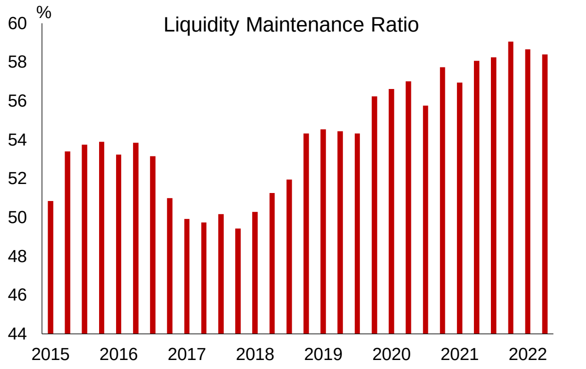
Liquidity ratios of category 1 institutions have remained stable.



Source: HKMA

Note: Category 1 institutions refer to institutions that either have significant international exposures or are significant to the general stability of the local banking sector.

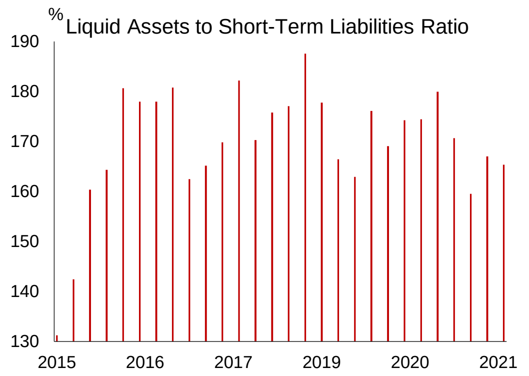
Liquidity maintenance ratio of category 2 institutions also remained firm.



Source: HKMA

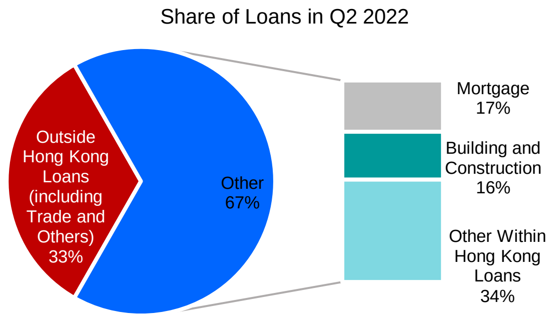
Note: Category 2 institutions to authorized institutions that are not designated as category 1 institutions.

However, liquidity has deteriorated from the perspective of the liquid assets to short-term liabilities ratio.



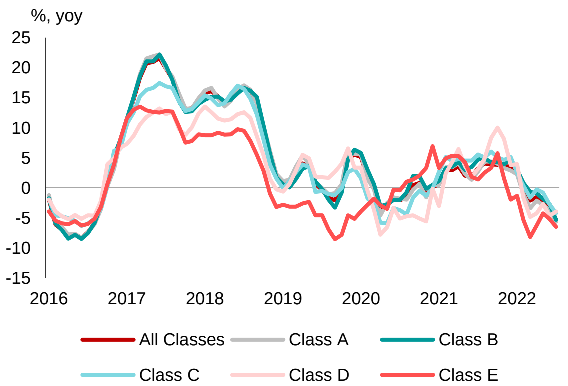
Source: IMF

Property-related loans are significant on banks' balance sheets.



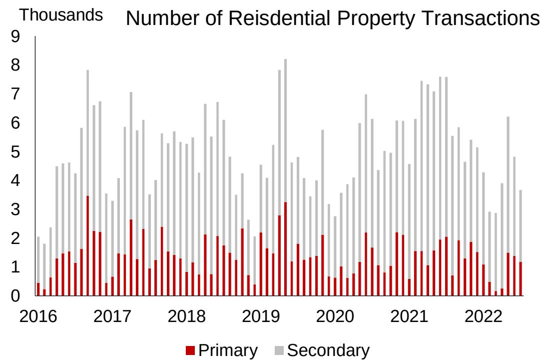
Source: HKMA; AMRO staff estimates

Residential property prices appear to be on a downward trajectory.



Source: Rating & Valuation Department; AMRO staff estimates

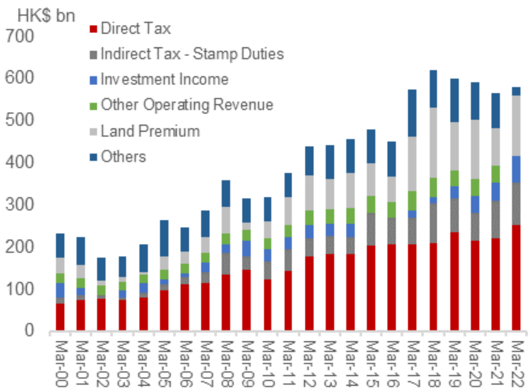
Sales and purchases have declined.



Source: Rating & Valuation Department

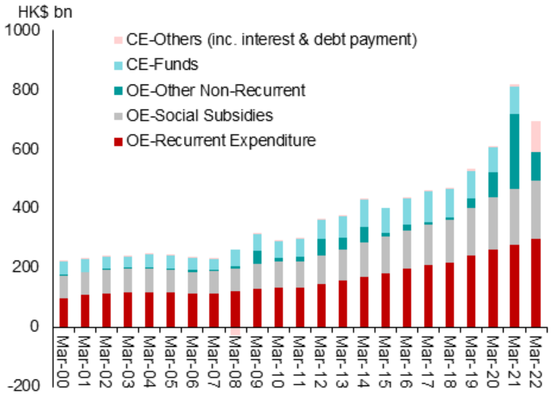
Figure 1.6. Fiscal Sector

Government revenue increased in FY2021 along with the economic recovery.



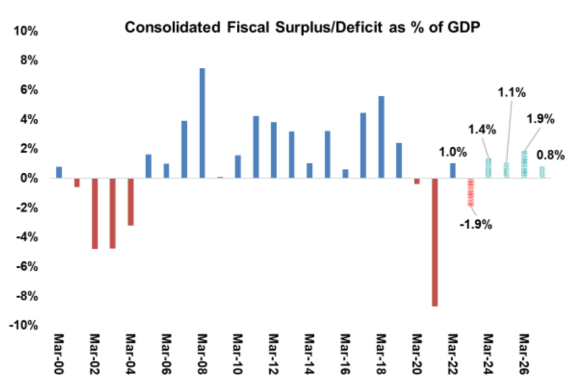
Source: Financial Services and the Treasury Bureau (FSTB); CEIC

Government expenditure declined, owing to less demand to support people, businesses and employment.



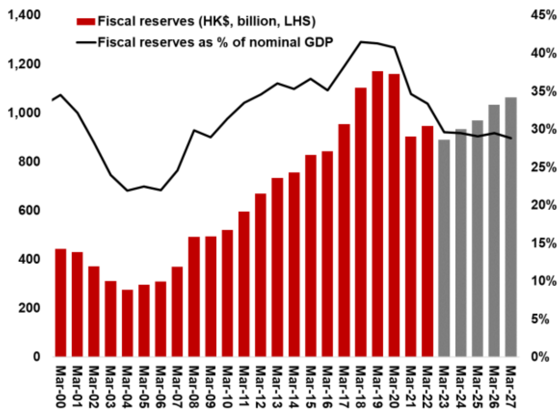
Source: FSTB; CEIC

The fiscal stance is projected to gradually tighten and return to a fiscal surplus in FY2023



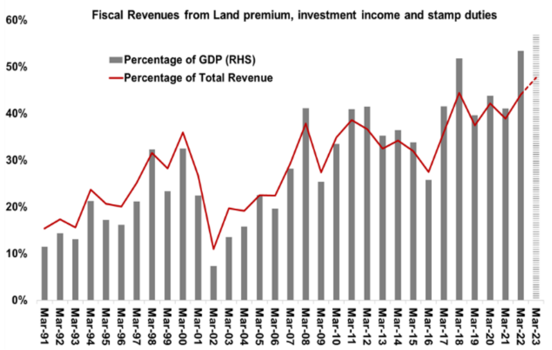
Source: FSTB; CEIC

Fiscal reserves are projected to fall to 29 percent of GDP at the end of FY2026, but to remain ample.



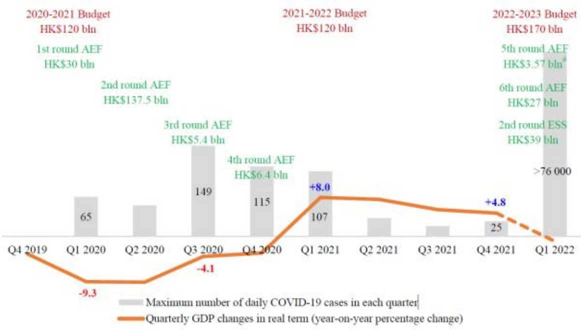
Source: FSTB; CEIC

Land premiums, investment income and stamp duties are increasingly important sources of government revenue.



Source: FSTB; CEIC
Note: Bars in grey denote the government's medium-range forecasts announced in the 2022 February Budget Speech.

Fiscal support to combat COVID-19 has been timely.



Source: Legislative Council
Note: The funding approved for the 3rd round AEF is HKD24 billion, including HKD5.4 billion injection into AEF.

Appendix 2. Selected Economic Indicators for Hong Kong, China

	2018	2019	2020	2021	2022 p/	2023 p/
Real Sector and Prices	(in annual percentage change)					
Real GDP	2.8	-1.7	-6.5	6.3	-2.5	4.3
Private consumption	5.3	-0.8	-10.5	5.4	-1.0	4.2
Government consumption	4.2	5.1	7.9	4.6	7.0	5.0
Gross domestic fixed capital formation	1.7	-14.9	-11.5	9.8	-8.0	5.0
Exports	3.7	-6.1	-6.7	17.0	-7.9	-3.3
Goods	3.5	-5.5	-1.4	18.9	-8.6	-4.1
Services	4.6	-9.6	-34.8	1.5	-1.0	3.4
Imports	4.5	-7.2	-6.9	16.0	-7.5	-3.4
Goods	4.7	-8.2	-3.2	17.4	-8.0	-4.0
Services	2.8	0.1	-32.2	1.7	-1.5	3.4
GDP deflator	3.7	2.0	0.6	0.9	1.8	2.0
Labor Market						
Unemployment rate (In percent, period average)	2.8	2.9	5.8	5.2	4.3	3.2
Prices						
Headline inflation (Period average)	2.4	2.9	0.3	1.6	2.0	2.3
Underlying inflation (Period average, netting out one-off govt relief measures)	2.6	3.0	1.3	0.6	2.0	2.3
External Sector	(in billions of U.S. dollars, unless otherwise specified)					
Current account balance (In percent of GDP)	3.7	5.8	7.0	11.3	6.9	7.0
Goods trade balance (In percent of GDP)	-8.9	-4.2	-1.5	0.7	-4.0	-3.8
Exports, f.o.b.	569	546	542	672	648	621
Imports, c.i.f.	627	579	574	714	707	678
Overall balance	1.0	-1.1	33.9	-1.2	-48.8	17.0
(In percent of GDP)	0.3	-0.3	9.8	-0.3	-13.4	4.4
Gross official reserves excluding net forward position	425	441	492	497	423	446
(In months of retained imports of goods)	33	41	51	44	38	42
Total external debt	1695	1675	1789	1879	1762	1901
Short-term external debt (% of international reserves)	266	249	239	249	247	249
Fiscal Sector (General Government)	(in percent of GDP, fiscal year)					
Revenue	21.2	20.8	21.1	24.2	23.7	23.0
Expenditure	18.8	21.4	30.5	24.2	29.0	22.7
Net Issuance & Repayment of Gov Bonds & Notes	0.0	0.2	0.7	1.0	1.2	1.1
Consolidated budget balance	2.4	-0.4	-8.7	1.0	-4.1	1.4
Public debt	0.1	0.3	1.0	2.0	3.1	4.1
Monetary and Financial Sector	(in annual percentage change, period end)					
Total loans	4.4	6.7	1.2	3.8	-1.5	4.0
Total loans (In percent of GDP)	342.9	364.8	392.4	379.7	376.9	368.3
Loan to deposit ratio (In percent)	72.6	75.3	72.3	71.8	70.0	72.0
Classified loan ratio (In percent)	0.5	0.5	0.8	0.8	1.1	1.3
Capital adequacy ratio (In percent)	20.3	20.7	20.7	20.2	19.8	20.1
Three-month Hibor (In percent, end of period)	2.3	2.4	0.4	0.3	2.5	2.0
Memorandum Items						
Exchange rate (LCY per USD, end-period)	7.83	7.79	7.75	7.80	7.85*	
GDP in billions of HKD	2,835.4	2,844.8	2,675.7	2,869.7	2,847.8	3,030.5
GDP in billions of U.S. dollars	361.7	363.0	344.9	369.1	362.8	389.5
GDP per capita (USD)	48,535	48,355	46,109	49,795	49,426	53,607
Interest rates (%, end-period)						
Three-month Hibor	2.3	2.4	0.4	0.3	3.2*	
10Y Govt' bond yield	2.1	1.8	0.7	1.5	3.6*	
Asset prices						
Hang Seng Index (end of period, 1964=100)	25,846	28,190	27,231	23,398	17,933*	
(% yoy)	-13.6	9.1	-3.4	-14.1		
Residential property prices (end of period, 1999=100)	359.4	379.2	379.9	393.9	376.5**	
(% yoy)	1.9	5.5	0.2	3.7	-5.4	

Note: p/ denotes AMRO's projections for 2022 and 2023.
* As of 23 September, 2022.
** As of July 2022.
Source: Hong Kong authorities, IMF, Haver Analytics, CEIC, AMRO staff calculations and estimates

Appendix 3. Balance of Payments

	2018	2019	2020	2021
	(In percent of GDP)			
Current account	3.7	5.8	7.0	11.3
Goods	-8.9	-4.2	-1.5	0.7
Total exports of goods	157.1	149.6	156.9	182.7
Imports of goods	-166.0	-153.8	-158.5	-182.0
Services	8.7	5.8	3.5	4.1
Exports of services	31.3	28.1	19.4	20.8
Imports of services	-22.6	-22.3	-15.9	-16.7
Primary income	4.8	5.1	5.8	7.1
Secondary income	-0.8	-0.8	-0.8	-0.7
Capital and financial account	-6.2	-8.3	-9.1	-13.3
Capital account	-0.1	0.0	0.0	-0.4
Financial account	-6.1	-8.3	-9.1	-12.9
Financial non-reserve assets	-5.9	-8.6	0.7	-13.2
Direct investment	6.1	5.6	9.9	14.4
Portfolio investment	-21.7	-7.6	-19.7	-28.5
Financial derivatives	1.2	0.0	0.7	1.5
Other investment	8.6	-6.7	9.9	-0.6
Reserve assets	-0.3	0.3	-9.8	0.3
Net errors and omissions	2.4	2.5	2.2	2.0
Overall Balance of Payments	0.3	-0.3	9.8	-0.3

Source: C&SD; CEIC; AMRO staff calculations

Appendix 4. Statement of Central/General Government Operations

	2018/19	2019/20	2020/21	2021/22
	(In billions of HKD)			
Opening Balance	1103	1171	1160	928
Consolidated Revenue	600	591	564	694
General Revenue	483	449	476	551
Operating Revenue	454	434	459	528
Direct Tax	236	214	221	254
Stamp Duties	80	67	89	100
Others	138	153	149	175
Capital Revenue	28	15	16	22
Land Premium	117	142	89	143
Conslidated Expenditure	532	608	816	693
Operating Expenditure	432	523	719	590
Capital Expenditure	99	85	97	103
Net Issuance & Repayment of Gov Bonds & Notes	0	6	19	29
Consolidated Surplus	68	-11	-233	29
Closing Balance	1171	1160	928	957
	(In percent of GDP)			
Opening Balance	38.9	41.2	43.4	32.3
Consolidated Revenue	21.2	20.8	21.1	24.2
General Revenue	17.0	15.8	17.8	19.2
Operating Revenue	16.0	15.3	17.2	18.4
Direct Tax	8.3	7.5	8.3	8.9
Stamp Duties	2.8	2.4	3.3	3.5
Others	4.9	5.4	5.6	6.1
Capital Revenue	1.0	0.5	0.6	0.8
Land Premium	4.1	5.0	3.3	5.0
Consolidated Expenditure	18.8	21.4	30.5	24.2
Operating Expenditure	15.3	18.4	26.9	20.6
Capital Expenditure	3.5	3.0	3.6	3.6
Overall balance	2.4	-0.6	-9.4	0.0
Primary balance	1.0	-2.3	-11.4	-2.8
Net Issuance & Repayment of Gov Bonds & Notes	0.0	0.2	0.7	1.0
Consolidated Surplus	2.4	-0.4	-8.7	1.0
Closing Balance	41.3	40.8	34.7	33.4
Memorandum Items:				
GDP in billions of HKD (Calendar Year)	2,835	2,845	2,676	2,870

Source: C&SD; CEIC; AMRO staff calculations

Appendix 5. Monetary Survey

	2018	2019	2020	2021
	(In percent of change, period end)			
Total money supply				
M1	-0.4	2.6	30.1	8.0
M2	4.3	2.8	5.8	4.3
M3	4.3	2.7	5.8	4.3
Hong Kong dollar money supply				
M1	-2.6	-1.5	28.7	5.4
M2	3.6	2.4	6.5	1.5
M3	3.7	2.3	6.5	1.5
Deposit				
Total	5.0	2.9	5.4	4.6
Hong Kong dollar	3.6	2.5	6.2	1.4
Foreign currency	6.4	3.2	4.6	7.9
Loans and advances				
Total	4.4	6.7	1.2	3.8
Hong Kong dollar	8.9	6.6	-1.8	5.2
Foreign currency	-1.7	7.0	5.6	1.8
Interest rates	(In percent, period average)			
Discount window base rate	2.2	2.5	0.9	0.5
HIBOR: 1 month	1.3	1.9	0.8	0.1
HIBOR: 3 month	1.8	2.1	1.1	0.2
Composite interest rate	0.6	0.9	0.6	0.2
HSBC's best lending rate	5.0	5.1	5.0	5.0

Source: C&SD; CEIC; AMRO staff calculations

Appendix 6. Data Adequacy for Surveillance: a Preliminary Assessment

Criteria / Key Indicators for Surveillance	Data Availability (i)	Reporting frequency / timeliness (ii)	Data Quality (iii)	Consistency (iv)	Others if any (v)
National Account	(i) For expenditure components, yearly and quarterly data in nominal and real terms are available; (ii) for production components, yearly data in nominal terms are available, and yearly and quarterly data in real terms are available; and (iii) for income components, yearly data in nominal terms are available.	Quarterly, about 1 month for expenditure and about 2.5 months for production after the end of the reference quarter	–	–	–
Balance of Payments (BOP) and external position	Quarterly data are available	Quarterly, within three months after the end of the reference period	–	–	–
Central government budget / external debt	Monthly central government public finances are available, while quarterly external debt data are available in detail	Budget: monthly, within one month after the end of the reference period	–	–	–
Inflation, money supply and credit growth	Monthly inflation, money supply and credit growth data are available	Monthly data are released within one month after the end of the reference period	–	–	–
Financial sector soundess indicators	Available	Financial sector soundness indicators (FSIs) are available from the IMF website	–	–	–
Housing market indicators	Available	Monthly data are released within one month after the end of the reference period	–	–	–

Notes:

(i) Data availability refers to whether official data is available for public access by any means.

(ii) Reporting frequency refers to the periodicity with which the available data is published. Timeliness refers to how up to date the published data is relative to the publication date.

(iii) Data quality refers to the accuracy and reliability of the available data, taking into account the data methodologies.

(iv) Consistency refers to both internal consistency within the data series itself and its horizontal consistency with other data series of either the same or different categories.

(v) Other criteria might also apply, if relevant. Examples include but are not limited to potential areas of improvement for data adequacy.

Source: AMRO staff compilations. This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the ERPD Matrix.

Annexes: Selected Issues

1. Could Downside Risks Tilt the Residential Property Market over the Cliff?[16]

1. This Selected Issue aims to assess risks to the Hong Kong property market, which is an important pillar in the domestic economy and financial system. In Hong Kong, roughly around 8 percent of GDP comes from the construction and real estate sectors, while 33 percent of the banking sector's loans go toward building and construction, property development and investment, and apartment purchases. On the back of this, the study considers the role of conjunctural factors that could put downward pressure on property prices. The existing policy tool kit meant to address those risks is discussed in light of Singapore's experience, given that both cities share a number of similarities, such as a high population density, sound legal system, urbanization, and well-structured housing schemes. Most importantly, both are small, open economies, constrained by limited land and confronted with a myriad of challenges in ensuring stability in the property market, and it would be useful to compare notes on the macroprudential policies to address risks.

2. Hong Kong's property market is driven by a host of macroeconomic factors, property market dynamics and government policies. The current study starts by undertaking empirical analysis to assess the relative importance of various factors. Table A1 lists a set of indicators and outlines the transmission channels through which these variables affect property prices.

3. Time series regressions on the prices of different property classes are estimated.[17] Quarterly data between Q4 2003 to Q1 2022 are applied, with a total of 74 observations. Table A2 reports the Ordinary Least Squares (OLS) regression coefficient estimates of the macroeconomic and policy factors that are expected to significantly affect prices.

4. The results suggest that local property prices are driven by both domestic and external macroeconomic and property market factors, in particular, GDP growth, labor growth and interest rates:

- Growth rates of GDP, labor and rents are important sources of drivers in the Hong Kong housing market. A one percentage point increase in growth rates of GDP, labor and rents are associated with 0.35, 1.38 and 0.88 percentage point increases in property prices, respectively.

- Higher interest rates in Hong Kong, a result of external funding conditions, could reduce property price increase as mortgage rates spike and potential borrowers face higher costs that deter their entry into the housing market. A one percentage point increase in the composite interest rate is associated with a 1.08 percentage point fall in property prices.

5. Hence, current developments, such as a decline in GDP growth arising from continued tight social-distancing measures to curb COVID-19 infections, a decrease in labor force, and the consequential reduced demand for rental property, could dampen

[16] Prepared by Siang Leng Wong, Senior Financial Specialist.
[17] Analyses were conducted for different classes, given the possible presence of heterogeneities. Classes A, B, C, D and E represent salable areas of less than 40 square meters, 40 to 69.9 sq m, 70 to 99.9 sq m, 100 to 159.9 sq m, and 160 sq m or above, respectively, each forming 32 percent, 48 percent, 12 percent, 6 percent and 2 percent of the private housing stock.

the upward price trajectory. The property market could be further weighed down by a sharper-than-expected rise in interest rates that is triggered by the external environment.

Table A1. List of Drivers in the Property Market

Factor	Impact on prices	Transmission channel
Fundamentals in the macroeconomy		
GDP growth	+	Higher GDP growth are proxies for higher household disposable income to support home purchases (Deghi and others 2020).
Labor growth	+	A higher labor growth or greater population growth increases the demand pool as more people require a roof over their heads (Bank for International Settlements 2020).
Interest rates	-	Higher interest rates represent tighter financial conditions (Deghi and others 2020) and increase the cost of mortgage borrowing. The opportunity cost of buying a property is also increased, thereby reducing the attractiveness of housing assets compared to other investment products, such as bonds.
Internal and external property market dynamics		
Foreign property price growth	+/-	As a small, open economy, Hong Kong is not insulated against foreign price shocks, given that international investors play a role in local asset markets (Bank for International Settlements 2020). Growth in foreign property prices could lead to lower property prices in Hong Kong should investors diversify out of Hong Kong. Alternatively, higher foreign property prices could raise the attractiveness of investing in Hong Kong as cost differentials between investments elsewhere and in Hong Kong are reduced.
Rental growth	+	High demand for rental units will result in high rents. The high rents will in turn lead to higher property prices, as some people might end up buying a property instead of renting one if finances allow. Higher rents will also mean higher expected returns (Ghysels and others 2013), which will raise the selling prices for investment units and attract more investors to purchase property units, driving demand in the property market.
Prudential, fiscal and supply-side policies		
Loan-to-value (LTV) limits	+	Higher LTV limits allow a borrower to take up higher leverage against the value of the property, increasing the budget for property purchases. Conversely, lower LTV limits can curb expectations and discourage potential speculators, which can effectively tame real estate booms (Igan and Kang 2011).
Tightening of debt-servicing ratio (DSR)	-	DSR tightening reduces a borrower’s leverage when measured against income, lowering the budget for property purchases. However, its effects appear to be less reined in than a tightening of the LTV ratio (Igan and Kang 2011).
Tightening of countercyclical capital buffer (CCyB)	-	CCyB tightening obliges banks, in particular the less resilient ones, to accumulate more capital (Basten and Casanova 2015), which in turn restricts the amount of mortgage loans extended.
Increase of tax on speculative properties	-	Higher taxes on properties that are held and sold within a short period of time could dampen speculative demand or sub-sales (Wong and others 2015).
Increase of tax on additional buyer	-	Imposing higher taxes on buyers with existing properties raises barriers to entry. It is a fiscal-based measure that could directly constrain property transactions as the pool of potential buyers is reduced, with attendant effects on property prices (Wong and others 2015).
Increase of tax on foreigners	-	Higher taxes on foreigners raise barriers to their market entry more effectively than the tightening of prudential measures, given that foreign investors rely less on local funding (Bank for International Settlements 2020).
Approval of new supplies	-	A lower housing supply could mean fewer apartments to meet demand in the longer term, and this supply constraint could lead to a price bidding war. Even announcements of land sales for housing would have significant signaling effects, with empirically significant impacts on prices, although the apartments will be completed only later (Wong and others 2015).

Table A2. Regression Results

Variables	Overall	Types of Properties				
		Class A	Class B	Class C	Class D	Class E
Constant	7.73	8.17*	7.48	5.36	2.66	0.06
Fundamentals in the macroeconomy						
GDP growth	0.35**	0.35**	0.33**	0.40***	0.34*	0.46**
Labor growth	1.38***	1.26***	1.53***	1.10*	1.22	0.98
Interest rates	-1.08**	-0.78**	-1.20***	-1.33**	-1.32**	-1.02
Domestic/External property price dynamics						
Foreign property price growth (-1)	-0.47*	-0.75***	-0.36	-0.08	0.16	0.11
Rental growth	0.88***	0.91***	0.84***	0.91***	0.85***	0.79***
Prudential policies						
LTV ratio	0.08**	0.06**	0.08**	0.12**	0.14**	0.15**
DSR limits (-2)	0.74	1.09	0.85	-0.08	-0.30	-1.88***
CCyB	-1.65	-1.57	-1.87*	-0.85	-0.07	-2.22**
Fiscal policies						
Tax on speculative properties (-3)	-3.55***	-4.08***	-3.50***	-2.69***	-3.28***	-2.39*
Tax on buyer with existing properties (-1)	0.49	0.39	0.79	0.23	-2.46**	0.84
Tax on foreign buyer (-2)	-2.13*	-2.03*	-2.50**	-1.79	-0.28	-2.94**
Supply-side policy						
Approval of new supplies	-2.48**	-2.33**	-2.37**	-2.53*	-2.29*	1.94
Adjusted R-squared	0.64	0.67	0.63	0.60	0.56	0.53
Observations	74	74	74	74	74	74

Notes: 1. *, ** and *** represent statistical significance at the 10%, 5% and 1% levels, respectively. 2. Variables with unit roots, based on Augmented Dickey Fuller tests, are first-differenced to ensure stationarity in the time series data. 3. Data on LTV limits and the other prudential policies (DSR and CCyB) are obtained from the IMF's Integrated Macroprudential Policy (iMaPP) Database. For the fiscal policies, they are based on self-constructed indices where tightening and loosening episodes are represented by "+1" and "-1". 4. Figures in parentheses represent the number of quarterly time lags for the respective independent variables. 5. The results remain robust amid the addition of variables such as lagged property price growth and the COVID-19 economic support index.

6. The results also show that macroprudential, fiscal and supply-side policies have been effective in reducing overheating in the property market and minimizing risks of a destabilizing price correction, although their effects vary across property types:

- Tightening of prudential measures such as LTV limits, DSRs and the CCyB are found to lower the momentum of price growth, in particular among the largest properties (Class E). These properties are more expensive, all else being equal, and buyers will likely be more reliant on banks to finance their purchases.
- Fiscal policies to tackle speculation appear to be the most effective in reducing price growth. Taxes imposed on foreign buyers create barriers to entry to the lower-priced

Class A and B properties, which are the most exposed to shocks in foreign property price movements, as seen in the regression estimates. Such taxes also seem to be effective for Class E properties, which tend to be luxury real estate for high-net-worth foreign investors. However, taxes on buyers who already own properties do not appear to create sufficiently large disincentives, with statistical significance found for only one of the property classes. A possible explanation is that after the buyer has held the property for a few years, the price growth is anticipated to outstrip the ad valorem stamp duty initially paid. [18]

- For supply-side policies, an increase in supply is found to have a statistically significant negative impact on prices, reducing any demand-supply gap.

7. Hong Kong has put in place a range of policies to address risks to the residential property market, but room for improvement remains in the macroprudential policy framework. The drivers leading to a dampened price trajectory are mostly transitory in nature, which suggests an increased likelihood of property prices reverting to earlier growth trends. While the current policies have been effective in reducing risks, some areas could be strengthened to ensure property market stability in the longer term.

8. As shown in Table A3, a number of policies in Hong Kong and Singapore have similar objectives and effectiveness, but some of Singapore's experiences could apply to Hong Kong, and vice versa, to ensure property market stability:

- Demand-side fiscal policies – Use higher tax rates to moderate investor demand should these buyers become more prominent after COVID-19 boundary restrictions are relaxed. While Hong Kong is more stringent than Singapore in tackling speculative demand, Singapore has applied higher tax rates on investor purchases. Singapore also makes further differentiation between investors buying their second, third and subsequent properties.

- Supply-side fiscal policies – Impose taxes on developers hoarding land and/or properties by using a remissible transaction tax or a tax on vacant apartments. Singapore employs fiscal policy through the remissible Additional Buyer Stamp Duties (ABSD) on entities) to reduce supply hoarding, while Hong Kong has not implemented a similar vacant-flat tax.

- Macroprudential policies – Disallow developers from providing mortgage loans unless the loans are subject to similar prudential standards as bank loans. The highest LTV limit in Hong Kong is 60 percent, significantly lower than the 75 percent in Singapore; however, borrowers in Hong Kong could be granted higher LTVs by taking out loans from developers.

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[18] The ad valorem stamp duty is 15 percent of the transaction price and is chargeable to Hong Kong permanent residents (PRs) buying their second property and non-resident foreigners (non-PRs). The taxes paid by existing Hong Kong PR buyers for property purchases are lower than the amount of taxes incurred by the non-PRs (in addition, the non-PRs are also subject to a 15 percent Buyer's Stamp Duty (BSD) on non-residents). Hence, the Hong Kong PR buyers with existing properties are more likely than the non-PR buyers to break even in their purchases after several years.
On a related note, the Chief Executive announced in the 2022 Policy Address on the Government's proposal to refund the extra stamp duty paid by eligible incoming talents in purchasing residential property in Hong Kong. Eligible talents who purchase a residential property in Hong Kong from 19 October 2022 and thereafter, and subsequently become a permanent resident upon residing in Hong Kong for seven years, can apply for a refund of the Buyer's Stamp Duty and the New Residential Stamp Duty paid for the first residential property purchased which they still own, while the Ad Valorem Stamp Duty at Scale 2 rates is still payable such that the overall stamp duty charged will be on par with that charged on first-time home buyers who are ordinary permanent residents.

9. **In addition, Hong Kong could benefit from a more formalized framework for property-related policies.** Although the broad coordination between the Council of Financial Regulators and government on taxation and supply-side policies has worked well in Hong Kong (International Monetary Fund 2021), and the new administration, which took office in July, has set up task forces to focus on housing supply and public housing. That said, efforts to address fluctuations in the private property market in the shorter term could benefit from having an interagency task force similar to Singapore's (Monetary Authority of Singapore 2019). A formal structure would allow agencies to officially share information and analyses of the property market, improve the coordination of demand-side measures to enhance policy effectiveness,[19] and better align the objectives of each agency with the overarching goal of promoting a stable and sustainable property market.

Table A3. Key Property-related Macroprudential Policies in Hong Kong and Singapore

Type of policies	Hong Kong	Singapore	Assessment
Demand-side fiscal policy: Additional buyer stamp duty	In February 2013, the Financial Services and the Treasury Bureau imposed the Doubled Ad Valorem Stamp Duty (AVD) on buyers with existing properties. In November 2016, it was divided into part 1 for residential property and part 2 for non-residential property and certain instruments. Current rate: Hong Kong PRs buying their second property and non-PRs are required to pay a 15 percent tax.	In December 2011, the Ministry of Finance introduced the Additional Buyer Stamp Duties (ABSDs) on buyers with existing properties. The ABSDs were increased in January 2013, July 2018 and December 2021. Current rates: Singapore citizens buying their second and third (or subsequent) properties are required to pay 17 percent and 25 percent ABSDs, respectively.	Both Hong Kong and Singapore have differentiated taxes for buyers with and without existing properties, to reduce investment demand. In Singapore, an even higher tax rate applies to people buying their third and subsequent properties.
Demand-side fiscal policy: Speculative buyers	In November 2010, the Transport and Housing Bureau introduced Special Stamp Duty (SSD1) on properties acquired and sold within a short time. SSD1 was tightened in October 2012. Current rates: SSD1 applies to properties held for less than 36 months. The highest rate is 20 percent.	In May 1996, the Ministry of Finance introduced Seller's Stamp Duty (SSD2) on properties acquired and sold within a short period of time. It was suspended in the same year and reintroduced in February 2010. SSD2 was later tightened in August 2010 and January 2011, and loosened in March 2017. Current rates: SSD2 applies to properties held for less than 36 months. The highest rate is 12 percent.	Both Hong Kong and Singapore impose taxes to curb speculative demand. Hong Kong's stamp duty requirements are stricter than Singapore's, subjecting the seller to duties that are at least 8 percentage points higher than duties in Singapore.
Demand-side fiscal policy : Non-residents	In October 2012, the Transport and Housing Bureau introduced BSD on non-PRs buying residential property. Current rate: BSD of 15 percent applies. This means that non-PRs pay a total of 30 percent, including AVD, when buying a residential property.	In December 2011, the Ministry of Finance introduced the ABSD on foreign buyers. The ABSD was increased in January 2013, July 2018 and December 2021. Current rate: ABSD of 30 percent applies.	Both Hong Kong and Singapore have taxes on property purchases by foreign buyers, in view of the large external liquidity and relatively small size of their domestic property markets.
Supply-side fiscal policy: Developer	In 2018, the Transport and Housing Bureau mentioned a tax on vacant apartments to deter developers from hoarding newly built housing. It proposed a tax value of 200 percent of the annual rental value of an apartment, equivalent to 5 percent of the apartment's value.	In December 2011, the Ministry of Finance introduced the ABSD on entities. Developers are subject to ABSD that is computed using the land cost of the project and would be reimbursed upon the sale of apartments, which must take place within five years of the developer being awarded the site.	Only Singapore has implemented taxes on developers, to reduce the hoarding of properties. While a tax on vacant apartments creates a disincentive for developers to hoard housing, the hurdle

[19] Demand-side policies reside across different agencies. For example, prudential policies reside with the HKMA, while fiscal policies come under the Housing Bureau. In addition to the main measures addressing property market risks, tax deductions for domestic rent and the progressive rating system, which are under the purview of the Financial Services and the Treasury Bureau, could have implications for property demand as well.

Type of policies	Hong Kong	Singapore	Assessment
	In November 2020, the government decided to withdraw the relevant Bill on this proposed tax.	The ABSD was increased in January 2013, July 2018 and December 2021. Current rate: ABSD of 30 percent applies.	cost is small compared with the larger upsides of the housing market. Price growth could easily negate the holding cost in a few years.
Prudential policy: LTV ratio limits	The HKMA introduced LTV caps in October 2009, then tightened the caps in August 2010, November 2010, June 2011, September 2012, February 2013, February 2015, May 2017 and August 2020. Current rates: LTV ratio limits range from 30 percent to 60 percent, depending on the borrower's purposes for the loan (for owner occupation or investment), on income derivation (from inside or outside Hong Kong), and on the property price associated with the loan. Note: LTV ratio caps might not apply to loans extended by the non-banking sector, such as developers.	In 1996, the MAS introduced LTV ratio limits for mortgage loans granted by lenders. It loosened the limits in 2005, then tightened them in February 2010, August 2010, January 2011, October 2012, January 2013, August 2013 and July 2018. Current rates: LTV ratio limits range from 15 percent to 75 percent for individual borrowers, depending on the loan tenure, age of borrower and number of existing housing loans. Note: In September 2009, Singapore banned developers from providing mortgage loans that would allow substantially lower regular installment payments in the first few years of a property purchase.	Both cities have LTV ratio limits in place to encourage prudent borrowing. While the HKMA's highest LTV ratio limit, of 60 percent, is lower than Singapore's, there could be borrowers who have been extended higher LTV ratios, such as 80-90 percent, under developers' lending schemes.
Prudential policy: DSR	The HKMA first introduced DSR limits in August 2010. The limits were tightened in September 2012, February 2015 and May 2017. Current rates: DSR limits range from 30 percent to 60 percent, depending on the borrower's income derivation (from inside or outside Hong Kong) and any outstanding loans.	The MAS introduced the Total Debt Servicing Ratio (TDSR) framework in June 2013 and tightened it in December 2021. Current rate: A TDSR of 55 percent for all borrowers applies.	Both cities have policies that limit debt over income, which can help borrowers avoid excessive leverage. Hong Kong's DSR is differentiated across borrower groups, whereas Singapore's DSR is uniformly applied across borrowers.
Supply-side policy: Housing supply	The Housing Bureau sets out the Long-term Housing Strategy with a rolling 10-year housing supply target every year. The Land Sale Program makes annual announcements on land sites that are estimated to be available in the financial year. The sites are then sold through tender every quarter.	The Ministry of National Development reviews the long-term plan every 10 years. The Government Land Sale is then announced every half a year.	Both Hong Kong and Singapore conduct advanced planning on supply. Adjustments are made in the short term as necessary.

Note: The Transport and Housing Bureau was split into the Transport and Logistics Bureau and the Housing Bureau on 1 July 2022.

Source: HKMA, Hong Kong's Transport and Housing Bureau; Hong Kong's Development Bureau; Monetary Authority of Singapore; Singapore's Ministry of Finance; Singapore's Ministry of National Development; and AMRO staff views

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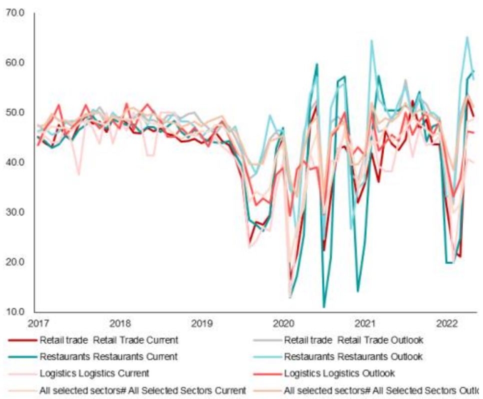
2. SMEs' Business and Financing Conditions: Challenges and Policy Support[20]

1. This Selected Issue looks at changes in financing conditions during the COVID-19 pandemic period for SMEs – which play a key role in Hong Kong's economy and job market – and also considers the importance of government support, with a few suggestions on what else the authorities could do. SMEs are critical for Hong Kong's economy and job market, accounting for 98 percent of enterprises and 45 percent of workers. They have therefore been a key focus of the government's policy support. By Q3 2022, what could be considered as the sixth wave of the pandemic in Hong Kong had disrupted economic activities once more, posing unrelenting challenges to SMEs as the authorities extended measures to ease financing conditions. This SI note seeks to briefly outline a few key observations of how SMEs' financing conditions have changed from the start of the pandemic to the present juncture; consider the extent to which government measures are likely to have affected these conditions; and raise a few modest suggestions on what more could be done.

2. For more than two years, the pandemic-induced economic downturn has heavily impacted SMEs in Hong Kong, especially those in contact-intensive sectors, such as travel and tourism, food and beverage (F&B), and retail services. As inbound tourist arrivals fell sharply to almost zero by Q2 2020, the revenue and profits of SMEs in these sectors plunged drastically and abruptly. Since then, these companies have remained under pronounced pressure, with the boundary closure remaining in force and social distancing measures being repeatedly imposed amid the recurrent waves of infections. Available data suggests that the number of cases of corporate bankruptcy proceedings increased from 7,518 in 2018 to 8,138 in 2019 and 8,687 in 2020; while anecdotal accounts further suggest that most of these cases were SMEs.

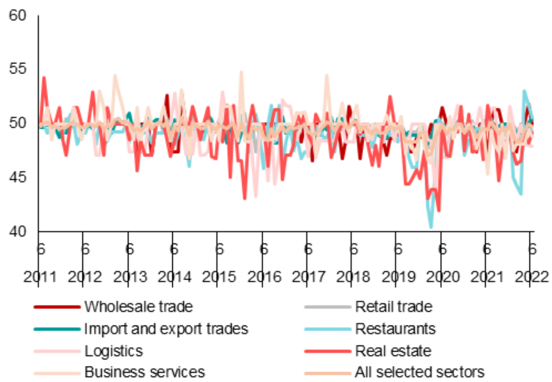
3. The above observations are unsurprising as the operating environment has been very difficult. Readings on the SME business situation index since the start of the pandemic show that periods of extended lockdowns coincided with sharp dips in the current and outlook diffusion indices for the retail trade, restaurants and logistics (Figure A2.1), though the drop was pronounced for services as a whole. The readings further show that these segments also came under marked pressure in terms of employment, though the differences with other segments were much less stark (Figure A2.2).

Figure A2.1. Business Receipts – Current and Outlook Diffusion Indices of SMEs



Source: C&SD

Figure A2.2. Employment Diffusion Index of SMEs



Source: C&SD

[20] Prepared by Suan Yong Foo, Senior Economist.

4. As SMEs have thinner financial buffers than large firms, financing conditions have greater implications for their prospects of staying in business and keeping workers employed. In this regard, SMEs' financing conditions abruptly became more difficult at the onset of the pandemic but eased afterwards as the local pandemic eased and the support measures took effect.

- **Before the pandemic, SMEs were already facing much more challenging financing conditions than larger enterprises, similar to the experiences across many advanced and emerging economies.** The themes are familiar. Compared to larger enterprises, SMEs tend to have short and patchy business track records and modest earnings, which means a more limited loan-servicing capacity; and less assets, which could have served as collateral for loans. SMEs also face information gaps, which prevent banks from conducting comprehensive credit risk assessments and fair loan pricings. The business environment became more difficult in H2 2019 when Hong Kong's economy went into recession. SME survey readings – in particular, the employment diffusion index (Figure A2.2) – and various accounts suggested that SMEs and their workers were being affected quite heavily.

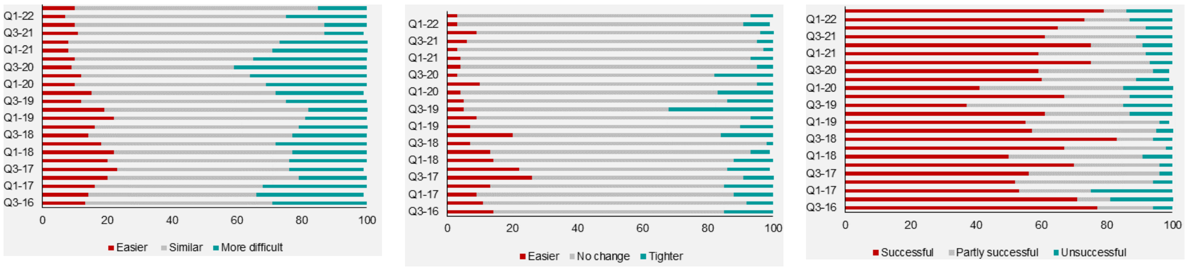
- **At the onset of the pandemic, SMEs' financing conditions tightened abruptly.** This was due to both demand and supply factors. On the demand side, SMEs became more wary of taking on debt or adding to their debt burden. On the supply side, banks took a cautious view toward the credit risks of SME borrowers and potential borrowers. These concerns were partly reflected by changes in key indicators reported in the HKMA's Survey on SMEs' Credit Conditions for Q1 2020. In particular, the survey found a deterioration in SMEs' perceptions of banks' credit approval stance relative to six months ago;[21] a perceived tightening in the stance of banks on existing credit lines;[22] and increases in the proportion of new bank credit applications which were rejected (Figure A2.3). It is important to note that owing to the small sample sizes of SMEs with existing credit lines (20% of surveyed SMEs in 2020Q1) and with new credit applications (7% of surveyed SMEs in 2020Q1) in the survey, the results could be prone to large fluctuations, and hence should be interpreted with care.

[21] The perception of more difficult credit approval stance may not necessarily reflect actual difficulties faced by SMEs in obtaining bank credit as the perception could be affected by a number of factors, such as media/news reports, business conditions and opinions of relatives and friends. It should also be noted that most respondents did not apply for new credit from banks during the quarter.

[22] In this survey, tighter stance on existing credit lines denotes a range of possible measures or arrangements, such as reducing unused and used credit lines, raising the interest rate, imposing additional collateral requirements, or shortening loan tenor. Therefore, respondents' indication of banks' stance on existing credit lines may not directly reflect banks' supply of credit to SMEs.

Figure A2.3. SME Credit Conditions Survey: Key Indicators

SMEs' perceptions of banks' credit approval stance vs six months ago | Changes in banks' stance on existing credit lines | Results of new bank credit application



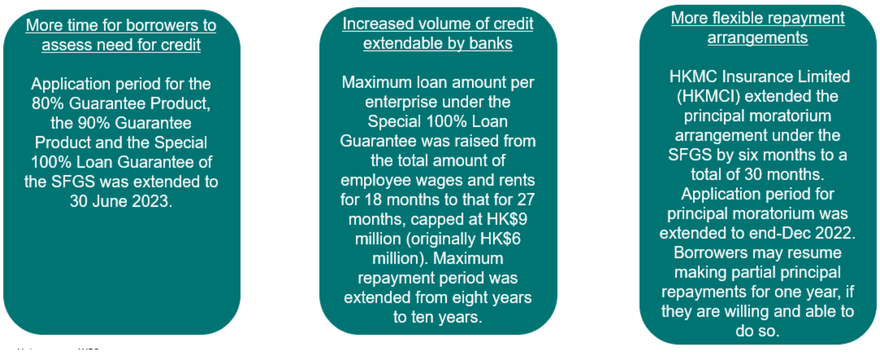
Source: HKMA

- To counter the challenging economic environment arising from the pandemic, **swift actions were taken.** By early April 2020, approval had been granted to 9,000 applications from SMEs under the Banking Sector SME Lending Coordination Mechanism, which was established in October 2019. The approved applications involved principal repayment holidays, loan extensions and relief loans to the tune of more than HKD57 billion in total. Banks also introduced measures to help SMEs, including principal repayment holidays for SME loans, extension of loan tenors, conversion of trade financing lines into temporary overdraft facilities, and special loans to SMEs in hard-hit sectors.

- **Half a year into the pandemic, SMEs' financing conditions eased markedly as forceful policy actions took greater effect – with the centerpiece being the SME Financing Guarantee Scheme (SFGS).** The SFGS, which was launched in 2011 and strengthened in 2012 and 2019, was further reinforced in 2020 – with the Financial Secretary announcing in the 2020-21 Budget Speech that a Special 100% Loan Guarantee would be introduced under the scheme. This move aimed to ease SMEs' financial burden in terms of wage and rental costs, with the ultimate policy objective being to minimize incidences of business closures and layoffs. As the name of the measure implied, the government provided unprecedented 100 percent guarantees for these loans, which also came with low interest rates. Implementation was swift; applications started on 20 April 2020. On the back of various policy supportive measures, SMEs' perceived credit conditions showed signs of improvement in Q4 (Figure A2.3).

- **In order to further alleviate the cash flow pressure of SMEs in the time of the pandemic, the authorities announced further enhancements to the SFGS in late February 2022.** The enhancements sought to give SME and other potential borrowers more time to assess their need for credit; increase the volume of extendable credit; and make repayment arrangements more flexible (Figure A2.4). The Survey on SMEs' Credit Conditions for Q1 2022 indicated that a large majority of the SME respondents continued to perceive a similar or easier credit approval stance in the quarter; a large majority of the SME respondents continued to gauge banks' stance on existing credit lines as easier or unchanged; and a large majority of the SME respondents which had applied for new credit found full or partial success in their applications (Figure A2.3). However, when interpreting the figures from Survey for SME Credit Conditions, it should be noted that owing to the small sample sizes of SMEs with existing credit lines and with new credit applications in the survey, the results from the survey could be prone to large fluctuations, and hence should be interpreted with care. In addition, the perception of more difficult credit approval stance may not necessarily reflect actual difficulties faced by SMEs in obtaining bank credit as the perception could be affected by a number of factors, such as media/news reports, business conditions and opinions of relatives and friends. Alongside these results, the April and May 2022 editions of the government's Survey on the Business Situation of SMEs indicated that, respectively, just 7.2 percent and 7.3 percent of the surveyed SMEs needed credit or more credit. This likely reflected not just contained demand for credit among SMEs, but also the authorities' success in improving conditions for the supply of credit to SMEs.

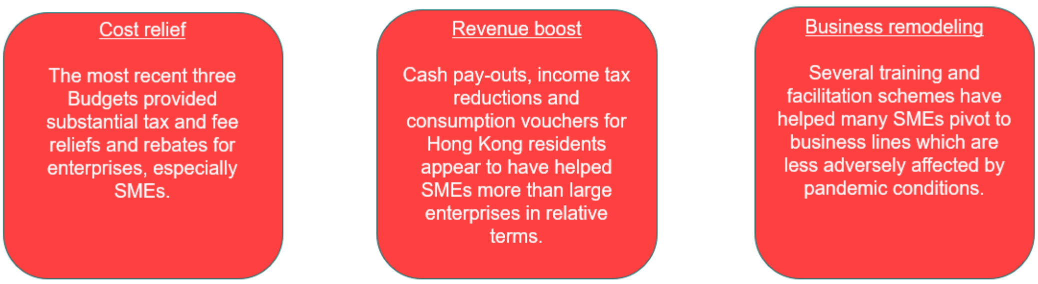
Figure A2.4. SFGS Enhancements Feb 2022



Source: HKMA

5. Alongside the help which the SFGS has provided to ease SMEs' financing difficulties, other government measures have also been supportive in averting worse outcomes (Figure A2.5).

Figure A2.5. Other Key Measures Taken by Hong Kong Authorities to Help SMEs



Source: Various government agencies

- **On the cost side: tax and fee relief and rebates announced in the last three Budgets have been substantial.** These include one-off reductions of profits taxes, subject to certain caps; a waiver of rates for non-domestic properties; waivers of business registration fees and companies' annual returns registration fees; and a rental enforcement moratorium to help tenants of some sectors through legislation.[23]

[23] The legislation would bar landlords from ending the tenancy of, or not providing services to, tenants of specified sectors for failing to settle their rent on schedule, or from taking relevant legal action against them. The moratorium would be valid for three

- **On the revenue side: cash payouts, income tax cuts and consumption vouchers for Hong Kong residents appear to have helped SMEs by boosting residents' disposable incomes. This has then helped to support demand for goods and services provided by SMEs.** Meanwhile, government-driven efforts to open new export markets for SMEs have continued unabated through the pandemic-induced economic downturn, partly aiming to strengthen SMEs' competitiveness in the coming years. A most notable example is Hong Kong's application to join the Regional Comprehensive Economic Partnership (RCEP). This is a comprehensive trade deal that covers not only liberalization of trade in goods, but also trade in services, foreign investment, intellectual property, e-commerce, and micro, small and medium enterprises (MSMEs). SMEs are often disproportionately burdened by the heavy fixed costs associated with duties and restrictions when they engage in export activities. The RCEP, by promising lower tariff and nontariff barriers, trade facilitation and simpler rules of origin, will help Hong Kong's SMEs to integrate into regional trade and investment. SMEs can avail themselves of the opportunities brought by the RCEP to participate in regional and global value chains and take advantage of wider sourcing and market options.[24]

- **As for business remodeling: several training and facilitation schemes have helped many SMEs pivot to business lines which are less adversely affected by pandemic conditions – including those which make workers employed by SMEs more skilled and adaptable and those which seek to revive hard-hit sectors (in due course).** Key initiatives contained in the past three Budgets aim to enhance formal courses in upskilling, strengthen on-the-job training and make it more tenable for workers to undergo training by raising allowances. Some other initiatives seek to position the travel and tourism sector for a strong revival once the boundaries are reopened, to encourage and enable the logistics sector to make productivity gains using technology, and to help Hong Kong people and entrepreneurs pursue development opportunities on the mainland through a new support scheme.

- **Structurally, all these policy measures have helped to preserve the productive capacity of SMEs**, which would position them for the hopefully imminent reopening of boundary with the mainland and enable them to maximize benefits in terms of decisive improvements in revenue, profits, employment, financing conditions and business confidence.

6. Bearing in mind how instrumental Hong Kong's policy measures have been in helping SMEs through the past few difficult years, the suggestions below on what more could be done for the long term focus on enabling further progress in enhancing information flow, business adaptability, credit channeling, and overall resilience through a "life cycle" (Figure A2.6).

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months and could be extended for another three months if necessary, with the legislation automatically lapsing after six months. Banks would exercise flexibility if the repayment ability of any landlord was affected due to a resultant reduction in his rental income.

[24] The RCEP includes a specific chapter on SMEs that aims to promote information sharing and cooperation to boost the ability of SMEs to make use of opportunities created by the regional agreement. However, the RCEP is a soft-law instrument and the direct benefits of this chapter to SMEs may be small (ADB, 2022).

- **First, efforts should continue in making various databases that contain useful information for SMEs more comprehensive and impactful.** For example, the Trade Development Council's (HKTDC) SME Centre is a centralized resource and interactive service hub which provides users with all the resources needed for doing business, and which functions as a one-stop shop for the HKTDC to provide SMEs with comprehensive services in export marketing.

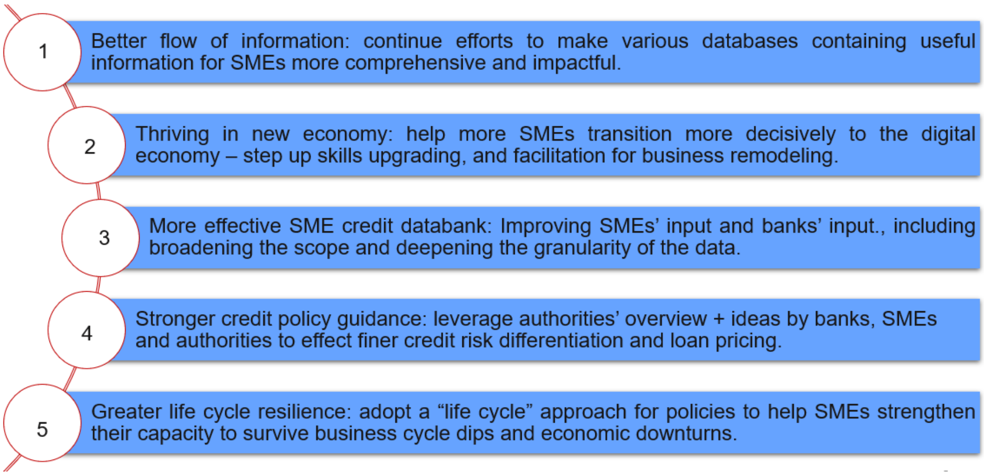
- **Second, bigger steps may be needed to help more SMEs switch to the much more digitalized "new economy" by upgrading the skills of employees, and to facilitate business remodeling by, for example, equipping SMEs with the know-how to extend from brick-and-mortar stores to digital sales channels through enlisting the help of more advanced companies to assist new start-ups.** More advanced technologies can also be adopted to let SMEs operate more nimbly regardless of their line of business – for example, on how to accept new orders in real time and to maximize efficiency gains from just-in-time logistics

- **Third, the SME credit databank could become a more effective platform by improving input from SMEs and banks.** This is challenging, as parties with the most information may not find it advantageous to share that information. However, the benefits of a more comprehensive and detailed SME credit databank are substantial. It would be worthwhile to try to make some headway in this area.

- **Fourth, authorities could consider working with banks that are leaders in providing SME loans, and possibly with the banking association, to strengthen the sector's capacity to serve SMEs.** This could involve creating stronger programs for training more banking professionals in SME credit, to improve the sector's abilities in credit risk differentiation, loan pricing, collateral assessment, loan quality management, provisioning estimations and so on.

- **Fifth, authorities could consider adopting a "life cycle" approach for policies to strengthen SMEs' capacity to survive business cycle dips and economic downturns.** Possible assistance includes programs to help companies make gradual but steady adjustments to their business lines, products and target customer segments, so SMEs could strike a judicious balance between specialization and adaptability. More efforts could also go toward boosting exchanges and collaboration between Hong Kong business associations and their mainland counterparts, to help more SMEs enter the mainland market and establish strong footholds.

Figure A2.6. A Few Ideas on What More Could Be Done



Source: AMRO staff

3. Hong Kong's Development and Prospects as a Super-connector for Mainland China[25]

1. Hong Kong's role in connecting mainland China with the rest of the world has evolved over time, shifting from being a key entrepot for the mainland in the 1990s to playing a greater role in financial intermediation later on. This transition was mainly due to the city's evolution into an international financial center with a strong institutional footing and deep pool of U.S. dollar liquidity. The current selected issue uses a series of heat maps spanning various sectoral linkages to show Hong Kong's deepening connections with mainland China and with the rest of the world by acting as a preeminent gateway over the years. As Hong Kong celebrates the 25th anniversary of the 1997 handover this year, it is timely to review the achievements made so far and think ahead to the future.

Figure A3.1. Real Sector

Indicator	Unit	1991–2000	2001–2010	2011–2020	2021–22	
		AFC	GFC	COVID-19		
GDP						
HK's GDP growth and CN's growth	Correlation	0.43	0.54	0.64	0.61	0.63
CN's GDP	Percent of total GDP of HK's key trading partners	8.2	18.7	31.0	31.8	31.9
HK's GDP	Percent of CN's GDP	14.2	3.8	2.3	2.1	2.0
GBA cities' GDP	Percent of CN's GDP		13.6	11.7	11.1	11.0
Trade						
CN trade with HK	Percent of CN's total trade	11.4	7.8	6.0	6.0	
HK trade with CN	Percent of HK's total trade	38.9	48.9	51.8	52.4	
Re-exports of CN origins to world	Percent of HK's total re-exports to world	61.0	61.5	52.9	51.4	
Re-exports to CN	Percent of HK's total re-exports to world	35.1	52.9	59.3	59.8	
HK exports to CN for outward processing	Percent of HK's total exports to CN	52.0	32.5	21.6	19.1	
HK imports from CN for outward processing	Percent of HK's total imports from CN	79.3	49.8	34.9	33.1	
ASEAN trade with HK	Percent of ASEAN's total trade	4.3	4.3	5.8	5.0	
HK trade with ASEAN	Percent of HK's total trade	8.3	10.4	12.6	12.1	
Investment						
CN's FDI through HK	Percent of CN's total FDI	38.1	52.8	65		
CN's ODI through HK	Percent of CN's total ODI		56.0	58.0		
Number of CN RHQs based in HK	Percent of total RHQs in HK	8.1	7.7	15.8	17.3	
Number of US RHQs based in HK	Percent of total RHQs in HK	24.8	22.4	18.8	17.4	

Source: national authorities via Haver Analytics; AMRO staff calculations

Note: AFC = Asian financial crisis; GFC = global financial crisis; ASEAN = Association of Southeast Asian Nations; CN = mainland China; HK = Hong Kong; FDI = foreign direct investment; ODI = outward direct investment; RHQ = regional headquarters. A lighter blue color reflects a lower data point for the particular indicator, and vice versa for a darker blue color. Figures represent end-of-period data points either at the end of a decade or latest available data points. 2022 data for correlation between Hong Kong and mainland China's GDP growth; GDPs of mainland China, Hong Kong and GBA cities is as of Q2 2022.

2. Hong Kong is increasingly integrated with the mainland and their business cycles are more synchronized with each other. Indeed, the heat map in Figure A3.1 shows that the correlation in growth between the two has grown over time, from 0.43 in 2000 to around 0.6 in recent years. The main reason could be the expansion in mainland China's GDP relative to other key trading partners of Hong Kong. At the same time, the GDPs of Hong Kong and the GBA have declined in the last two years to around 2 percent and 11 percent of the mainland's, respectively, from around 4 percent and 14 percent in 2010. These statistics highlight strong economic expansion in other parts of China where a further strengthening of links should allow Hong Kong to capitalize on rising opportunities.

3. While Hong Kong's role as an entrepot for the mainland has remained important, albeit at a reduced degree, the trading hub has forged ahead to form stronger ties with the ASEAN region. Hong Kong was a successful trading post for the mainland in the 1990s, when it represented an average of 15 percent of the mainland's total merchandise trade. That share has since diminished to around 6 percent in the past two years even as the mainland's weight in Hong Kong's total trade grew over time. To a large extent, re-exports and outward processing activities[26] with the mainland have been slowing. Nonetheless, the city would

[25] Prepared by Chiang Yong (Edmond) Choo, Associate Economist and Kimi Xu Jiang, Economist.
[26] According to the Census and Statistics Department, exports to the mainland for outward processing refer to raw materials or semi-manufactures exported from or through Hong Kong for processing under a contractual arrangement that specifies Hong

continue to be a prominent trading hub for mainland China, given its extensive trading network and strategic geographical location. Equally important, trade with ASEAN economy have flourished over the years, peaking in 2020, when trade between the two economies took up the highest share in the respective economies' total trade.

4. Hong Kong has strengthened its roles in facilitating direct investment flows for mainland China and in hosting regional headquarters[27] operations for multinational companies. According to the latest available data, Hong Kong handled 65 percent and 58 percent of mainland China's foreign direct investment in 2018 and outward direct investment (ODI) in 2020, respectively. Compared to 2010, both proportions have increased. While more Chinese firms, especially state-owned enterprises, have made use of Hong Kong as a platform to invest overseas, a significant part of the growing facilitation of investments were related to the indirect channeling of capital from mainland companies through the financial center to leverage its institutional advantages (Huang 2019). Indeed, given its robust regulatory framework, supportive professional services, and strong treasury and risk management capabilities, Hong Kong has long been a destination for multinational enterprises to set up regional headquarters (RHQs). In particular, the proportion of mainland Chinese RHQs has grown solidly since the China-U.S. trade war started in 2017, while the proportion of U.S. companies in Hong Kong has declined over the same period (Figure A3.1).

Figure A3.2. Financial Sector

Indicator	Unit	2001–2010	2011–2020	2021–22
Financial		GFC	COVID-19	
Offshore CN firms' IPOs in HK (value)	Percent of total CN firms' IPOs	29.6	42.5	29.0
CN corporate bond issuance in HK	Percent of total CN corporate bond issuance	1.24	5.1	4.84
CN corporate bond issuance in HK	Percent of total HK corporate bond issuance	49.3	80.3	84.7
CN green bond issuance in HK	Percent of total CN green bond issuance		16.9; 80.8	75.9
CN green bond issuance in HK	Percent of total HK green bond issuance		0.7; 29.7	25.7
CN firms listed on HKEX	Percent of total listed companies on HKEX		42.3	48.4; 50.7
HK RMB Deposits	Percent of global total	81.2	71.6	73.9; 72.0
HK Turnover of RMB FX and derivatives trading	Percent of global turnover	86; 25.7	29.8	
HK Equity market capitalization	Percent of CN market capitalization	67.3	50.2	37.8
HK Financial sector GDP	Percent of CN financial sector GDP	25; 11.0	6.8	6.2
HK foreign reserves	Months of retained imports of goods	28.7	51.5	44.3; 41.4
HKD/RMB	Exchange rate	1.17	1.19	1.22; 1.17

Source: national authorities via Haver Analytics; AMRO staff calculations

Note: GFC = global financial crisis; CN = mainland China; HK = Hong Kong; HKEX = Hong Kong Exchanges and Clearing Limited; HKD/ RMB = Hong Kong dollars per Chinese renminbi; IPO = initial public offering. A lighter blue color reflects a lower data point for the particular indicator, and vice versa for a darker blue color. Figures represent end-of-period data points either at the end of a decade or latest available data points. 2022 data for Chinese firms listed on HKEX and for RMB deposits in Hong Kong is as of July 2022; foreign reserves as of May 2022; and the exchange rate as of June 2022.

5. Hong Kong has been leveraging its unique position as an international financial center to serve as a source of equity and bond financing, and as a channel for the opening up of mainland China's capital accounts (Figure A3.2).

- In light of the mainland's growing overseas financing needs, Hong Kong has become more important as the destination for Chinese firms to issue bonds and launch initial public offerings (IPOs). This is particularly so for corporate bonds and, lately, green bonds. As mainland China has committed to reaching carbon emissions peak before 2030 and carbon neutrality before 2060, the need for green financing would be huge. In addition, firms having major operations in the mainland now account for half of the listings on the Hong Kong Exchanges and Clearing. The growing number of Chinese

Kong will later re-import the processed goods. Imports from the mainland related to outward processing refer to processed goods imported from the mainland, of which all or part of the raw materials or semi-manufactures had been exported from or through Hong Kong to the mainland for processing under the contractual arrangement.

[27] A regional headquarters is an office whose parent company is located outside Hong Kong and which has managerial control over offices and operations in the region.

firms' listings underscores Hong Kong's continued importance as a platform for mainland companies to raise funds through IPOs, especially as rising tensions between China and the U.S. could drive more Chinese businesses to Hong Kong for listing (Yau, 2022).

- The mainland is opening its capital account in a measured manner through various Connect schemes with Hong Kong, covering stocks, exchange-traded funds (ETFs), bonds, wealth management products and derivatives. These Connect schemes have fared well, with broad investor participation and growing turnover. Taking Northbound Bond Connect as an example, total trading volume reached RMB6.5 trillion in 2021, representing average annual growth of more than 34 percent per year.
- Hong Kong is also the primary offshore renminbi center and a key avenue to promote the internationalization of the currency. More than 70 percent of offshore renminbi deposits and Certificates of Deposit, exceeding RMB900 billion, are placed in Hong Kong, followed by London and Singapore. Hong Kong is also the largest offshore renminbi foreign exchange and interest rate derivatives market.

Figure A3.3. Other Linkages

Indicator	Unit	1991–2000	2001–2010	2011–2020			2021–22	
		AFC	GFC			COVID-19		
Connectivity and tourism								
CN major airlines' available seat kilometers to HK	Number (in thousands)		14.3		25.0	4.0	3.9	
HK major airlines' available seat kilometers to CN	Number (in thousands)		9.6		11.3	1.5	0.8	
Tourist arrivals from CN	Percent of HK's total arrivals	29.0	63.0		78.3	75.8	71.9	
CN's tourist arrivals and HK's retail sales	Correlation	-0.1	0.8		0.7	0.9	0.4	0.4
Intellectual Property								
Non-resident trademark applications	Percent of total applications		62.3		62.1	57.6		
Non-resident industrial design applications	Percent of total applications	60.2	56.2			71.9		
Non-resident patent applications	Percent of total applications	99.4	98.9			98.0		
Patent applications by Chinese firms	Percent of total applications			6.9		31.1	32.0	
Patent applications by Chinese firms granted	Percent of total applications granted			5.0		7.5	23.5	
Talent								
CN immigrants in HK	Number (thousands)	57.5	42.6		39.1	10.1		
Admission scheme for mainland talents in HK	Number of applications approved (thousands)			10.4	14.1	7.0	9.1	5.7
Non-local student enrolment for universities	Percent of total student enrolment	2.2	13.5			19.1	20.1	
CN student enrolment for universities	Percent of total student enrolment	1.8	11.7			13.4	14.6	
Student enrolment from rest of the world	Percent of total student enrolment	0.4	1.8			5.8	5.5	
Immigration approval for CN graduates	Percent of total non-local applications approved			92.7		85.6	84.1	81.3

Source: national authorities via Haver Analytics; AMRO staff calculations

Note: AFC = Asian financial crisis; GFC = global financial crisis; CN = mainland China; HK = Hong Kong. A lighter blue color reflects a lower data point for the particular indicator, and vice versa for a darker blue color. Figures represent end-of-period data points either at the end of a decade or latest available data points. 2022 data for admission scheme approvals, immigration approvals, and correlation between mainland tourist arrivals and Hong Kong's retail sales is as of June 2022.

6. Demand for travel to and from mainland China has grown, which could spell larger spillover effects on Hong Kong's retail sector. The available seat kilometers[28] of flights shuttling between the Mainland and Hong Kong had been increasing notably before the pandemic disrupted travel, highlighting the demand for travel between both sides for work and play (Figure A3.3). Furthermore, from the 1990s onwards, Hong Kong has attracted a rising share of mainland tourists, who now represent the largest group of inbound travelers. In this regard, the number of mainland arrivals would have a significant bearing on Hong Kong's retail sales performance.

[28] Available seat kilometers (ASK) capture the total flight passenger capacity of an airline in kilometers. It is calculated by multiplying the total number of seats available for scheduled passengers with the total number of kilometers over which those seats were flown. In this case, ASK is used as a proxy for flight demand between the mainland and Hong Kong.

7. Hong Kong's role as a regional hub for intellectual property (IP) services has grown over time, becoming the preferred choice of mainland firms. Among the advantages of doing business in Hong Kong, the strong rule of law, particularly on intellectual property rights, and the wide range of related services have combined to maintain its competitive edge over other hubs. Apart from being a springboard for overseas companies looking to enter the mainland Chinese market, Hong Kong was also a preferred platform for many mainland firms looking to expand their businesses abroad and register their IPs (Yuen 2019). As shown in Figure A3.3, non-resident IP-related applications have either increased or remained high as a share of total IP-related applications. Specifically for mainland firms, their share in total applications and total approvals have jumped during the pandemic.

8. However, talent inflows from the Mainland have recently slowed in Hong Kong, notwithstanding the city's attractiveness to global professionals. Migration from the mainland peaked in 1996, just before the year of Hong Kong's handover, but has fluctuated since then (Figure A3.3). In more recent times, the social unrest in 2019 has dampened the influx of mainland immigrants, and after that the COVID-19 outbreak in 2020 has shut down boundaries on both sides such that only 10,000 immigrants are allowed into Hong Kong as shown in the heatmap. Likewise, admission approvals for mainland talent and professionals[29] dived in 2020, though the number has since picked up gradually. Another channel to attract mainland talent is through universities. Non-local student enrolment in Hong Kong's publicly funded universities[30] stands at 20.1 percent of total student enrolment and mostly comprises students from the mainland. That said, the share of immigration approvals for mainland students to stay and work in Hong Kong after graduation[31] fell to 81.3 percent in 2022 from 92.7 percent in 2016.

9. To strengthen growth over the medium to long term, Hong Kong should further enhance its status as a super-connector by establishing closer links between China and the rest of the world. Hong Kong could expand its unique role by positioning itself as a premier exchange of Chinese and foreign capital, fostering closer human capital linkages and forging broader partnerships on technological innovation within and outside mainland China. On one hand, the city's proximity and better connections to mainland China would encourage overseas investors to participate in vast opportunities, especially in high-growth and high-technology sectors in the GBA and projects in the Belt and Road Initiative (BRI). On the other hand, Hong Kong could link mainland investors more efficiently with overseas opportunities and open an additional source of investments for the rest of the world.

10. Financial links with the mainland could be reinforced in both breadth and depth as the mainland expands the Connect schemes with Hong Kong while gradually opening up its capital account. By including ETFs into Stock Connect in July 2022 and announcing to add the Swap Connect Scheme in early 2023 to the existing Connect schemes, the authorities are making relentless and commendable efforts to create more opportunities for cross-boundary investment. Looking ahead, these Connect schemes could be expanded steadily while strengthening the associated risk management practices. To develop an even

[29] Under the Admission Scheme for Mainland Talents and Professionals (ASMTP), mainland Chinese residents who possess special skills, knowledge or experience of value to and not readily available in Hong Kong may apply to work in Hong Kong. The ASMTP is quota-free and non-sector-specific.
[30] Referring to the eight universities under the University Grants Committee (UGC), including the Chinese University of Hong Kong, City University of Hong Kong, Hong Kong Baptist University, Hong Kong University of Science and Technology, Lingnan University and Hong Kong Polytechnic University.
[31] Under the Immigration Arrangements for Non-local Graduates (IANG), mainland Chinese and other non-local students who have obtained an undergraduate or higher qualification in a full-time and locally accredited program offered by UGC-funded institutions may apply to stay and work in Hong Kong. The IANG is quota-free and non-sector-specific.

more vibrant offshore renminbi ecosystem, the authorities could consider introducing a renminbi securities trading counter under Southbound Stock Connect and continue to support renminbi bond issuances by both corporate and government entities from mainland China and beyond. Meanwhile, accelerating green finance and digital infrastructure would fully capitalize on Hong Kong's first-mover advantage and generate more opportunities. Collectively, these initiatives could further foster Hong Kong's importance as an international financial center and a super-connector for financial flows as mainland China continues to liberalize its capital account.

11. There is scope for Hong Kong to expand other links to leverage the increasing potential presented by the GBA, the BRI and the ASEAN region. Given mainland China and ASEAN's rapidly growing consumer market and manufacturing prowess, Hong Kong could continue to play a bridging role in boosting commerce between GBA-based and ASEAN businesses (HKTDC and UOB 2021). The formalization of the ASEAN-Hong Kong FTA and the city's application to join the RCEP (see Selected Issue 4 on the RCEP) could provide more stability and opportunities for businesses amid challenges arising from deglobalization and evolving supply chain trends (Tang and Lai 2022). With the GBA primed to become an innovation hub and a leading driver of IP applications, inviting more mainland Chinese and foreign firms to register their IPs in Hong Kong would elevate its status as a regional IP trading hub to the next level. Additionally, more publicity campaigns and incentives to lure overseas and mainland Chinese talent amid the global labor shortage could mitigate the shortfall in the domestic workforce in the short term, and declining productivity trend due to the aging working population in the longer term.

12. Ensuring ample policy buffers, bolstered by Hong Kong's strong institutions, should continue to provide a cushion against greater spillovers as integration with the mainland strengthens. Deeper integration with the mainland will naturally lead to larger spillovers to Hong Kong. In this regard, the authorities should ensure policy buffers, such as fiscal and foreign reserves, remain ample. Hong Kong would continue to be the preferred gateway for connecting mainland China with the rest of the world, as reaffirmed in the national-level 14th Five-year Plan.[32] However, to perform this role better, it would require more high-priority discussions, commitment and conviction among key stakeholders to streamline policies and strategies. More importantly, maintaining its tradition of innovation and strong institutions would be crucial for Hong Kong to stay ahead of the changes and embark on a firmer long-term growth trajectory.

[32] The 14th Five-Year Plan for Economic and Social Development and Long-Range Objectives Through the Year 2035 of the People's Republic of China sets out the role and positioning of Hong Kong in the overall development of the country between 2021 and 2025. It sets out room for enhancement and opportunities in sectors of particular importance, including international centers for finance, transport and trade; international hubs for aviation, information and technology; and a regional center for IP trading.

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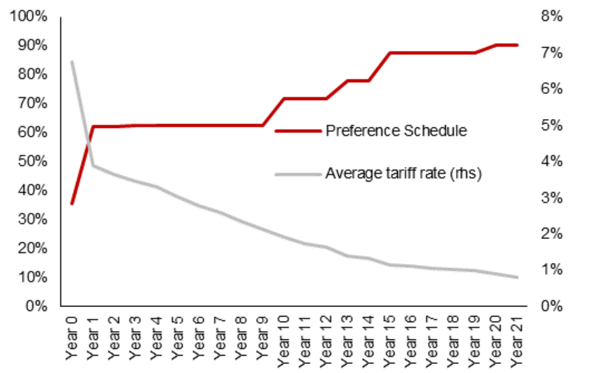
4. Will Hong Kong Benefit from Joining the RCEP?[33]

1. Hong Kong made an official application to join the Regional Comprehensive Economic Partnership (RCEP) in January 2022, right after the agreement entered into force on 1 January 2022. The RCEP is the world's largest free trade agreement (FTA), which would cover 30 percent of global GDP and the world's population, and more than 40 percent of the world's manufacturing output. It aims to create a single and deeply integrated market among its 15 member countries,[34] which holds great promise for fostering trade and investment throughout the Asia-Pacific region and making significant contributions to the region and the global economy. Hong Kong could be a member in the RCEP in mid-2023 at the earliest.

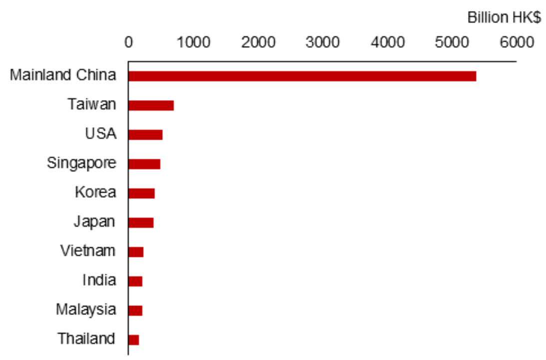
2. Overall, the near-term impacts of the RCEP on member economies will likely be small, as the depth and scope of the trade agreement are quite limited. The RCEP is comprehensive, covering not only liberalization of trade in goods, but also trade in services, foreign investment, intellectual property (IP), e-commerce, and micro, small and medium enterprises (MSMEs). However, compared with other mega regional FTAs, like the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the degree of liberalization under the RCEP is shallower and its coverage is more limited. Most of its liberalization disciplines are less rigorous, and its provisions on IP, services, investment and e-commerce are relatively weak (Park, Petri and Plummer, 2021; Park, 2022). Although the RCEP will eliminate 92 percent of tariffs imposed by its members on originating goods, the move will be implemented progressively over 20 years (Figure A4.1). Moreover, the RCEP offers a differential tariff concession, which, along with its resulting complex tariff schedules, may discourage firms from leveraging the agreement extensively.

Figure A4.1. RCEP Tariff Reduction Schedule



Source: AMRO staff calculations based on RCEP tariff concession schedules

Figure A4.2. Hong Kong's Value of Merchandise Trade, 2021



Source: C&SD

3. That said, the RCEP's "living" agreement framework under its institutional provisions enables it to evolve and be dynamic, offering potential for improvement and expansion. A range of "unfinished business" has been incorporated in the RCEP work program as part of a built-in agenda. For example, the services chapter allows for both positive-list and negative-list approaches to increasing market access, but all the countries are committed to adopting a negative-list approach within six years. A major drawback of the RCEP's investment chapter

[33] Prepared by Fan Zhai, Senior Economist.
[34] The 15 participating economies are the 10 members of the Association of Southeast Asian Nations (ASEAN), Australia, China, Japan, Korea and New Zealand.

is the absence of an investor-state dispute settlement mechanism, but there is a built-in work program requiring the parties to discuss setting up such a mechanism within two years after the agreement enters into force (Park, Petri and Plummer, 2021), that is, by 31 December 2023.

4. One important feature of the RCEP is that it aligns and streamlines rules of origin (ROOs) for all member countries, which can deepen value chains among these economies. The RCEP consolidates the ROOs in existing ASEAN-plus-one FTAs and simplifies the origin verification process, so as to provide greater flexibility and integration of value chains across the region. By adopting a common, diagonal cumulation scheme[35], the RCEP's ROO provisions are generally on a par with or better than the region's existing FTAs. In fact, prior to the RCEP, less than 30 percent of intra-regional trade conducted under FTAs in the Asia-Pacific were making use of trade preferences (Kawai and Wignaraja, 2013), significantly lower than the typical utilization rate of 70-80 percent in the E.U. and North America. The simplified ROO regime under the RCEP will increase the use of preferential tariffs, helping dismantle the "noodle bowl" of existing bilateral agreements in the region. The RCEP's built-in agenda also includes an extension from diagonal cumulation to full cumulation, which will allow for the cumulation of processing across the FTA territory, even when the initial input does not originate in the FTA member.

5. As for Hong Kong, it can benefit significantly as an entrepot city economy by acquiring membership in the RCEP, notwithstanding its existing FTA network.

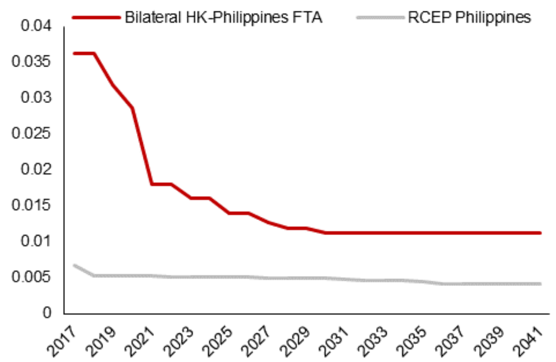
- Hong Kong has FTAs with 13 members of the 15-strong RCEP, namely, mainland China (2003), New Zealand (2010), the 10-member ASEAN (2017) and Australia (2019). Joining the RCEP would expand Hong Kong's FTA network to Korea and Japan, the fifth and sixth largest trading partners of Hong Kong in 2021 (Figure A4.2). Japan is the third largest re-export and the fifth largest off-shore trading partner of Hong Kong. As the two advanced economies in the region, Japan and Korea have also close economic ties with Hong Kong in terms of services trade and bilateral investment. Having FTAs with these two economies will enable Hong Kong to tap significant new trade and investment opportunities with them.
- Compared with the existing FTAs between Hong Kong and RCEP members, the RCEP generally contains more ambitious liberalization provisions. On tariff cuts, most RCEP members offer larger tariff concessions than in their own FTAs with Hong Kong (see, for example, Figure A4.3 for the Philippines and Figure A4.4 for Australia). Within the service trade, the RCEP mandates the opening up of at least 65 percent of the service sector along with increased foreign shareholding limits, including many new service access provisions beyond individual regional FTAs (Asian Trade Center, 2021). Moreover, Australia, Brunei, Indonesia, Malaysia and Singapore have all opted for the negative-list approach to scheduling service trade commitments under the RECP, in contrast to the positive-list approach adopted in the ASEAN-Hong Kong FTA and Australia-Hong Kong FTA. Under the negative-list approach, any new services that are created will automatically be opened to foreign competition without further negation. The RCEP, by having negative list in services liberalization in several important

[35] Cumulation is a ROO provision which allows goods obtained or processing in one FTA member country to be considered as originating in another. There are three types: bilateral cumulation, in which each member of a bilateral trade agreement can use products originating in the other as intermediate input without the final goods losing its originating status; diagonal cumulation, in which goods originating in one FTA member country and further processed in multiple other member countries can be treated as the originating products; and full cumulation, in which cumulation can be applied to goods not originating in the FTA member country but processed in the FTA territory.

members, offers an important advantage for Hong Kong given its strong orientation in services and its ambitions in fintech and other services innovations.

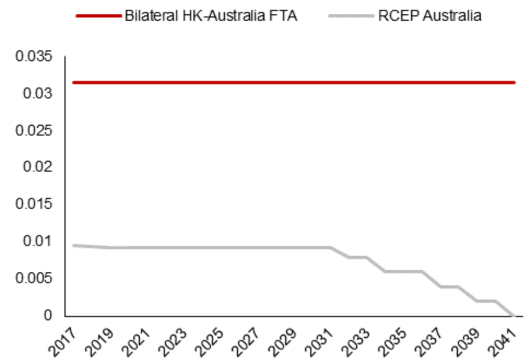
- Joining the RCEP would enable Hong Kong to shift from being a rule-taker to acting as a rule-co-maker in regional trade and investment policy. Hong Kong has the potential to be a significant participant of the RCEP. By leveraging the evolving nature of the RCEP, Hong Kong can play a large role in setting priorities and shaping the liberalization agenda of the agreement, thereby better pursuing its own interests.

Figure A4.3. Comparison of Tariff Reduction Schedule - the Philippines



Source: Market Access Maps Database, AMRO staff calculations. Tariff rates are average rates weighted with import values.

Figure A4.4. Comparison of Tariff Reduction Schedule – Australia

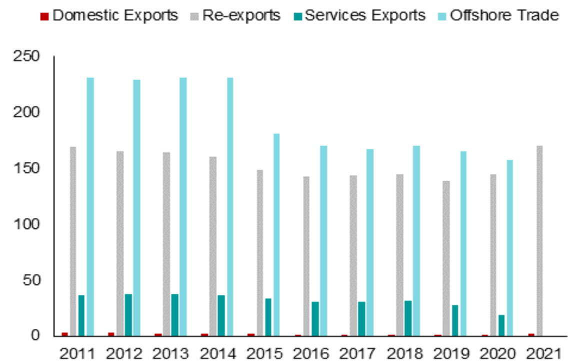


Source: Market Access Maps Database, AMRO staff calculations. Tariff rates are average rates weighted with import values.

6. An important and opportune implication of RCEP membership is that it would offer Hong Kong a chance to cope with challenges arising from the ongoing reconfiguration of the global value chain.

- **As an important global re-export hub, Hong Kong is deeply integrated into regional production chains, but its dependence on regional manufacturing trade and production is often underestimated.** Although manufacturing accounts for only 1.0 percent of the GDP, Hong Kong has actively participated in regional value chains through its massive re-export activities and offshore trade (Figure A.3.5). The rapid growth of Hong Kong's re-exports and offshore trade reflects not only its historical role as an entrepot hub, but also its strength in providing key services to facilitate the creation and operation of supply chains. That said, the recent fragmentation of production chains poses challenges to managing and coordinating operating activities at different stages of the production and distribution process, leading to increased demand for service solutions to supply chain management. Riding on the trend of international production fragmentation in the past two decades, Hong Kong has transformed itself from a traditional trading and shipping center into a regional supply chain hub. For example, in electronics, Hong Kong handles about 40 percent of China's integrated circuit (IC) trade. Some of mainland China's neighboring trading partners, such as Korea and Taiwan, also route about one quarter of their IC exports to mainland China through Hong Kong (MAS, 2020; Jones et al, 2020). Acting as an intermediary of trade in these products, Hong Kong also addresses various needs for logistics, distribution, financial, legal and other professional services, facilitating and enhancing the functionality of regional production networks.

Figure A4.5. Hong Kong's Domestic Exports, Re-exports of Goods, Services Exports and the Value of Goods Involved in Offshore Trade (as % of GDP)



Source: C&SD

- **The ongoing global value chain reconfiguration has brought challenges for Hong Kong.** The onset of the China-U.S. trade war and the outbreak of COVID-19 have forced companies to reassess risks to their global supply chains. Since then, firms have increasingly shifted their emphasis from efficiency to resilience and reconfigured their value chains through diversification or simplification. Geographically, this reconfiguration has given rise to not only trends of reshoring or nearshoring, but also dual sourcing and regionalization of supply chains (AMRO, 2021). In Asia, the "China plus one" strategy, which multinational firms have used for over a decade to spread out production between China and a Southeast Asian country, such as Vietnam, has gained momentum since the start of the trade war. The popularity of this strategy reflects the importance of regionalizing production and trade, that is, producing and trading in the region for the region, as shorter value chains and more geographical diversification of sourcing can be reconciled only by forming regional supply chains. Hong Kong's business sector has been adapting to the changing trading landscape and increasingly acting as a super-connector, not only between mainland China and the rest of the world, but also for the broader East Asia and Southeast Asia. Partly reflecting these efforts, Hong Kong re-exports that were sourced from ASEAN with the U.S. and E.U. as destinations increased by 74 percent and 73 percent (yoy) respectively in H1 2022, in contrast to the contraction of its trade with mainland China. To date, however, Hong Kong's international trade and logistics still largely rely on supply chains between mainland China and western markets. With the regional production and trade network deepening, Hong Kong needs to strengthen its role as a hub in the region to avoid the risk of being marginalized.
- **Being an RCEP member will allow Hong Kong to fully exploit RCEP benefits, such as preferred market access, simplified ROOs and trade facilitation procedures, and reduced barriers in services and investment.** Hong Kong can build on its existing role in regional production chains and its strengths in capital raising, supply chain management and other professional services, to take advantage of the trade and investment opportunities brought by an RCEP membership so as to widen its trading network and connectivity. This will not only help Hong Kong's firms integrate into regional value chains among the RCEP members, but also spur them to actively adapt to the ongoing transformation in global and regional trading patterns.

7. Participation in the RCEP can also be mutually reinforced with the Hong Kong government's strategies of reindustrialization and GBA development. The success of modern manufacturing largely hinges on the development of local value chains and their integration into international value chains. With its status as a regional supply chain hub in certain types of manufacturing, Hong Kong is well positioned to move up the value chains by engaging in high-value advanced manufacturing. This will help diversify Hong Kong's economic bases and enhance its economic resilience. However, this transformation needs to be facilitated by strong government policies in promoting R&D and innovation, and in attracting and retaining talent. Moreover, given its land scarcity and high labor costs, Hong Kong can leverage the GBA integration and utilize the advanced industry chain and production base in Guangdong province on the mainland (Chu and Qian, 2021). If Hong Kong capitalizes on the synergy between RCEP participation, GBA development, and reindustrialization efforts, the move will hold great promise for transforming the city from a service provider for GBA firms engaging in export markets to a value chain leader for the whole RCEP region.

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