AMRO Annual Consultation Report

Hong Kong, China - 2020

ASEAN+3 Macroeconomic Research Office (AMRO)

November 2020

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 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), which was conducted virtually.
2. This Report is drafted on the basis of the Annual Consultation of AMRO with Hong Kong, China from July 13 to 24 2020 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr Chaipat Poonpatpibul. Members include Mr Suan Yong Foo, Senior Economist and Desk Economist for Hong Kong, China; Mr Ming Han (Justin) Lim, Researcher; Mr Yang-Hyeon Yang, Senior Economist; Dr Xinyi (Simon) Liu, Economist; Ms Laura Grace Gabriella, Researcher; Mr Haixin Fu, Associate Researcher. AMRO Director Dr Toshinori Doi 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 2020 was peer reviewed by Dr Siu Fung (Matthew) Yiu and Dr Xianguo (Jerry) Huang; and approved by Dr Hoe Ee Khor, AMRO Chief Economist.
3. The analysis in this Report is based on information available up to 25 August 2020.
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.

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Executive Summary

1. Hong Kong, China's[1] economic contraction has deepened and broadened since the start of 2020 due to the COVID-19 pandemic. Negative GDP growth of -1.2 percent for 2019 was followed by a 9.0-percent y-o-y contraction in H1 2020. In particular, the government's imposition of restrictions on social mobility to contain the pandemic has brought a range of economic activities to a standstill.

2. The recovery ahead is likely to be weak and bumpy. It is uncertain when the pandemic will be fully contained. Hong Kong's economy will continue to face strong headwinds from weak demand in key exports markets. The recent emergence of a third wave of the pandemic in Hong Kong has exerted a further drag on the economy. Accordingly, AMRO has revised its baseline growth forecasts for Hong Kong for both 2020 and 2021, to -7.5 percent and +4.5 percent respectively.

3. Labor market weakening has become sharper since March 2020. The seasonally adjusted unemployment rate soared from 3.7 percent in December 2019 – February 2020 to 6.2 percent in April – June 2020, before improving slightly to 6.1 percent in May – July 2020. Over the same period, the underemployment rate also spiked from 1.5 percent to 3.7 percent, before receding slightly to 3.5 percent.

4. Inflation has eased markedly and will remain muted. Headline CPI inflation fell in H1 2020 and turned to a negative 2.3 percent in July, while underlying inflation came in at a mild 0.2 percent. Looking ahead, price pressures are likely to remain low due to subdued domestic demand and the global recession.

5. The overall external position continues to be strong. Capital inflows continued in H1 2020. The Hong Kong dollar has traded at the strong end of the Convertibility Undertaking band due to these inflows.

6. Domestic financial conditions have eased moderately. Bank credit continues to grow modestly, supported by government actions to underwrite credit risk, particularly for loans to small and medium-sized enterprises (SMEs). HIBORs have fallen markedly, reflecting US Federal Reserve's cut in policy rate and easier global financial conditions.

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

- The topmost risk is that recurring outbreaks of COVID-19 in Hong Kong and globally could exert a sharp drag on the economy through severe dampening of domestic activities as well as exports including trade-related services and tourism-related activities.

- Financial distress among businesses especially SMEs could worsen, resulting in more workers being retrenched and a further dip in investment. This could severely worsen already-weak labor market conditions. If unemployment rises further and wages continue to weaken, consumption would contract further, impinging on the economic recovery.

- Rising US-China tensions could hinder the recovery of trade activities globally, and also continue to affect Hong Kong given its highly open economy and role as a gateway to

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

China. Uncertainty from the tensions has also risen following the enactment of the National Security Law (NSL) and the US' decision to remove the special status for Hong Kong. While the effects on the financial sector and capital flows have been limited so far, the impact ahead shall be observed.

- Risks related to the property sector will likely be contained but a prolonged recession could still pose risk of a significant property price correction with considerable impact on the economy.

- Further worsening of credit quality for hard-hit sectors and SMEs will pose challenges for banks and bank supervisors, although the banking sector will likely remain resilient and able to perform its financial intermediation role.

8. Policy response to the COVID-19 pandemic has been swift, large in scale, and broad in scope. Fiscal support has totalled over HK$300 billion or about 11 percent of GDP. The measures have provided comprehensive support for enterprises, jobs and livelihoods. Policy support has also entailed leveraging on the banking sector's strong buffers, with authorities exercising regulatory forbearance, implementing a pre-approved principal payment holiday scheme, and boosting credit guarantees to support hard-hit corporates and businesses.

9. If the economic downturn becomes deeper or more prolonged, the authorities could strengthen policy support further and make greater use of targeted measures. More targeted measures can be deployed to support the most severely affected economic sectors and households, businesses and workers. This would help preserve fiscal buffers. As the government continues to provide support through the growth recovery phase, multi-tiered wage supplements could be considered for workers of different profiles across sectors, taking into account the anticipated recovery trajectories for different sectors. Rental relief for businesses could be extended or increased, depending on economic conditions ahead.

10. Reopening the economy and strengthening its recovery while containing the virus constitute a delicate challenge, which needs to be managed carefully. This should be based on a continuous assessment of the headroom for boosting resumption of business activities while maintaining control over the infection. The eventual exit from policy stimulus measures should be done cautiously to avoid cliff effects, even as extended policy support should be directed towards viable businesses. The government should work with the private sector to assess the outlook and extent of overcapacity in hard-hit sectors and come up with targeted measures to address the issues.

11. While fiscal reserves provide ample policy space to deal with the difficult near term and address long-term challenges, they are projected to decline significantly over the next five years. The annual fiscal deficit is estimated to average 3.8 percent between FY 2021/22 and FY2024/25, due to rising spending on infrastructure, education, healthcare, social welfare, and security. As a result, fiscal reserves are projected to decline from about HK$863 billion in FY2020/21 to around HK$400 billion by end-FY2024/25, which would still be sufficient to cover about half a year of government expenditure.

12. Looking ahead, this crisis has highlighted the need for Hong Kong to take measures to sustain its long-term growth potential and resilience to large shocks as well as to enhance inclusiveness and strengthen social safety nets:

- Greater efforts to diversify sources of growth and to play a key role in connecting China with the world will help enhance growth and economic resilience.

- Strengthen support for the least upwardly mobile groups and create more jobs across different wage brackets to enhance inclusiveness.

- Enhance social safety nets such as through an enhanced unemployment benefits program – with stringent yet sufficiently flexible conditions attached – would help ensure that government support kicks into effect promptly when vulnerable groups are affected by adverse shocks.

- Further increase supply of affordable housing, which remains a critical policy imperative. Indeed, during this crisis, cramped living conditions have also made pandemic containment more difficult than it would have been otherwise.

- Boost fiscal revenue to provide support for rising spending to address long-term challenges and preserve fiscal reserves as a buffer. The option of raising some tax rates or introducing new taxes could be feasible given Hong Kong's low tax rates. Income taxes and corporate taxes could be raised moderately and still be kept at competitive levels. A modest value-added tax (VAT) could be introduced.

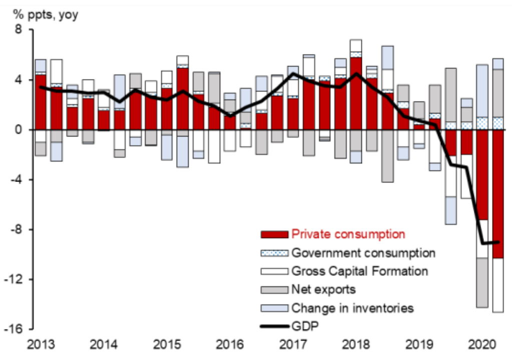
A. Recent Developments and Outlook

A.1 Real Sector Developments and Outlook

1. Following the 2019 recession brought on by the global economic slowdown, US-China trade tensions and domestic social incidents, Hong Kong's economic contraction has become more pronounced since the start of 2020 due to the COVID-19 pandemic. The pandemic has led to a collapse in growth across economies in the region and globally, through supply-side disruptions and demand-side weakening. As a highly open economy, Hong Kong has been severely impacted. Negative GDP growth of -1.2 percent for 2019 was followed by a 9.0-percent (y-o-y) contraction in H1 2020 (Figure 1).

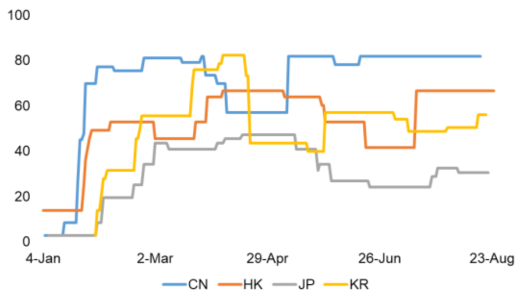
2. The recession has been sharp and broad-based. In H1 2020, the government's imposition of social distancing measures (Figure 2) and the general public's voluntary safe-distancing behavior brought range of economic activities to a standstill. There has been pronounced contraction for key components of GDP – except government spending. Private consumption and gross domestic fixed capital formation shrank by 12.4 and 18.6 percent, respectively in H1. Goods exports fell by 6.0 percent, while services exports tanked by 41.5 percent. Tourism in particular came to a complete halt, especially in Q2. Higher-frequency data such as retail sales, exports, business receipts and business expectations point to continued pronounced weakness into Q3, as a third wave of the pandemic emerged in July, and containment measures had to be tightened.

Figure 1. GDP Growth



Source: Hong Kong authorities; CEIC

Figure 2. Containment Measures Stringency Index

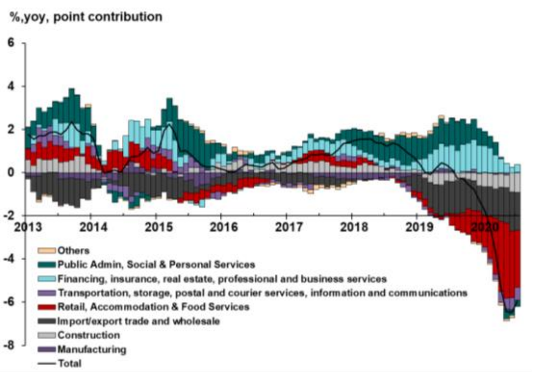


Source: University of Oxford; Blavatnik School of Government

3. Labor market weakening has become sharper since March 2020. Overall labor market conditions, which gradually weakened in 2019, have worsened pronouncedly in recent months as more enterprises may have reached the limit of their ability to retain workers (See Selected Issue: Scanning the Labor Market: Covid-19 Impact, Recovery Prospects, Policy Suggestions). The seasonally adjusted unemployment rate soared from 3.7 percent in December 2019 – February 2020 to 6.2 percent in April – June, before improving slightly to 6.1 percent in May – July. Over the same period, the underemployment rate also spiked from 1.5 percent to 3.7 percent, before receding slightly to 3.5 percent. Job creation has turned negative across all sectors except the financing, insurance, real estate, professional and business services sector (Figure 3).

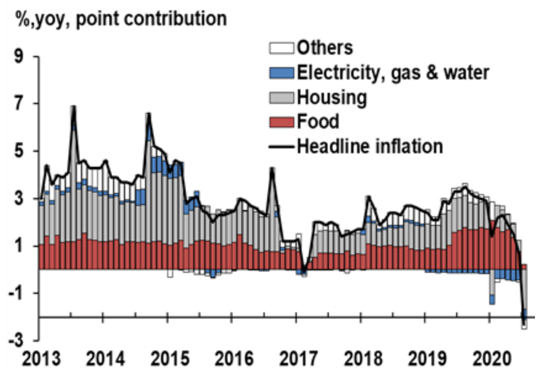
4. Inflation has eased markedly, due to the impact of the economic downturn on domestic demand. Headline CPI inflation eased steadily through H1 2020 and turned into a negative 2.3 percent in July (Figure 4), while underlying inflation (netting out the effects of all Government's one-off relief measures) came in at a very mild 0.2 percent. Looking ahead, overall price pressures are likely to remain low on account of subdued domestic demand and the global recession, as well as government measures to help people defray costs.

Figure 3. Job Creation by Sector



Source: Hong Kong authorities; CEIC

Figure 4. Inflation



Source: Hong Kong authorities; CEIC

A.2 External Sector and the Balance of Payments

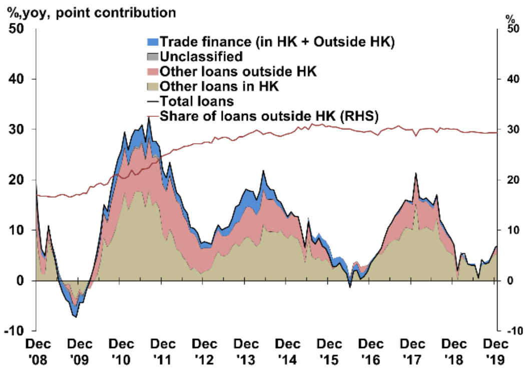
5. The overall external position continues to be strong. Hong Kong's balance of payments have continued to be in surplus for most quarters, with capital inflows continuing in H1 2020. Its international investment position has also remained robust. Foreign currency reserve assets cover 46 months of retained imports and two times the monetary base.

6. The Hong Kong dollar has traded at the strong side of the Convertibility Undertaking band due to continued capital inflows. The adverse impact of domestic social incidents and COVID-19 on sentiments has been offset by continued confidence in the longer-term future of Hong Kong as reflected in the continuing flows of funds into the banking system and stock market.

A.3 Monetary Condition and Financial Sector

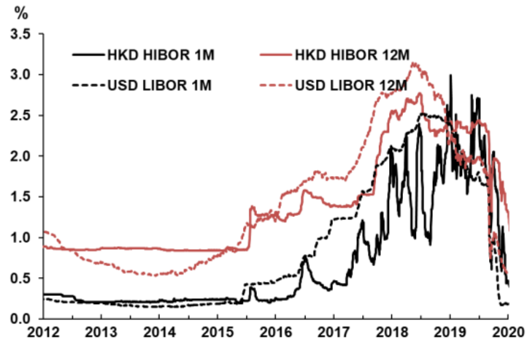
7. Domestic financial conditions have eased moderately in H1 2020 and into Q3. Bank credit growth remains in the single-digit range (Figure 5), supported by government actions to underwrite credit risk, particularly for loans to small and medium-sized enterprises (SMEs). HKD HIBORs have fallen markedly (Figure 6), reflecting the US Federal Reserve's cut in policy rate and easing global financial conditions. The composite interest rate (Figure 7), which is a measure of the average cost of funds of banks, has dipped significantly from March onward. The US Federal Reserve's policy moves have been a key driver. So too has been HKMA's establishment of the US Dollar Liquidity Facility in April 2020 and its decision in late-July to extend the facility to 31 March 2021.[2] Apart from this, the easing of competition for deposits among Hong Kong banks domestically is also a key factor.

Figure 5. Bank Credit Growth



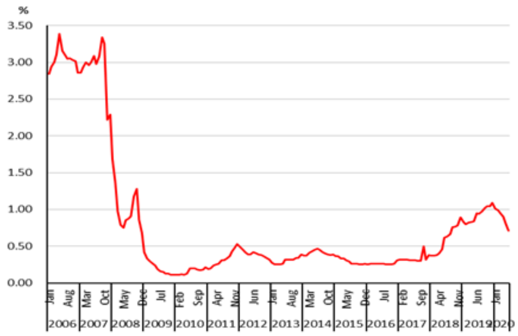
Source: Hong Kong authorities; CEIC

Figure 6. HKD Hibor vs USD Libor



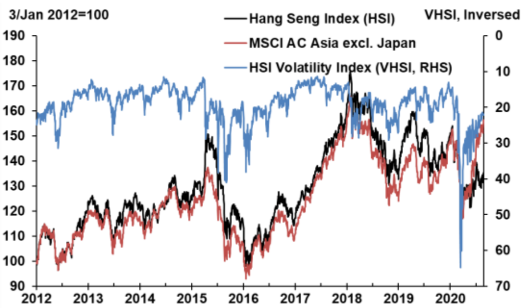
Source: Hong Kong authorities

Figure 7. Composite Interest Rate



Source: Hong Kong authorities; CEIC

Figure 8. Stock Market Index and Volatility



Source: Hong Kong authorities

8. Downward pressure on the stock market since the start of the year has been followed by more frequent bouts of upswings in recent months (Figure 8). Intermittent sell-offs have reflected warning signs about Hong Kong's economic recovery and prospects for corporate earnings. On the other hand, downward pressures have been mitigated by: (i) the recent firm pick-up in Mainland China's growth upswing and its positive impact on Mainland companies listed in Hong Kong's stock exchange; and (ii) considerable optimism related to strong IPO activities plus the likelihood of more listings by Mainland companies in the quarters ahead, partly driven by the increased US-China tensions.

9. The residential property market remains resilient, but price declines have been pronounced in commercial property. Residential property prices have held up as homebuyers and investors have stayed focused on the positive long-term outlook for Hong

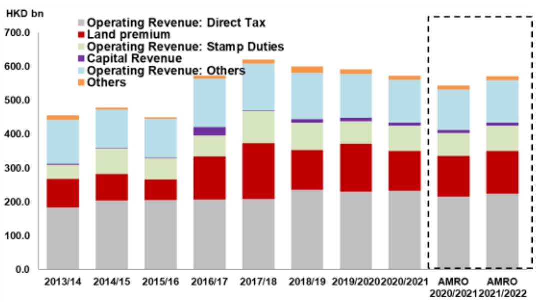
[2] On 31 March 2020, the US Federal Reserve announced the establishment of a temporary repurchase agreement facility for foreign and international monetary authorities (FIMA Repo Facility) to help alleviate tightness in the global US dollar interbank money markets amid volatilities and uncertainties in the global financial markets brought about by the spread of COVID-19. In April, HKMA launched the temporary US Dollar Liquidity Facility using the funds obtained through the FIMA Repo Facility, in order to provide licensed banks with an additional channel to obtain US dollar liquidity. Considering the Federal Reserve's decision to extend the FIMA Repo Facility to 31 March 2021, the HKMA announced on 30 July its move to extend the temporary US Dollar Liquidity Facility accordingly. It clarified that while the US dollar funding market in Hong Kong was working smoothly, the Facility would continue to provide a backstop in case there were unexpected market tightness.

Kong's real estate market on the back of strong underlying demand. Just as importantly, property owners' financial resilience and low interest rates have helped to avert distressed sales on a significant scale. The decline in prices for retail space and office space, especially office space, has been significant due to the pronounced impact from the pandemic on these types of properties. Rentals have been falling across the board, although the pace of decline eased in Q2 2020. New lease contracts continue to reflect weak sentiment as well as reduced capacity and willingness of tenants to pay elevated rents.

A.4 Fiscal Sector

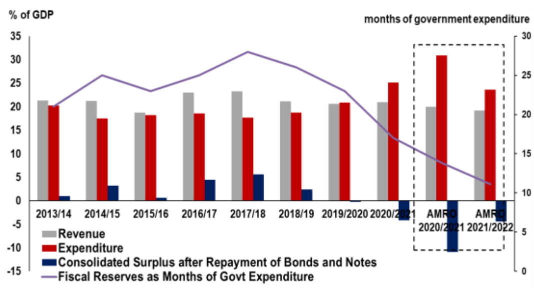
10. Government revenue declined in FY2019/2020 and will likely remain weak this year, while government spending is on course to rise sharply to support livelihoods, jobs and businesses. Government revenue decreased by 1.5 percent in FY2019/20 in tandem with the economic contraction (Figure 9). Overall, total government spending in FY2019/2020 increased by 14.9 percent, as the government ramped up spending in support of households and businesses. As a result, the government ran a small budget deficit for the first time in well over a decade, estimated at 0.3 percent of GDP (Figure 10). For FY2020/2021, AMRO projects Hong Kong's revenue to fall by about 8.0 percent due to the deep economic contraction while expenditure is expected to escalate further by 38.3 percent, as policy prioritizes economic recovery and employment generation in the next two years. AMRO expects the fiscal deficit to widen to about 10.9 percent of GDP, and fiscal reserves to fall from 39.5 percent of GDP at the end of FY2019/2020 to 31.7 percent of GDP at the end of FY2020/2021, which would still cover more than one year of government spending.

Figure 9. Government Revenue



Source: Hong Kong authorities; AMRO calculations

Figure 10. Revenue, Spending and Reserves



Source: Hong Kong authorities; AMRO calculations

A.5 Outlook

11. Hong Kong's economic recovery ahead is likely to be weak and bumpy. Conditions in the domestic economy and many parts of the global economy are likely to remain difficult. It remains uncertain when the pandemic will come under control. Hong Kong's economy will continue to face strong headwinds from weak demand in key exports markets, although the anticipated recovery of Mainland China will provide support to the financial services and goods trade related sectors. The recent emergence of a third wave of the pandemic in Hong Kong will exert a further drag on the economy. Domestically, high unemployment and subdued sentiment will weigh on both investment and consumption through 2020 and into 2021. The recovery is expected to start in H2 2020, but will likely be gradual and bumpy, with base effects and moderate improvements in exports helping headline growth for 2021. Accordingly, AMRO has revised its baseline growth forecasts for Hong Kong for both 2020 and 2021, to -7.5 percent and +4.5 percent respectively.

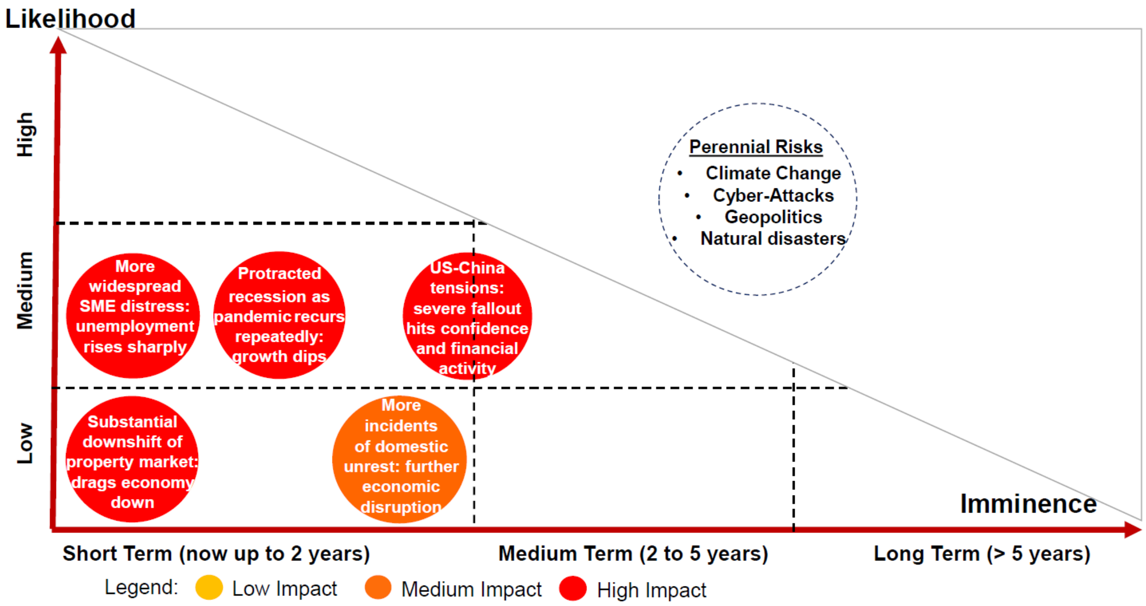
Authorities' Views

12. The near-term outlook for domestic economic activity will hinge critically on the local COVID-19 situation. This will also be a key factor affecting business sentiment. The third wave of the local epidemic stabilised in September. If this trend persists, domestic economic activity will likely revive further in the rest of 2020. Meanwhile, the global economy has initially recovered after the trough of the second quarter, easing slightly the downward pressure on world trade. Yet COVID-19 will continue to cloud the global economy until an effective vaccine is widely available. The government has adjusted its 2020 growth forecast to -6 percent to -8 percent.

B. Risks, Vulnerabilities and Challenges

13. Risks to growth have heightened since the turn of the year (Figure 11)**.** If pandemic control does not gain sufficient traction – or worse, falters, global and domestic demand could suffer a big setback well into 2021. For Hong Kong, this would mean severe dampening of domestic activities as well as exports of services. If financial distress among businesses especially SMEs worsens, more workers will be retrenched and investment will dip further. This could severely worsen an already-weak labor market. If unemployment rises further and wages continue to weaken, consumption would contract further, impinging on the growth recovery. Alongside these, rising US-China tensions could hinder the recovery of global trade, and also continue to affect sentiment regarding Hong Kong's status as a business hub and financial center. Additionally, uncertainties related to US-China tensions have risen following the NSL enactment and the US' decision to remove the special status accorded to Hong Kong.

Figure 11. Risk Map for Hong Kong



Source: Hong Kong authorities; AMRO calculations

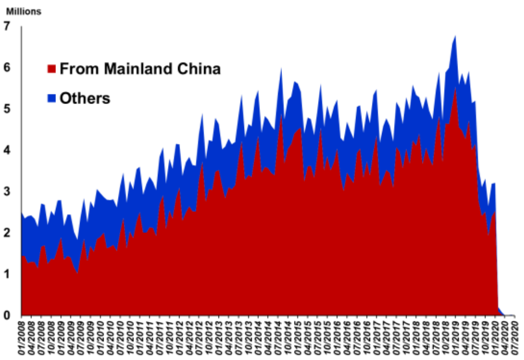
B.1 Near-term Risks to the Macro Outlook

14. At the current juncture, the topmost risk is that recurring outbreaks of COVID-19 could exert a sharp drag on the economy, and weaken the recovery. First, a third wave of outbreak in Hong Kong has necessitated the continuation of highly-restrictive border control measures and (re-)tightening of domestic social distancing measures. This means prolongation of the almost-complete freeze in tourism-related business activities and continued weakness in other types of domestic activities. Second, lower export of trade-related services reflecting weaker external demand. Given the likely contraction in world trade, Hong Kong's trade-related services exports could see double-digit shrinkage, exerting a further drag on growth. Third, job market conditions could worsen, especially since the third-wave virus outbreak has imposed yet another setback for the recovery outlook.

15. The severe strain on tourism-related sectors will be prolonged and very challenging to alleviate. Tourism involves a large number of SMEs, which have thinner financial buffers than large enterprises. AMRO's findings from the 2020 consultation indicate the following balance of risks for Hong Kong's tourism-related sectors. First, the near-term strains on affected enterprises and workers are very severe, as visitor arrivals have practically vanished for several months now (Figure 12). Both the private sector and the authorities expect agreements on "travel bubbles" to be difficult to reach, limited in scope (mostly to business travel and official travel) in the short term. Restoration of near-normality for travel and tourism may start to materialize only in H2 2021 or even later. Second, a significant part of the shrinkage will be permanent. As other attractive tourist destinations emerge, the number of visitor arrivals in Hong Kong will likely taper. With this in mind, many affected enterprises, especially SMEs, will likely need to shut down, and many workers may either be retrenched or voluntarily look for other jobs. (See Box C on the tourism sector)

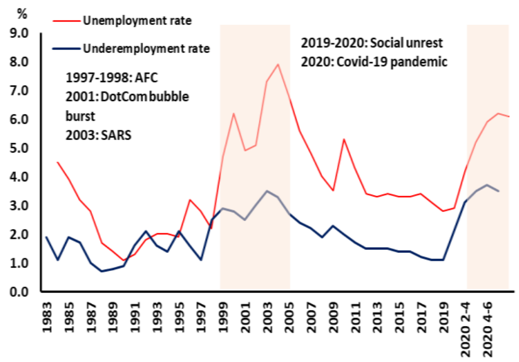
16. Financial distress among businesses can lead to a worsening of labor market conditions (Figure 13). Although the rapid adjustments of wages and working arrangements during the first few months of this pandemic have helped contain the extent of job losses, the room for further adjustments is becoming increasingly thinner as the recession becomes prolonged. (See Selected Issue: Scanning the Labor Market: Covid-19 Impact, Recovery Prospects, Policy Suggestions). Adverse feedback effects have formed between the corporate sector and labor market. With earnings pressure and financial strains on businesses – especially SMEs – becoming more pronounced, retrenchment has become more broad-based. If financial strains intensify across companies especially SMEs, and sizeable rental reliefs are not forthcoming, businesses could shed more jobs. This would push up the unemployment and underemployment rates. These developments can exert a large drag on incomes and therefore consumption, which would in turn make it more difficult for investment activity to restart.

Figure 12. Tourist Arrivals



Source: CEIC

Figure 13. Unemployment and Underemployment



Source: Hong Kong authorities; CEIC
Note: The unemployment rate figures for moving three-month periods are seasonally adjusted.

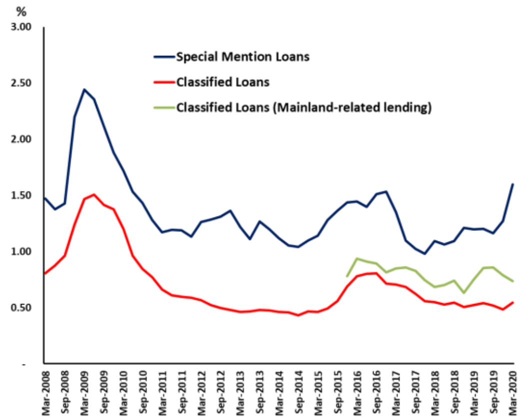
17. US-China tensions have heightened further with the enactment of the NSL. The enactment of the law has led the U.S. to withdraw its special status for Hong Kong. Nonetheless, the overall impact on Hong Kong's trade performance is likely to be limited because the amount of trade directly affected by the special status removal (i.e. Hong Kong's domestic exports to the U.S.) is very small and US-China trade channelled through Hong Kong is also a relatively small share of its total trade. That said, some sectors such as electrical machinery might be affected significantly, given their greater shares in export-import trade.

18. Uncertainty has heightened, with the likelihood of phase 1 of the US-China trade deal not being fulfilled, and concurrently, imposition of sanctions by the US on China's technology companies. These uncertainties have raised the prospect of weaker trade performance and capital inflows for Hong Kong. With regard to the impact on capital flows including investment flows and banking flows, Hong Kong's resilience will likely be anchored for two key reasons. First, Hong Kong can continue riding on Mainland China's economic development for its own continued growth. Second, Hong Kong has developed a high degree of competitiveness as a financial center – including but not limited to being a channel for global investment into Mainland China. However, in the longer term, Hong Kong's status as an "international financial center" may face increasing competition from other places.

19. The banking sector will likely remain resilient and operationally sound, but further worsening of credit quality for hard-hit sectors and SMEs will bring challenges for banks and bank supervisors.

- Not only does the banking system as a whole have strong capital and liquidity buffers, variations across banks are also limited.
- The bulk of the banking system's corporate loan exposures is to financially strong conglomerates, which have applied lessons from past crises to: (i) build up cash reserves, (ii) reduce leverage, and (iii) diversify industry and geographical footprints.
- Loans to Mainland China are mostly to large state-owned enterprises SOEs as well as international entities which are more stable in terms of their credit quality.
- The mortgage portfolio is characterized by: (i) low loan-to-value (LTV) ratios implying that collaterals provide adequate buffers; and (ii) very low delinquency rates reflecting the fact that a majority of borrowers continue to be able to service mortgage payments.
- The key credit risk is tied to banks' exposures to SMEs and firms from hard-hit sectors, especially SMEs. So far, the banking system's overall classified loan ratios have remained low (Figure 14). At the same time, the increase in the banking system's overall risk-weighted assets RWA has been gradual.
- However, as the authorities and banks recognize, these are necessarily lagged indicators, and many nonviable businesses are being supported by the fiscal stimulus and regulatory forbearance measures which will be withdrawn in the months ahead. Hence, NPLs of these businesses will likely rise quite noticeably ahead. AMRO understands from the 2020 consultation that key banks have specialized loan management units which regularly review borrowers' financial standing and "behaviors" so that the banks can take prompt action to address loan quality deterioration concerns if need be. Some banks also have institutionalized arrangements with sister banks in Mainland China to do on-the-ground assessment of borrowers' creditworthiness. While the authorities should mitigate cliff effects of the withdrawal of the stimulus and forbearance measures, the challenge on this front is still significant.

Figure 14. Banking System Capital Adequacy Ratio (CAR) and Loan Quality Indicators



Source: CEIC

20. Risks related to the property sector will likely be contained but a prolonged recession could still pose risk of a significant property price correction with considerable impact on the economy. For residential property, borrowers have demonstrated continued ability to service their loans while low LTV ratios provide banks with adequate buffers against the risk of a large downshift in prices. For commercial property, developers are financially strong, while the ongoing decreases in rents for office space will provide relief to businesses. Continued confidence in Hong Kong's long-term prospect as an economic and financial hub should put a floor on the value of real estate, averting a large shock to the balance sheet of property owners. Nonetheless, a sharp price correction could occur if the recession becomes deeper and more protracted. In that event, the impact on the economy through consumption would be considerable as housing is the major part of household wealth.

21. A sharper global recession due to further waves of COVID-19 infection, heightened US-China tensions, and recurring outbreaks in Hong Kong would lead to a deeper and more protracted recession. In AMRO's worse-case scenario, growth would be -12 percent in 2020 and +1.0 percent in 2021. These projections would reflect: even sharper weakening of consumption as unemployment overshoots current expectations, more severe crimping of investment reflecting greater concerns over viability of businesses, and weaker external demand from countries hit by recurrences of the pandemic. AMRO's growth-at-risk analysis also suggests that in an even more severe scenario, there is a 5 percent probability that growth could contract by as much as 21 percent in H2 2020 or 15 percent for 2020 (See Box A).

Authorities' Views

22. The still-serious pandemic situation in various parts of the world, and recent surge in local cases are a timely reminder that the economic outlook is still subject to heightened uncertainties. Authorities generally agree with the above assessment of risks and vulnerability. To what extent external and domestic demand may pick up for Hong Kong in the remainder of 2020 and into 2021, as well as how the local labor market situation may change going forward, will depend very much on how the global and local epidemic situations evolve. Considering the risks, the authorities have revised the official growth forecast for 2020 to -6 to -8 percent.

B.2 Longer-term Challenges and Vulnerabilities

23. While the current crisis focuses attention on near-term difficulties, fundamentally, it highlights even more starkly than before the pressing need for Hong Kong to find ways to sustain its long-term growth potential and resilience to large shocks. The impact of supply-side disruptions and demand-side weakening brought about by the global pandemic on Hong Kong's economy, enterprises and labor market strongly suggest that more diversified sources of growth should help to cushion the effects of exogenous shocks in at least some of the cases. The prospect of a sizeable segment of the workforce losing their jobs presents an important challenge for policymakers to find effective approaches to help with job search and training. [See Box B. Supporting Businesses and Households in the "New Normal".]

24. The need to boost supply of affordable housing remains a critical policy imperative as it was before the onset of this crisis. According to the authorities' housing demand projection as of December 2019, the total housing supply target for the ten-year period from 2020-21 to 2029-30 is 430,000 units and the public housing supply target is 301,000 units. These targets are attainable but challenging, with the shortage of land which can be used for development being the biggest constraint. Indeed, this crisis has also highlighted the importance of addressing the housing supply challenge as cramped living conditions have made pandemic containment more difficult than it would have been otherwise.

25. Socioeconomic inequalities could become more pronounced over the next few years, as Hong Kong undergoes a gradual and bumpy growth and labor market recovery. This is because the current crisis has impacted lower-income households, especially those in hard-hit business sectors, more significantly than other groups. Furthermore, they will continue to encounter greater obstacles to job mobility as firms fold and new business models emerge.

C. Policy Discussions and Recommendations

C.1 Near-term policy support in response to COVID-19

26. Policy response to the COVID-19 pandemic has been swift, large in scale, and broad in scope. It has focused on arresting the drop in confidence quickly, easing liquidity conditions broadly, averting mass layoffs – particularly of workers employed by the more vulnerable SMEs; and conveying clear assurance that the government will backstop economic and financial stability and – critically – livelihoods. Fiscal support totalled over HK$300 billion or about 11 percent of GDP, comprising HK$191.5 billion under three rounds of the Anti-epidemic fund and HK$120 billion under the FY2020/21 Budget, which includes a one-time cash handout for adult Hong Kong permanent residents. The measures have provided comprehensive support for enterprises, jobs and livelihoods.

27. Leveraging on the banking sector's resilience, the authorities have exercised regulatory forbearance and boosted credit guarantees to support hard-hit corporates and businesses. Large financial sector buffers have been built up over many years, with the banking sector's capital adequacy ratio (CAR) and liquidity coverage ratio (LCR) at a high 20.1 percent and 160.4 percent respectively. Alongside this, HKMA's set-up of the US Dollar Liquidity Facility in April 2020 and its decision in late-July to extend the facility to 31 March 2021 have helped ease liquidity conditions even more, and provided a further anchor for confidence. These factors have provided space for HKMA to take policy measures including allowing more flexibility in banks' treatment of corporate and housing loans (including suspension of principal payments) and relaxing some regulations including provisioning rules to increase the banking system's lending capacity. At the same time, credit guarantees for SME loans under the SME Financing Guarantee Scheme have been enhanced, with guarantee ratios as high as 100 percent and the total approved loan amount of about HK$38 billion in the first nine months of 2020.[3] At the start of September, HKMA announced that the Pre-approved Principal Payment Holiday Scheme had been extended for a further six months to April 2021, so that all loan principal payments of eligible customers falling due between November 2020 and April 2021 would be deferred by six months except for repayments of trade loans, which would be deferred by 90 days. It also announced that in order to alleviate the cash flow pressure on SMEs, the application period for principal moratorium for the 80% Guarantee Product and the 90% Guarantee Product under the SME Financing Guarantee Scheme was extended for six months to 31 March 2021, and the maximum duration of principal moratorium was increased from 12 months to 18 months. The loan guarantee period can also be extended accordingly. In these ways, the banking sector is leveraging its resilience and working with the authorities to support businesses and jobs.

[3] The SME Financing Guarantee Scheme operated by the HKMC Insurance Limited (HKMCI) has been in place for nearly 10 years. In response to the COVID-19 pandemic, a number of enhancements have been introduced recently, including raising the maximum loan amount, extending the guarantee period, lowering the guarantee fee, providing interest subsidy for one-year period, extending the eligibility criteria to cover publicly listed companies in Hong Kong for a one-year period, and offering a principal moratorium under the 80 percent Guarantee Product. In mid-December last year, the new 90 percent Guarantee Product was rolled out to provide more support to small and micro enterprises and those with relatively less operating experience, to help them to obtain financing. The principal moratorium, and the enhancements such as interest subsidy for one-year period and extension of the eligibility criteria to cover publicly listed companies in Hong Kong for a one-year period under the 80% percent Guarantee Product are also applicable to the 90 percent Guarantee Product. In the first nine months of 2020, more than 3,700 applications were approved under the 80 percent and 90 percent Guarantee Products, involving more than HK$11.2 billion. In his Budget speech earlier this year, the Financial Secretary announced the introduction of the Special 100 percent Loan Guarantee to enhance the cash-flow support to enterprises affected by the COVID-19 outbreak, thereby reducing business closures and layoffs. The special loans are fully guaranteed by the Government, with an interest rate of the Prime Rate (as quoted by The Hong Kong Mortgage Corporation Limited) minus 2.5 percent per annum (i.e. the current interest rate at 2.75 percent), and all guarantee fees are waived. Since the introduction of the Special 100% Loan Guarantee on 20 April up to end-September 2020, the HKMCI has approved about 17,000 applications from banks amounting to some HK$27.2 billion.

28. If the economic downturn becomes deeper or more protracted – as has become more likely with the third-wave virus outbreak, the authorities could consider strengthening policy support further and make greater use of targeted measures. Rather than relying on universal relief, more targeted measures can be deployed to support the most severely affected economic sectors and population segments, businesses and workers – including lower income workers and those employed by small businesses. This would help to preserve fiscal buffers. As the government continues to provide support through the growth recovery phase, multi-tiered wage supplements could be considered for workers of different profiles across sectors, taking into account the anticipated recovery trajectories for different sectors. Rental relief for businesses, especially SMEs, could be extended or increased, depending on economic conditions in the coming quarters. At the same time, it may be worthwhile to consider the setting up more government units to solicit quick feedback from different segments of the business community and household sector to get prompt reads of changing economic and labor market conditions. This would strengthen the authorities' capacity to come up with new policy measures or augment existing ones to provide timely relief.

C.2 Reopening the economy

29. Reopening of the economy should be based on a continuous assessment of headroom to balance boosting resumption of business activities and maintaining safety. Overall, it would be wise to accept a more moderate but steady recovery, with safety being a key priority. Effective communication between policymakers and the general public would be needed to ensure policy objectives are met. It is important that businesses and workers work closely with the authorities to switch nimbly between opening-up and (re-) tightening of containment measures in order to generate growth, earnings and incomes while keeping infection under control.

30. The eventual exit from policy measures to support crisis-hit businesses and workers should be done cautiously to avoid cliff effects. A good example is extending the runway for credit guarantees to expire, so that businesses which have taken bank loans can get their finances on a more stable footing before repaying the loans. Time-bound forbearance measures could be extended, but dialled down in line with improvements in economic conditions. Another area is gradual reduction of rental subsidies and wage subsidies before full removal.

31. That said, extended policy support should be directed more towards businesses that are likely to remain viable in the post-pandemic environment. A blanket approach for the extended debt relief measures can lead to a build-up in excessive leverage, and higher losses when nonviable firms go bankrupt. Therefore, authorities should develop a comprehensive assessment framework that also takes into account inputs from key stakeholders, to direct extended support towards viable businesses. The framework should be based on a thorough examination of the capital and liquidity positions of banks, and the sectors that are experiencing significant deterioration in creditworthiness.

32. The government should work with the private sector to assess the outlook and extent of overcapacity in hard-hit sectors, and come up with policies to address the issues. In the tourism-related sectors for example, several specific actions can be taken. These may include: timely forecasting of demand, mapping of labor oversupply and shortage; programs to help some enterprises adjust their business models to stay afloat and become viable. Policy should also focus on helping nonviable firms to wind up in an orderly manner, and facilitate the shifting of business owners and workers to other sectors with stronger growth potential. [See Box C: Hong Kong Tourism: Strains, Government Support, Recovery Prospects, and Some Policy Ideas]

Authorities' Views

33. Hong Kong authorities are prepared to strengthen fiscal support in the near term. Policymakers' commitment to supporting enterprises, workers, and families through these extraordinarily stiff challenges remains undiminished by the recent setbacks to recovery and by the already-substantial drawdowns on fiscal reserves. There is a clear recognition that for the long term, only the return of healthy growth and employment conditions can sustain Hong Kong's continued socioeconomic development, resilience and inclusiveness. Strong fiscal support in the near term is a necessary condition for that to happen.

34. Hong Kong authorities remain committed to reopening the economy. The government aims to strike the right balance between controlling the epidemic and restoring economic vitality. Whenever there is a recurrence of virus outbreak, the top priority will be to tighten containment measures to bring the infection under control as quickly as possible so that economic activities can be resumed. Such an approach of flexible adaptation is the best way to avert pandemic-control fatigue and excessive economic damage.

C.3 Long-term imperatives: fiscal considerations; sustainable and inclusive growth

35. Fiscal reserves provide ample policy space for the authorities to support the economy through near-term difficulties and address long-term challenges.

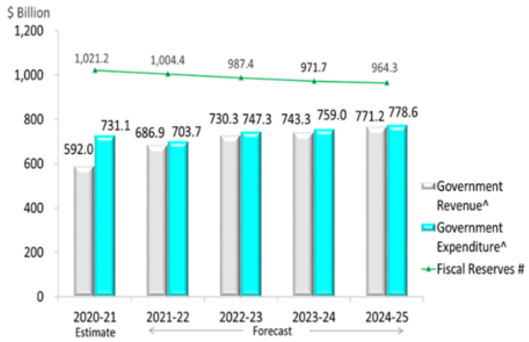
- There are multiple long-term challenges. These include economic restructuring, boosting growth, and enhancing inclusiveness – including through providing affordable housing, and strengthening the social safety net – including unemployment benefits schemes with stringent yet sufficiently flexible conditions.

- Fiscal sustainability is still assured despite the large reserve drawdown. Overall expenditure, especially recurrent expenditure, is expected to continue rising over the next few years. Accordingly, government spending in FY2024/2025 would be about 10 percent larger than government spending in FY2021/2022. The estimated fiscal reserves at end-FY2024/2025 are sensitive to assumptions about important drivers of revenue including land premium and "others".

- In AMRO's assessment, fiscal reserves will decline significantly over the next five years but still remain sizeable. The authorities' projections, presented in the Budget in February 2020, indicate that fiscal reserves would be about HK$964.3 billion by the end of FY2024/25 (Figure 15). This would sufficient to cover about 15 months of government spending. AMRO's projections, based on more conservative assumptions for key revenue items, suggest that fiscal deficits would average about 3.8 percent of GDP over the next five years and fiscal reserves would decline to HK$397.3 billion[4], which would still cover about half a year of government expenditure (Figure 16).

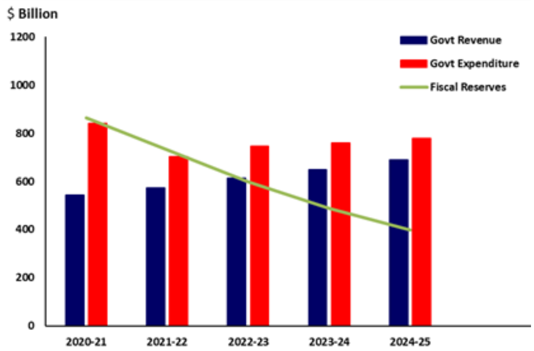
[4] These projections assume that: (i) economic growth will return to trend after 2021; (ii) overall revenue increases thereafter will be moderately brisk, supported by healthy expansion of receipts from land sales; and (iii) expenditure will increase further, albeit with a gentler pace towards 2025.

Figure 15. Medium Range Forecasts: Fiscal



Source: CEIC
^Included issuance / repayment of bonds and notes
The forecast fiscal reserves balances have been revised to take into account the actual results in 2019-20.

Figure 16. AMRO's Projections: Fiscal



Source: Hong Kong authorities; CEIC

36. Both the authorities' medium range forecasts and AMRO's projections for the same timeframe assume that fiscal revenue should be boosted significantly in preparation for the longer term. Recurrent expenditure will keep rising over time. Stronger fiscal revenue would provide more flexibility for spending and help to preserve and rebuild fiscal reserves. The option of raising some tax rates or introducing new taxes should be given serious consideration given Hong Kong's low tax rates. Income taxes, and even corporate taxes could be raised moderately and still be kept at competitive levels. A modest value-added tax (VAT) could be introduced. Concurrently, income support measures for lower-income households could be used to address concerns that the VAT could have some regressive effects. Such an approach has worked quite well in other advanced economies, and could be considered for Hong Kong.

37. At the same time, the authorities could consider issuing debt to finance certain types of long-term projects such as physical infrastructure. Infrastructure spending tends to involve big sums, and is often lumpy. Issuing long-term debt for this specific purpose would help to spread out the financial burden over time. This would be more in sync with the benefits being spread over a few decades. Such an approach would also be more equitable for intergenerational sharing of the fiscal burden.

38. Long-term policy efforts should focus on enhancing inclusiveness and improving the social safety nets. These include further providing training and other support for the least upwardly mobile groups, creating more jobs across different wage brackets, and enhancing social safety nets so that they kick into effect promptly when vulnerable groups – including low-skilled workers – are affected by adverse shocks.

39. Greater efforts to diversify sources of growth and play a key role in connecting China with the world will help enhance growth and economic resilience. Public agencies and businesses, including SMEs, have collaborated to find new ways of tapping global and regional demand, while riding on China's rapid growth and the Greater Bay Area (GBA)'s development. Efforts to seek greater opportunities in economies which Hong Kong has signed free trade agreements with – including Australia, New Zealand, member states of the European Free Trade Association, Chile, Georgia, and importantly, ASEAN – should be further enhanced. The Stock Connect, Bond Connect and Wealth Connect Schemes enable Hong Kong to play a key role in intermediating investment flows between China and the world, and to boost its own growth by further deepening its financial sector and generating spillovers to other sectors.

40. The implementation of the Faster Payment System (FPS) will help to boost efficiency and financial inclusion (See Box D). The FPS, which was launched in September 2018, expanded substantially and leaped forward during the pandemic period. Linking FPS with other similar payment systems in the region could be a major step forward. Although this cross-border feature will likely be very challenging to develop, it would significantly benefit consumers and businesses, help to boost sectors like trade-related services and tourism, and enhance the value proposition of financial services.

41. The authorities' fin-tech efforts will help to boost Hong Kong's efficiency and competitiveness as a financial center further. The recent launch of the Global Fast Track Program – a business-driven program to help local and global fin-tech enterprises leverage Hong Kong's proven resilience and fin-tech opportunities to scale business and accelerate innovation – is another initiative to be welcome.

Authorities' Views

42. On the fiscal front, three key anchors for guiding policy are: growth-positive; sustainability; and appropriate dial-down of relief measures. First, on the revenue side, to maintain growth and vibrancy. Second, on the expenditure side, to be mindful of and manage long-term affordability. Third, for one-off relief measures implemented during downturns or crises, to reduce progressively. The authorities are confident that Hong Kong's medium-term growth potential will remain healthy and can be lifted as policy measures taken over the past few years – such as developing promising sectors, forging more partnerships with ASEAN countries, and strengthening Hong Kong's role in the GBA – begin to yield more tangible results. This would in turn support further efforts to boost growth, resilience and inclusiveness.

43. For the financial sector, policymakers' efforts to keep strengthening Hong Kong's competitiveness as a global hub are relentless and have persisted even through this crisis. Hong Kong's robust financial infrastructure, sound regulatory system, deep expertise as well as strong buffers built up over the years, underpin its resilience as an international financial center. As for the NSL, the authorities have clearly stated their strong belief that the restoration of law and order would benefit Hong Kong, and have reiterated their commitment to upholding the integrity of the financial system. The implementation of the NSL will not have any adverse impact on the normal functioning of the financial markets. The authorities have also pursued financial center development efforts – with good results. The recent policy initiatives include the establishment of the Wealth Connect Scheme, further progress in green finance initiatives, facilitating strong IPO activities on the stock exchange, and implementation of the FPS.

C.4 Overall capacity to address challenges

44. While Hong Kong is well-positioned to meet multiple challenges, the extent to which the authorities have had to use fiscal and financial sector buffers to address the fallout from this crisis shows that rebuilding policy space for the longer term remains important. Hong Kong's strong macro fundamentals, financial soundness, and large fiscal buffers should enable the authorities and private sector to cope with extraordinarily stiff challenges for growth and livelihoods in the near term – and emerge from this crisis to focus on structural challenges.

Box A. Growth-At-Risk in Hong Kong

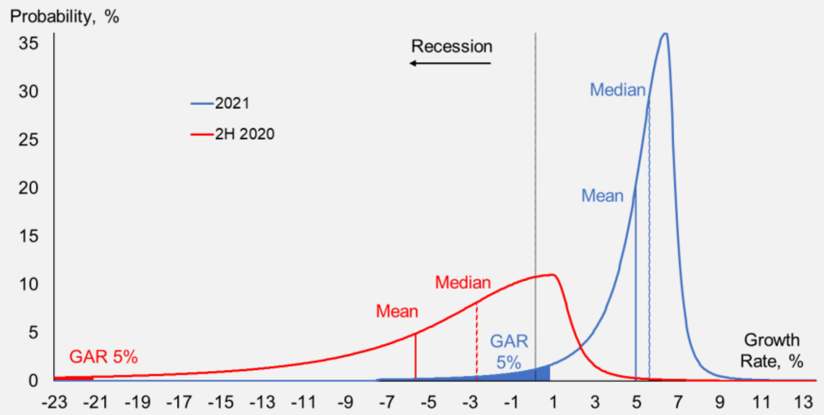
This analysis employs the Growth-at-risk (GaR) methodology to examine the likelihood of a severe adverse growth scenario for Hong Kong.[5] Using a large set of economic and financial indicators, the GaR approach links current macroeconomic and financial conditions to project a range of future real GDP growth including the possible worst-case scenarios (Prasad et al, 2019). The aim of this framework is to assess the likelihood of a severe recession in the near- to medium term in addition to the traditional point forecasts. As such, it can be useful for policymakers in their policy deliberations in light of the more quantifiable and comprehensive risk assessment. In the case of Hong Kong, principal component analysis was employed to extract trends from a set of six main groups of variables based on quarterly data from Q1 2002 to Q2 2020 (Figure A1). The conditional density forecast of future growth is estimated using quantile regressions with the group trends as regressors. Then the probability distribution for Hong Kong's growth in 2020 is derived from the quantile regressions results.

Table X1. List of Variables used for each Group

Group	Variables
Domestic Financial Conditions	Overnight HIBORs, Inflation, Property Price, Growth in Equity Market Capitalization
Domestic Leverage	Credit Growth, Loan-to-Deposit Ratio, Non-Performing Loans Ratio
GDP Growth of Main Trade Partner	China
GDP Growth of Other Key Trade Partners	United States, European, Union Japan
Global Financial Conditions	CBOE Volatility Index, Federal Funds Rate, US 10-year Treasury Yield
Tourism-related Activities	Retails Sales, Tourism Arrivals

Hong Kong's tail risk is still substantial for the rest 2020 but is expected improve in 2021. Based on the macroeconomic and financial conditions as of Q2 2020, Figure A2 shows that downside risk to growth is considerable and growth could contract by as much as 21 percent in H2 2020 with a probability of 5 percent under a severe adverse scenario. As such, authorities should remain vigilant and be prepared to further support the economy given that the likelihood of a severe recession is still high in the near-term. However, the findings indicate that the probability of a recession in 2021 is much lower with a 5-percent tail risk that growth will be below 0.7 percent.

Figure A2. Conditional Distribution of Real GDP Growth Forecast for 2020 and 2021



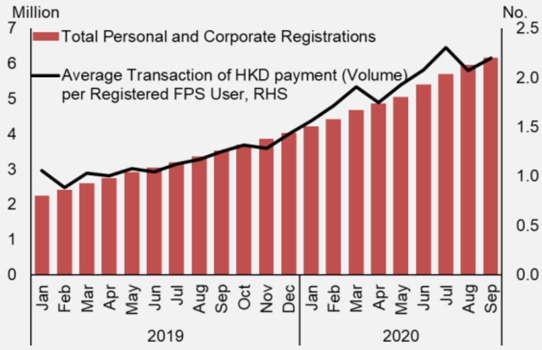
Source: AMRO; Prasad et al (2019)
Note: Based on information available as at Q2 2020

[5] Prasad et al. (2019). Growth at Risk: Concept and Application in IMF Country Surveillance. IMF Working Paper

Box B. Supporting Businesses and Households in the "New Normal"

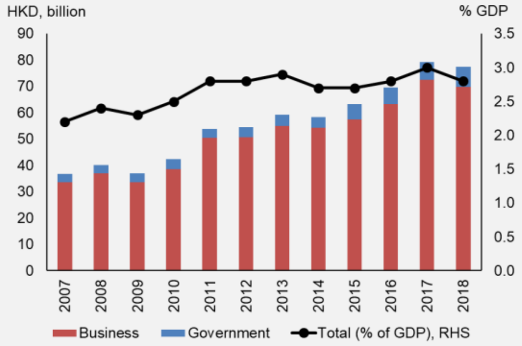
The COVID-19 pandemic has accelerated the shift towards "new normal" economic activities. The transition from face-to-face towards contactless interactions has been swift and widespread as a result of the social distancing measures to contain the COVID-19 pandemic. The "new normal" economic activities, particularly in the areas of online shopping, digital payments and remote working, have accelerated as consumers and businesses have adapted quickly to the new environment. For example, e-commerce sales in Hong Kong rose sharply[6] and the average daily turnover of HKD real-time payments via the FPS accelerated further in 2020 (Figure B1). Moreover, traditional sectors such as education and healthcare, have relied significantly on new digital technologies as a means to facilitate e-learning[7] and telemedicine[8] during this period.

Figure B1. FPS Average Daily Turnover of HKD Real-Time Payments



Source: Hong Kong Interbank Clearing Limited

Figure B2. Total ICT Spending by Businesses and Government



Source: Hong Kong Census and Statistics Department; Office of the Government Chief Information Officer

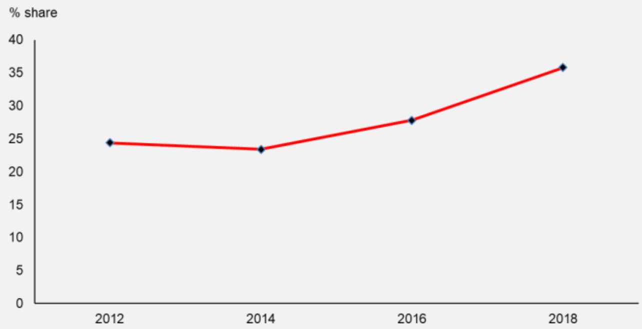
This transition, which is supportive of Hong Kong's longer-term growth potential, reflects continued structural changes in consumers' preferences and business models that began before the social incidents in 2019 and COVID-19 pandemic. The global shift towards digitalization and the new economy have gained further momentum in the past several years[9] (AMRO, 2020). In the case of Hong Kong, this shift has been notable in areas such as e-commerce, digital payments and spending on ICT. For example, ICT spending, which is key in fostering digital innovation and the longer-term growth potential[10] (OECD, 2017), more than doubled from approximately HKD40 billion in 2007 to HKD80 billion in 2018 (Figure B2). On the e-commerce front, more than one-third of Hong Kong residents were making purchases online in 2019 (Figure B3), and the share of online sales of total business receipts also grew significantly to about 6 percent in 2018. Looking ahead, they are expected to continue to expand in the post-pandemic economy due to underlying shifts in consumers' preference and businesses.

However, some segments of households and SMEs, as well as the hard-hit sector, would benefit less than the other sectors in the "new normal" economy, potentially leading to growing skills gap and economic inequalities. Although close to 94 percent[11] of Hong Kong households have access to the Internet at home in 2019 – which is among the highest in the world[12], lower-income households have much less access to basic ICT and internet connectivity compared to the higher-income households (Figure B4). This digital divide[13] can in turn have sizeable effects

[6] https://asia.nikkei.com/Business/Business-trends/Hong-Kong-warms-to-online-commerce-amid-pandemic-and-protests
[7] https://www.scmp.com/news/hong-kong/education/article/3075280/coronavirus-hong-kong-students-adapt-online-learning-amid
[8] https://www.scmp.com/news/hong-kong/health-environment/article/3078507/telemedicine-offers-solutions-hong-kong-patients
[9] ASEAN+3 Macroeconomic Research Office. (2020). "ASEAN+3 Regional Economic Outlook (2020)". ASEAN+3 Macroeconomic Research Office.
[10] OECD (2017), OECD Digital Economy Outlook 2017, OECD Publishing, Paris.
[11] Hong Kong as an Information Society, Statistical Report, 2020 Edition. Census and Statistics Department
[12] https://data.worldbank.org/indicator/IT.NET.USER.ZS
[13] https://www.scmp.com/comment/insight-opinion/article/3010789/smart-hong-kong-must-first-figure-out-how-bridge-its

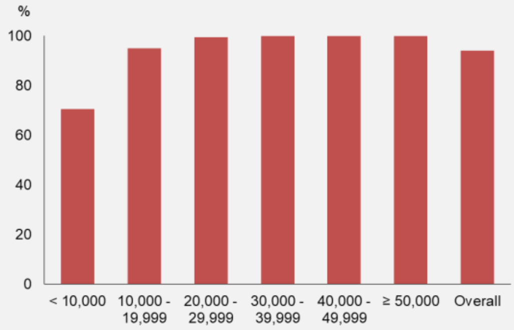
on students' educational outcomes[14] should home-based e-learning becomes a permanent feature of future education. In addition, statistics shows that smaller firms tend to be less engaged in e-commerce activities than larger firms (Figure B5), and thus would be disadvantaged in the "new normal" economy.

Figure B3. Rate of persons who had used online purchasing services for personal matters



Source: Thematic Household Survey Report No. 67: Information technology usage and penetration, Hong Kong Census and Statistics Department

Figure B4. Rate of Households with Access to the Internet at Home by Monthly Household Income, 2019



Source: Thematic Household Survey Report No. 69: Personal Computer and Internet Penetration). Hong Kong Census and Statistics Department

Figure B5. Firms Receiving and Placing Orders Online by Firm Size, 2019

Source: Hong Kong Census and Statistics Department

While policy support has cushioned the impact in the short term, there is scope for the authorities to facilitate a more rapid and inclusive transition in the "new normal" economy. This may entail:

- Bolstering ICT spending, digital skills training for workers, and supporting smaller firms' digital capacities. The authorities have rolled out several measures to boost firms' digital capabilities, for example, the launch of the Distance Business Program (DBP), which is funded by the Anti-Epidemic Fund, to encourage firms to adopt digital solutions during the pandemic. Also, the Reindustrialization and Technology Training Program was launched in 2018 to support workers' training in advanced technologies and digital skills. Nevertheless, the DBP scheme can be enhanced such that greater support can be provided for smaller SMEs, and potentially be extended to over the longer-term to support Hong Kong's digitization efforts and spur greater ICT investments more broadly. Workers in the hard-hit sectors should also be encouraged to explore these reskilling opportunities.

- Enhancing digital literacy and accessibility of lower-income households. In particular, authorities should boost digital accessibility and literacy among schooling-age children in these households. This can potentially be achieved through targeted subsidies, cash or in-kind transfers, for example, through the provision of e-learning devices or subsidized internet bills.

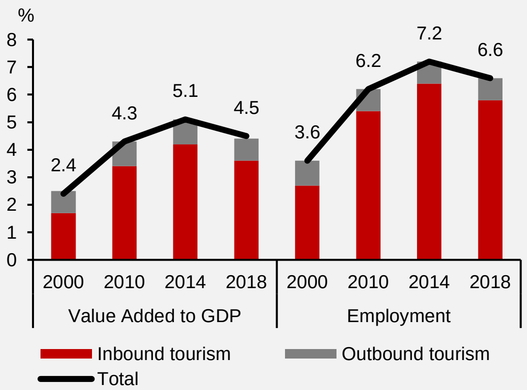
[14] https://web.edu.hku.hk/f/page/6171/Press-release_Eng.pdf

Box C. Hong Kong Tourism: Strains, Government Support, Recovery Prospects, and Some Policy Ideas

Hong Kong's tourism sector has been battered by severe shocks since H2 2019. The tourism sector benefited from buoyant increases in visitor arrivals which numbered 65.1 million for the year 2018 and 34.9 million in H1 2019. Due to domestic social incidents that started in June 2019, visitor arrivals decreased substantially to 55.9 million for the year. Then, in 2020, the pandemic and containment measures including border/boundary controls brought tourist arrivals and the sector's activities to a near-complete standstill. Visitor arrivals were negligible by Q2, and then the outbreak of the third wave of the pandemic necessitated re-tightening of social distancing measures and an indefinite extension of border controls with very few exceptions.

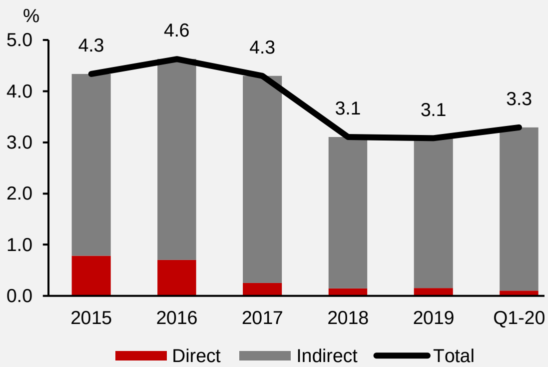
The sector's health and outlook are important to Hong Kong's economy and employment as well as its financial system. Although the sector's direct share of GDP is only about 4.5 percent, its total contribution to GDP is much greater at about 14-15 percent. Its share of employment is about 11-12 percent (Figure C1), translating into some 320,000 jobs. As for the financial sector, banks' total loan exposures (direct and indirect) come up to a sizeable 3.3 percent (Figure C2).

Figure C1. Inbound Tourism and Outbound Tourism Contribution to Hong Kong's GDP and Employment



Source: Hong Kong Census and Statistics Department; Note: Direct contribution refers to contribution from "Accommodation and Food Services" and "Travel Agency and Related Services". Indirect contribution refers to contribution from the "Transportation services" and "Retail."

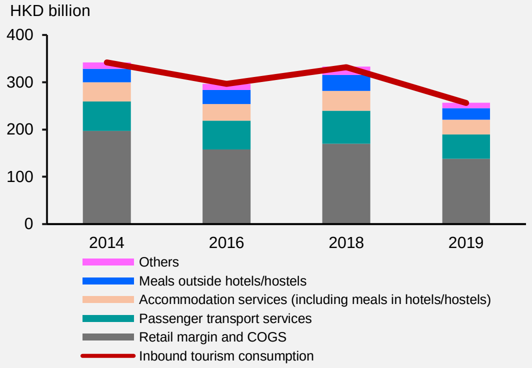
Figure C2. Banking Sector Loans to Tourism-Related Sectors: Direct and Indirect Exposures as Percent of Total



Source: Haver Analytics; AMRO's staff calculation
Note: The direct contribution is the contribution from the "Hotel and Accommodation" and "Recreational Activities," while the indirect contribution is the contribution from the "Transport/Transport Equipment" and "Wholesale/Retail Trade."

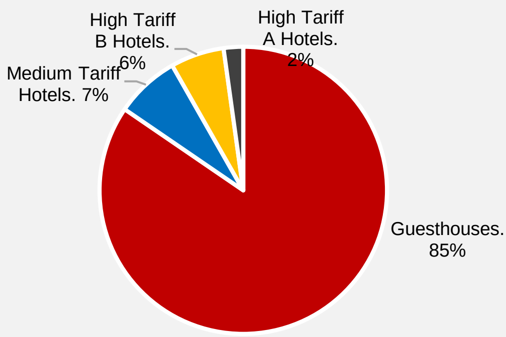
Prior years' earnings have provided a significant buffer for the tourism sector as a whole, and the government stimulus measures have provided broad support while leaning towards smaller players. In 2018 alone, tourism receipts generated HKD 331.6 billion of direct revenue – which was up five-fold from 2000 (Figure C3). Accordingly, while the government's 2020 package of relief measures across both rounds under the ambit of its Anti-Epidemic Fund (Figure C4) has provided support across the entire sector, the support has been greater for guesthouses which are financially weakest but account for a hefty 85 percent of total accommodation establishments (Figure C5). This is an example of how government measures can be targeted – leaning towards SMEs which have thinner buffers but are collectively important for the sector and also as employers.

Figure C3. Tourism Receipts



Source: Hong Kong Tourism Board (HKTB) AMRO's staff estimates

Figure C4. Share of Total Tourist Lodgings: Hotels and Guesthouses (June 2020)



Source: Haver Analytics; AMRO's staff calculation
Note: The Hong Kong Tourism Board scores the hotels based on their facilities, location, staff-to-room ratio, achieved room rate and business mix. Using this classification system, the High Tariff A hotels have composite score between 3.00 and 3.99, the High Tariff B hotels scores between 2.00 and 2.99, and the Medium Tariff hotels scores between 1.00 and 1.99.

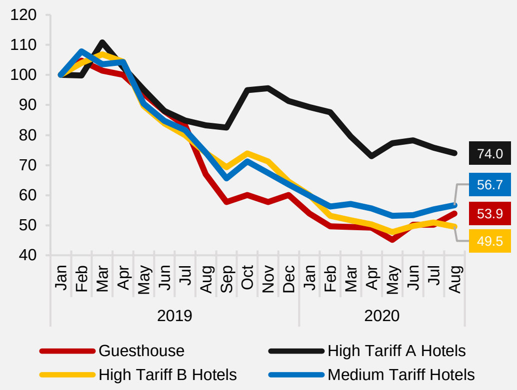
Figure C5. Government Measures for Tourism Sector

Measures	Scheme	One-Off	Amount	Announced
Licensed Guesthouses Subsidy Scheme	First Round Anti-Epidemic Fund	Yes	Either HKD 50,000 or HKD 80,000, depending on the number of licensed guestrooms	21-Feb
Travel Agents Subsidy Scheme	First Round Anti-Epidemic Fund	Yes	HKD 80,000	21-Feb
Travel Agents and Practitioners Support Scheme	Second Round Anti-Epidemic Fund	Yes	Ranging from HKD 20,000 up to HKD 200,000 to each licensed travel agent, depending on the number of its employees	18-Apr
	Second Round Anti-Epidemic Fund	Yes	Equivalent to a monthly subsidy of HKD 5,000 for six months to each travel agent's staff and freelance accredited practitioners whose main occupations are tourist guides or tour escorts. Each person can receive one subsidy at most.	18-Apr
Hotel Sector Support Scheme	Second Round Anti-Epidemic Fund	Yes	Either HKD 300,000 or HKD 400,000 to each licensed hotel, depending on the number of licensed guestrooms.	18-Apr
Tour Service Coach Drivers (Mainly Serving Tourists) Support Scheme	Second Round Anti-Epidemic Fund	Yes	HKD 10,000	6-May
Green Lifestyle Local Tour Incentive Scheme		No	Cash incentive amount per tour participant served by a travel agent to increase from the original HKD 100 to HKD 200.	18-Jun

Source: Hong Kong Tourism Board

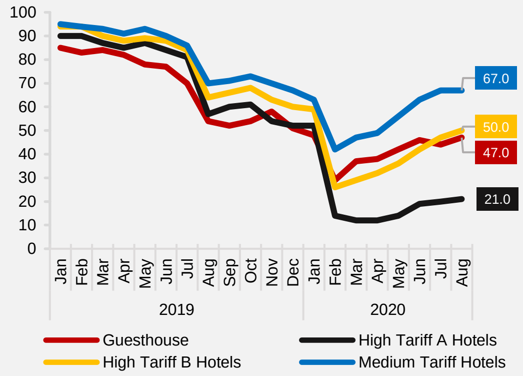
Business owners have reacted swiftly to the plunge in demand via pricing, but the trough is deep. Compared to the start of 2019, many guesthouses and hotels had cut their prices by about half by early-2020 (Figure C6). This move, along with the pandemic coming under control in Q2 2020, resulted in significant pick-ups in occupancy rates through the quarter (Figure C7). The improvement was most pronounced for guesthouses in particular, perhaps reflecting also some staycation demand. In comparison, the improvement was most subdued for Tariff-A hotels, whose main clientele are well-off tourists and business visitors. Nevertheless, the trough is a deep one, with earnings well below those of "business as usual" times, and a pronounced turnaround nowhere in sight.

Figure C6. Average Room Rate (Jan 2019 = 100)



Source: Haver Analytics; AMRO's staff calculation

Figure C7. Average Occupancy Rate

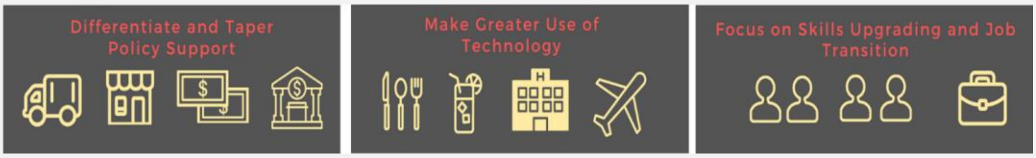


Source: Haver Analytics; AMRO's staff calculation

The tourism sector's recovery will be gradual and its revenue is unlikely to recover to the 2018 level within the next few years due to lingering concerns about infection and likely retightening of safeguard measures, and competition from alternative destinations. Given this prospect, there are a few policy ideas that policymakers and businesses in the sector may consider (Figure C8):

- <u>First, differentiate and taper policy support.</u> This would involve facilitating the orderly wind-down of nonviable enterprises; maintaining strong targeted support for viable ones; and tapering this support when demand conditions for the sector improve. This would help to consolidate the sector but also avoid cliff effects excessively hurting companies with sound longer-term prospects.
- <u>Second, make greater use of technology.</u> The authorities and tourism sector players can harness technology including artificial intelligence for timely demand forecasting, and job matching identifying where there is labor oversupply and where there is labor shortage. This can be part of the sector's broader exercise of adjusting its business models to prepare for the "new normal".
- <u>Third, focus on skills upgrading and jobs transition.</u> Given the dim prognosis for the tourism sector in the short term, many more workers may be retrenched or forced to look for other jobs. Help should be provided to workers for retraining and transition especially into jobs which are different but can leverage on some of their existing skills or new skills which they picked up in (re)training programs. For example: from cooks at F&B establishments in hotels to staff in centralized kitchens preparing food for deliveries; from tour guides to virtual-tour guides; from hotel concierges and guesthouse frontline staff to cleaning service on call.

Figure C8. Policy Support for Hong Kong Tourism: From Short Term to Medium Term



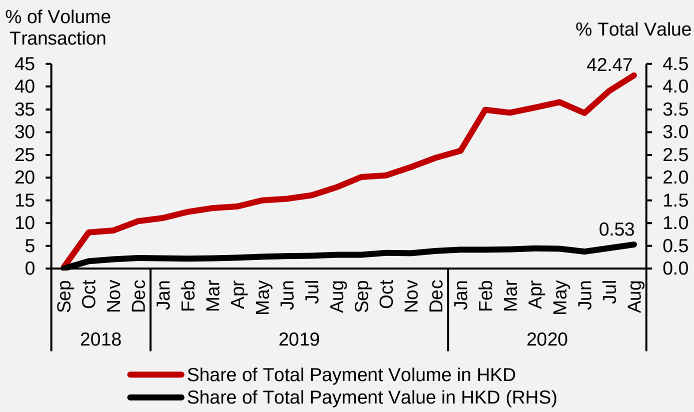
Source: AMRO staff

Box D. Rapid Development of Hong Kong's Faster Payment System (FPS)

Hong Kong's Faster Payment System (FPS), aimed at boosting efficiency and financial inclusion, has expanded rapidly since its launch in September 2018. The system is operated by Hong Kong Interbank Clearing Limited (HKICL). The objective is to provide consumers and merchants with a safe, efficient and widely-accessible retail payment service on a 24/7 basis. As of September 2020, the FPS recorded 6.17 million registrations – an impressive penetration when compared to Hong Kong's population of 7.5 million. Over the same short timeframe, FPS has come to account for a rapidly-increasing and substantial share of Hong Kong dollar (HKD) transactions in Hong Kong in both volume and value terms (Figure D1) – with the former trend being more pronounced, reflecting that FPS is designed for relatively small value payments.

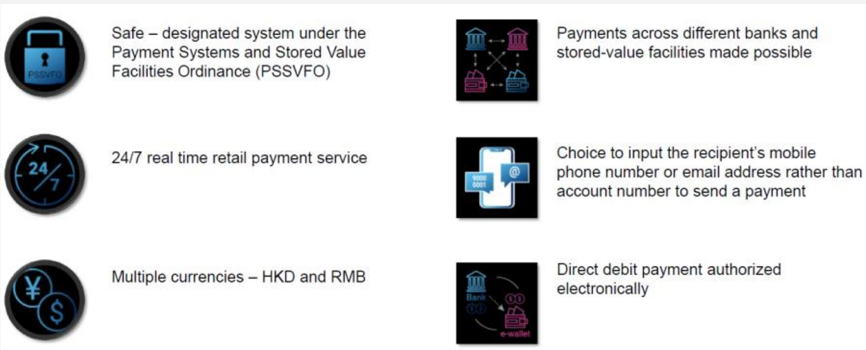
This success is due to several mutually-reinforcing factors (Figure D2). First, stringent security features ensuring safety of transactions gives consumers and merchants peace of mind. Second, ease of use even for those who are not very technology-savvy is an important factor that has induced switching from cash payments. Third, a wide range of functionalities allow users to link their local bank and e-wallet account(s) to their proxy IDs (such as mobile numbers, email addresses, or FPS-generated ID), and then use FPS free-of-charge to top up their e-wallets (including Alipay, WeChat, or Octopus, etc) and use these for a variety of payments.[15] Fourth, COVID-19 pandemic has prompted more people to use FPS to reduce physical contact.

Figure D1. FPS Transactions in HKD: Share in All Payment Transactions



Source: Hong Kong Interbank Clearing Limited; HKMA
Note: The total payment volume refers to payments processed by the HKICL which does not include payments made by the credit cards or e-wallets.

Figure D2. Important Features of FPS



Source: Hong Kong authorities; AMRO

[15] Octopus is an e-wallet that can be used to make payments on public transport and at a wide range of retailers in Hong Kong. It is launched in September 1997, and has been used by over 95% of people in Hong Kong. Octopus card also provides payment service for cross-border travelers, especially for frequent travelers between the Mainland China and Hong Kong. The FPS allows people to instantly top up their Octopus cards and is expected to support greater Octopus usage moving forward.)

Hong Kong's FPS compares favorably with similar systems in other countries when one considers important factors such as payment speed, access channels, settlement mode, and currency denomination options (Figure D3).

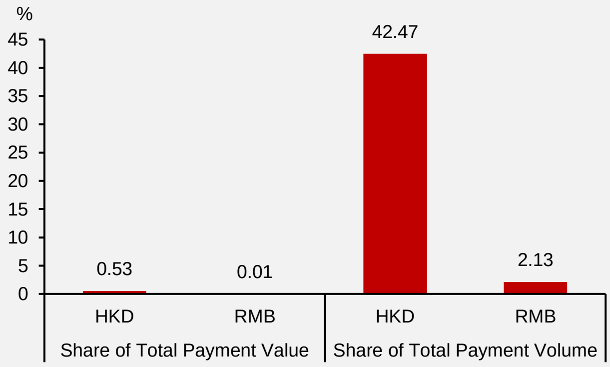
Figure D3. Comparison of Faster Payment Across Countries

Country	Implementation	Year	Payee speed	Current access channels			Inter- payment system provider (PSP) settlement model	Currency
				Online	Mobile	Physical channels		
Korea	Electronic Banking System (EBS)	2001	1–2 seconds	x	x		Deferred net	KRW
Korea	CD/ATM System	2007	1–2 seconds			x	Deferred net	KRW
United Kingdom	Faster Payments Service (FPS)	2008	0–120 seconds	x	x	x	Deferred net	GBP
China	Internet Banking Payment System (IBPS)	2010	0–20 seconds	x	x	x	Deferred net	RMB
Singapore	Fast And Secure Transfers (FAST)	2014	About 15 seconds	x	x	x	Deferred net	SGD
Hong Kong	Faster Payment System (FPS)	2018	Instantly	x	x	x	Real-time (24x7)	HKD, RMB

Source: Bank for International Settlements (BIS)
Note: All fast payment systems require immediate clearing between the payment service providers (PSPs) of the payer and payee. Funds settlements between the PSPs, however, do not necessarily need to occur immediately for each and every payment order. Payee funds availability and inter-PSP settlement can be either coupled (i.e. real-time settlement) or decoupled (i.e. deferred settlement).

The smaller volume of RMB transactions in the FPS reflects that the HKD is the local currency in Hong Kong, and is most commonly used for local spending (Figure D4). This may increase in the future when there are more use cases in RMB. Relatedly, at present, the customer-facing banks/e-wallets can readily provide foreign exchange service for customers, who may choose to change to the other currency at either the sending end or the receiving end. Therefore it is not necessary for FPS to provide foreign exchange service even if cross-border transactions may be enabled in future.

Figure D4. FPS Transactions in HKD VS RMB (Aug 2020)



Source: Hong Kong Interbank Clearing Limited; HKMA

Cross-border payment is possible in future but would require significant efforts across jurisdictions. The technical base of FPS retains the possibility of introducing cross-border payment features in future. However this would be challenging. Technical issues would include: working out complex details for making interoperability across jurisdictions possible, taking care of compliance with regulatory requirements of different jurisdictions, and establishing practices and mechanisms to address anti money-laundering / combating financing of terrorism concerns.

In sum, FPS has been a success and will continue to benefit residents and businesses. FPS was set up with a clear objective in mind. Security for users has been assured. The already-high penetration rate means network effects bringing benefits for residents and businesses. With these in mind, as long as the authorities and the operator continue to maintain the system well and steadily introduce more features to improve FSP' coverage and user-friendliness, it should remain an important part of Hong Kong's financial architecture for the long term.

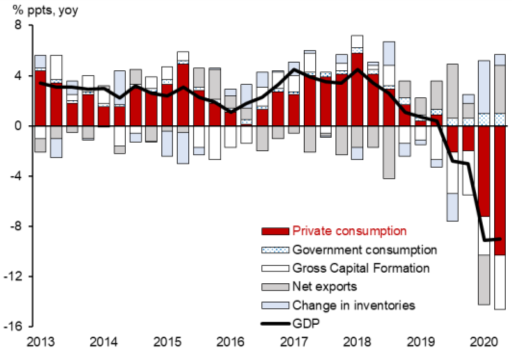
Appendices

Appendix 1. Selected Figures for Major Economic Indicators

Figure 1.1. Real Sector

With the 2020 COVID-19 pandemic following 2019 domestic unrest, growth contraction has been increasingly sharp and broad-based.

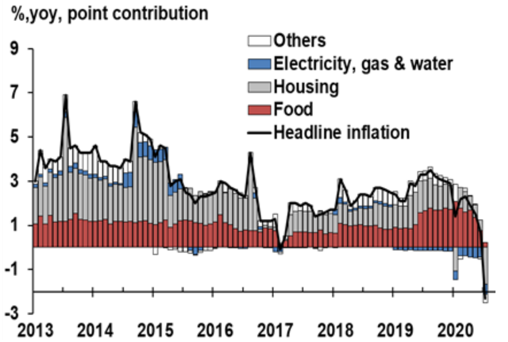
GDP Growth



Source: CEIC

Inflation pressures have eased markedly due to austere economic conditions, and kick-in of government support measures.

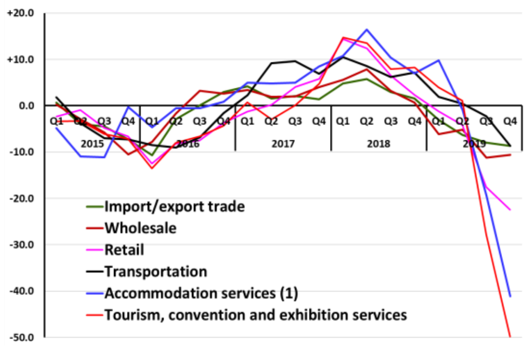
Inflation



Source: CEIC

Reflecting the impact of the pandemic on people movement, sentiment and incomes, several sectors' business receipts have dipped markedly.

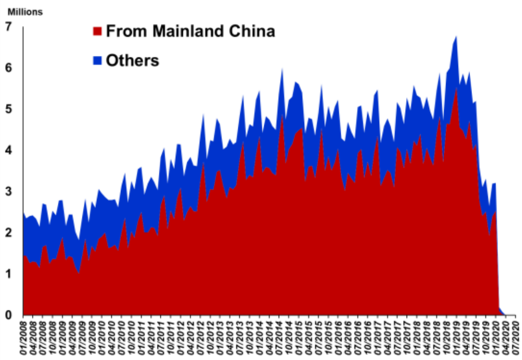
Receipts: Selected Sectors



Source: Hong Kong authorities

Tourist arrivals have plunged, with the pandemic necessitating comprehensive travel restrictions.

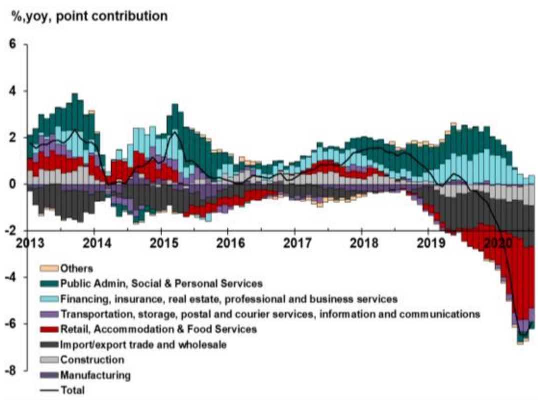
Tourist Arrivals



Source: CEIC

Job creation has turned sharply negative, and this is broad-based across sectors.

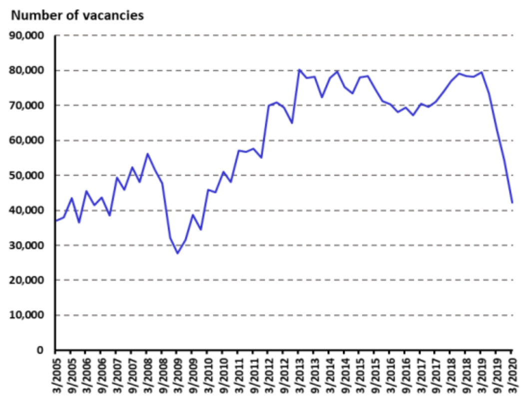
Employment Creation



Source: CEIC

Concurrently, the number of private sector job vacancies has fallen to a multiyear low.

Job Vacancies

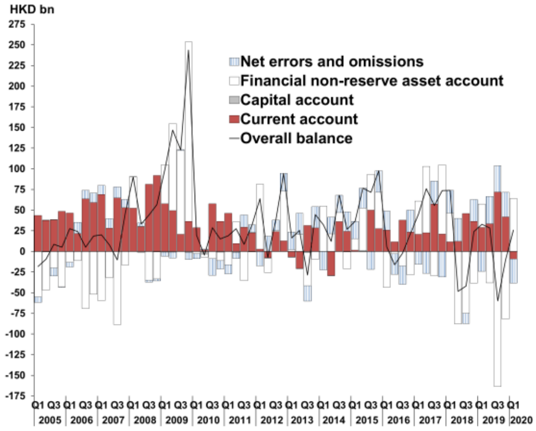


Source: Hong Kong Census and Statistics Department

Figure 1.2. External Sector

The overall balance of payments remains in surplus in most quarters, underpinning external resilience …

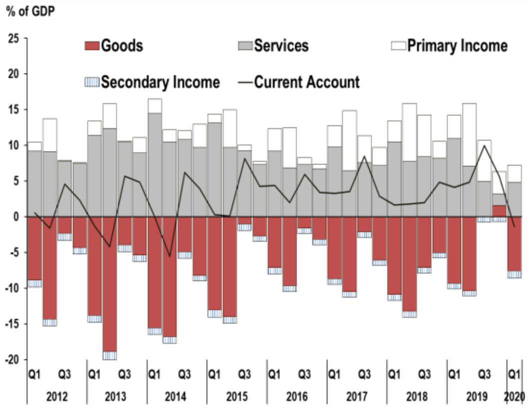
Balance of Payments



Source: CEIC

… with the surplus in services and primary income tending to outweigh the goods balance deficit.

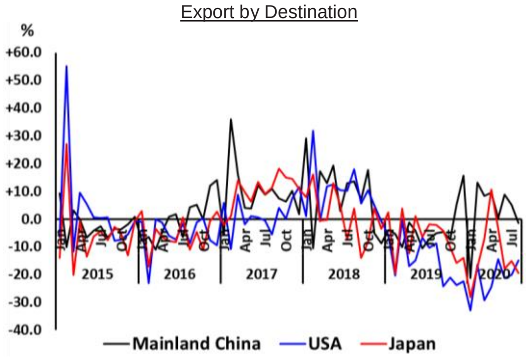
Current Account Balance



Source: CEIC

Export contraction has become more moderate in recent months, reflecting partly the firming of growth in Mainland China.

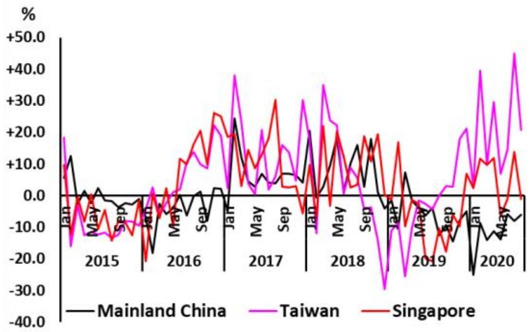
Export by Destination



Source: Hong Kong authorities

Import contraction has likewise eased, reflecting in large part Hong Kong's large role in re-export trade.

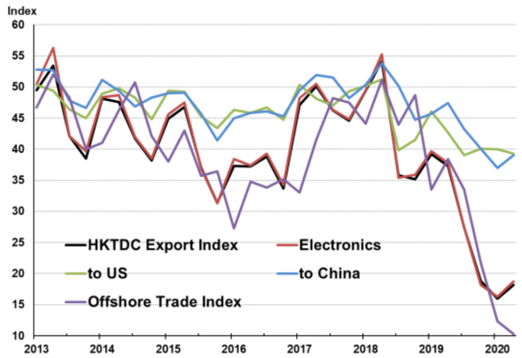
Import by Supplier Source



Source: Hong Kong authorities

Exporters have remained cautious about the outlook through successive quarters.

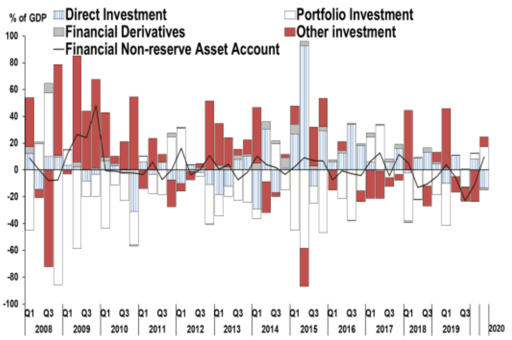
HKTDC Export Index



Source: CEIC

Hong Kong's financial account volatility reflects its status as a financial center; inflows have continued, partly due to strong IPO activities.

Financial Account Balance

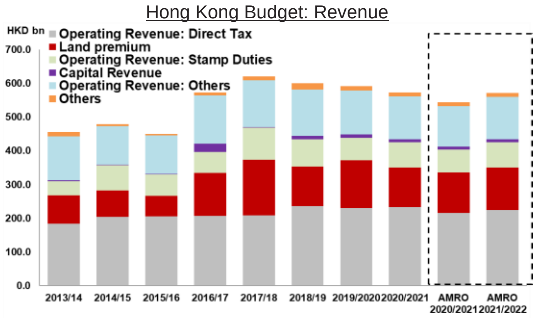


Source: CEIC

Figure 1.3. Fiscal Sector

Government revenue decreased in FY2019/20 along with the economic downturn.

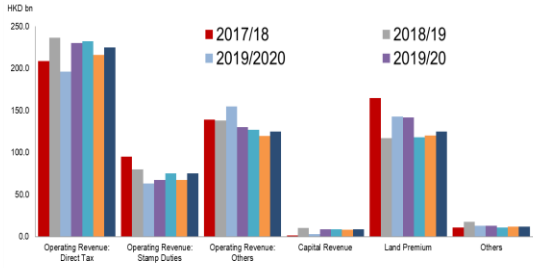
Hong Kong Budget: Revenue



Source: Financial Services and the Treasury Bureau; AMRO estimates
Note: BE refers to budget estimates.

Tax revenue in particular came under pressure.

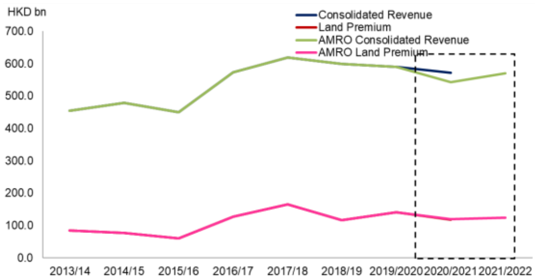
Taxes vs Other Revenue Sources



Source: Financial Services and the Treasury Bureau; AMRO estimates
Note: BE refer to budget estimates.

Land premium has been relatively resilient.

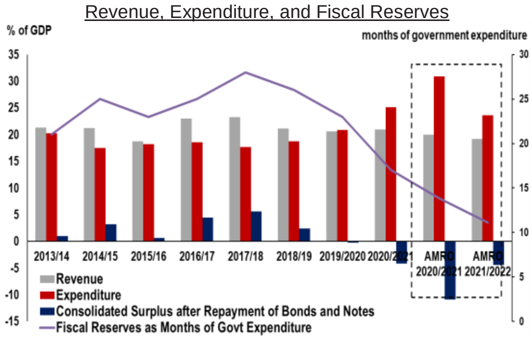
Land Premium vs Consolidated Revenue



Source: Financial Services and the Treasury Bureau; AMRO estimates

Revised estimates suggest the FY2019/2020 budget position recorded a modest deficit.

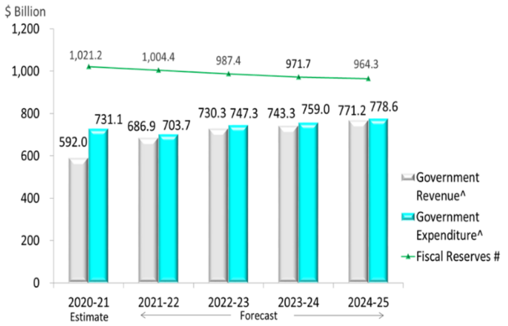
Revenue, Expenditure, and Fiscal Reserves



Source: Financial Services and the Treasury Bureau; AMRO estimates

The Government's Medium Range Forecasts are relatively benign at this juncture.

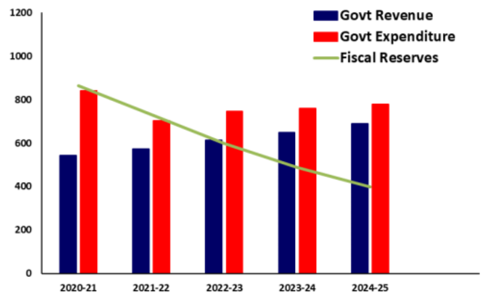
Medium-Range Forecasts (MRF): Hong Kong Authorities



Source: Financial Services and the Treasury Bureau

AMRO's projections reflect less positivity on the revenue side but still ample resilience overall.

Medium-Term Projections: AMRO

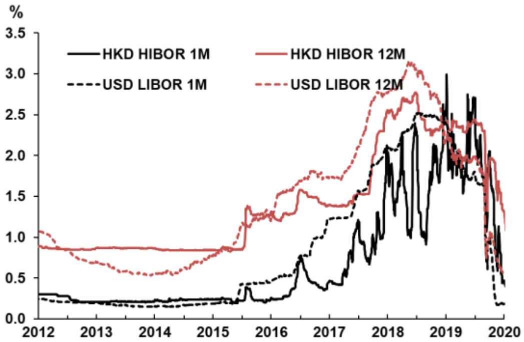


Source: AMRO estimates

Figure 1.4. Monetary and Financial Sectors

Domestic interest rates have trended down, broadly tracking the lower US interest rates due to the US Federal Reserve's easier monetary policy stance.

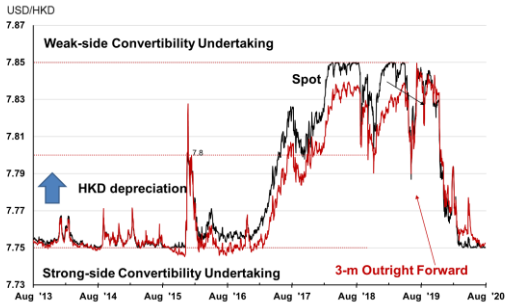
HKD Libor vs USD Libor



Source: Reuters

Given the Linked Exchange Rate System, strong equity-related demand for HKD, and spread between short-term HKD and USD interest rates, the HKD has been at the strong side of the CU band.

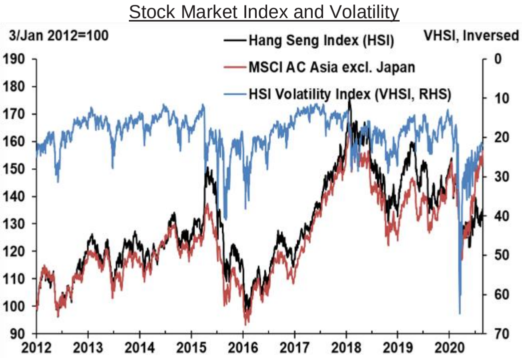
USD-HKD Convertibility Undertaking



Source: Reuters

The stock market has remained under pressure, with the pandemic clouding the recovery outlook for Hong Kong and Mainland China enterprises.

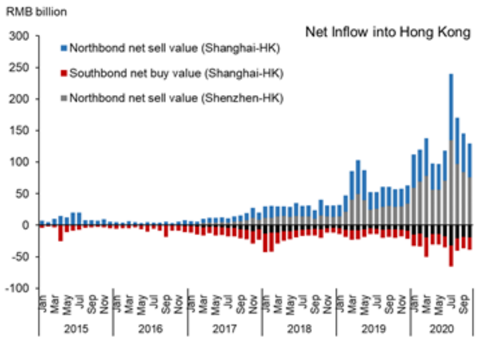
Stock Market Index and Volatility



Source: Reuters

Equity flows from Mainland China to Hong Kong have held up, reflecting continued confidence in Hong Kong as a key hub for raising equity.

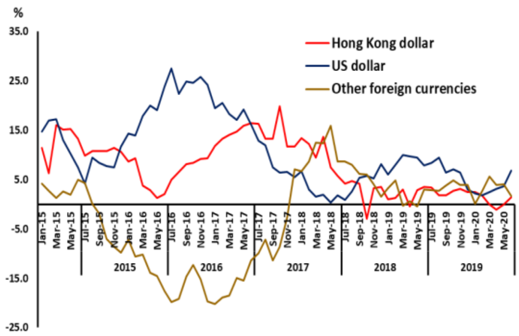
Stock Connect Flows



Source: Reuters; Hong Kong authorities

Banking deposit inflows have continued, suggesting that concerns about the impact of the Security Act on Hong Kong's financial center status are contained.

Banking System Deposits: HKD and USD



Source: Hong Kong authorities

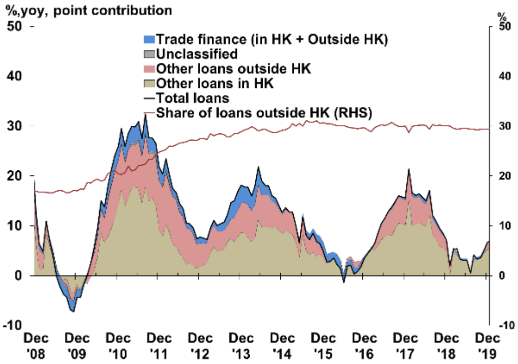
Banks' costs of funds have also been decreasing, alongside lower domestic interest rates.

Banking System Composite Interest Rate

Source: Hong Kong authorities

Credit expansion has moderated in line with the growth contraction, but remains positive.

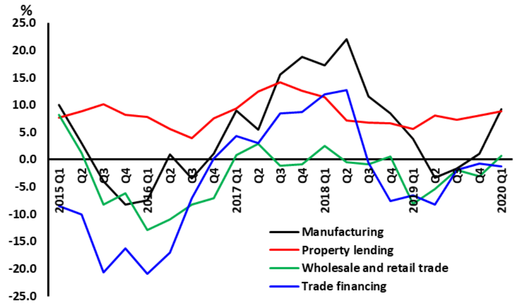
Bank Credit Expansion by Type



Source: CEIC

The main drags are credits to wholesale and retail trade and trade financing.

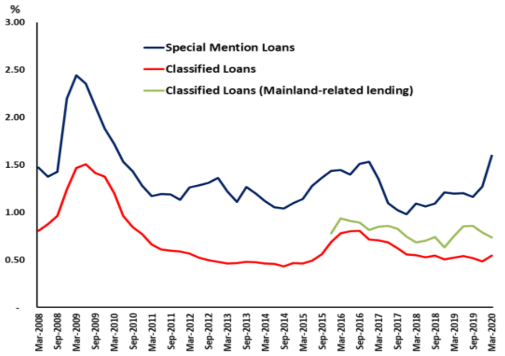
Domestic Loans by Economic Sectors



Source: Hong Kong authorities

Banking sector continues to be strongly capitalized; loan quality remains sound alongside more flexible treatment of loans as a key covid-19 policy response.

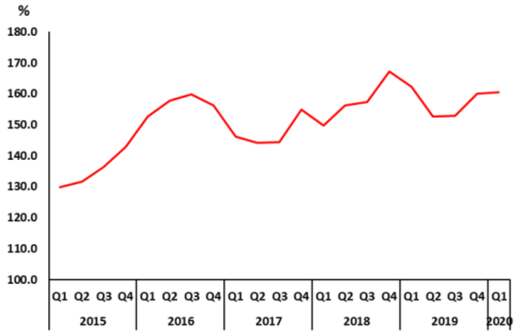
Banking Sector Capital Adequacy Ratio (CAR) and Non-Performing Loan (NPL) Ratio



Source: CEIC

Banking sector liquidity has remained ample, with buffers built up over an extended period of time.

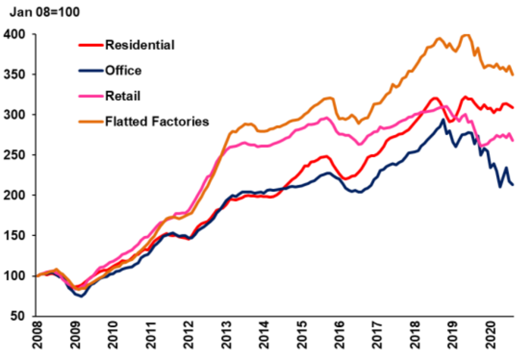
Banking Sector Liquidity Ratio



Source: Hong Kong authorities

Property prices fell, but n a contained manner considering the economic recession and extent to which sentiment has become much more cautious have stabilized in recent months; office space prices have been under more pronounced downward pressure.

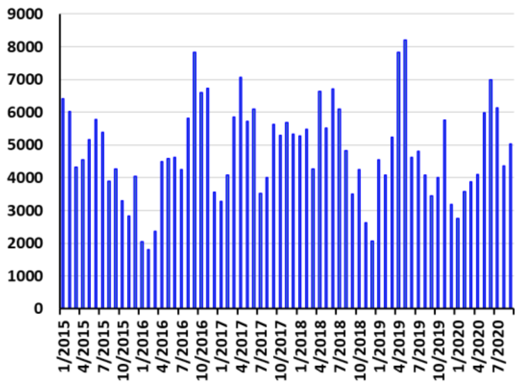
Property Price Indices



Source: CEIC

Residential property transactions have fluctuated in recent months, with underlying demand finding some support in buyers focusing on long-term prospects.

Residential Property Transactions



Source: CEIC

Appendix 2. Selected Economic Indicators for Hong Kong, China

	2016	2017	2018	2019	2020 p/	2021 p/
Real Sector and Prices	(in annual percentage change)					
Real GDP	2.2	3.8	2.8	-1.2	-7.5	4.5
Private consumption	2.0	5.5	5.3	-1.1	-10.6	3.8
Government consumption	3.4	2.8	4.2	5.1	49.5	-15.1
Gross domestic fixed capital formation	-0.1	3.1	1.7	-12.3	-26.3	2.8
Exports	0.7	5.8	3.7	-5.6	-11.5	9.6
Goods	1.6	6.5	3.5	-4.6	-5.0	3.0
Services	-3.5	2.8	4.6	-10.2	-22.5	11.0
Imports	0.9	6.6	4.5	-6.8	-6.5	-1.9
Goods	0.7	7.3	4.7	-7.3	-5.8	-1.6
Services	2.0	2.0	2.8	-2.4	0.1	0.1
GDP deflator	1.6	2.9	3.7	2.4	1.7	2.2
Labor Market						
Unemployment rate (In percent, period average)	3.4	3.1	2.8	2.9	6.2	5.0
Prices						
Headline inflation (Period average)	2.4	1.5	2.4	2.9	1.0	2.0
Underlying inflation (Period average)	2.3	1.7	2.6	3.0	1.7	2.2
External Sector	(in billions of U.S. dollars, unless otherwise specified)					
Current account balance (In percent of GDP)	4.0	4.6	3.7	6.1	-5.0	0.0
Goods trade balance (In percent of GDP)	2.3	1.0	-0.2	1.7	-10.3	4.4
Exports, f.o.b	462	497	530	509	450	543
Imports, cif	516	559	602	563	486	527
Overall balance	1.1	32.1	1.0	-1.1	-4.0	-3.0
(In percent of GDP)	0.4	9.4	0.3	-0.3	-1.1	-0.8
Gross official reserves excluding net forward position	386	431	425	441	422	415
(In months of retained imports of goods)	36.0	36.8	33.0	41.5	30.0	30.0
Total external debt	1,357	1,575	1,695	1679	1750	1800
Short-term external debt (% of international reserves)	237	244	266	249.0	215.0	225.0
Fiscal Sector (General Government)	(in percent of FY GDP)					
Revenue	23.0	23.3	21.2	20.6	20.0	19.9
Expenditure	18.6	17.7	18.8	21.2	30.9	24.4
Consolidated budget balance	4.5	5.6	2.4	-0.4	-10.9	-4.5
Public debt	0.1	0.1	0.1	0.3	0.1	0.1
Monetary and Financial Sector	(in annual percentage change, period end)					
Total loans	6.5	16.1	4.4	6.7	5.0	5.0
Total loans (In percent of GDP)	322.2	350.2	342.9	362.1	403.7	397.4
Loan to deposit ratio (In percent)	68.4	73.0	72.6	75.3	77.4	75.0
Classified loan ratio (In percent)	0.7	0.6	0.5	0.5	0.80	0.90
Capital adequacy ratio (In percent)	19.2	19.1	20.3	20.7	20.0	19.5
Three-month Hibor (In percent, end of period)	1.0	1.3	2.3	2.4	1.1	1.5
Memorandum Items						
Exchange rate (LCY per USD, end-period)	7.75	7.81	7.83	7.79	7.75	7.75
GDP in billions of HKD	2,490.4	2,659.4	2,835.2	2,865.1	2,699.0	2,878.6
GDP in billions of U.S. dollars	320.9	341.2	361.7	365.1	348.2	371.4
GDP per capita (USD)	43,733	46,161	48,540	48,713	46,428	49,520
Interest rates (%, end-period)						
Three-month Hibor	1.0	1.3	2.3	2.4	1.1	1.5
10Y Govt' bond yield	1.9	1.8	2.0	1.8	0.6	1.0
Asset prices						
Hang Seng Index (end of period, 1964=100)	22,001	29,919	25,846	28,190	25,458	25,458
(% yoy)	0.4	36.0	-13.6	9.1	2.5	0.0
Residential property prices (end of period, 1999=100)	307.4	352.7	359.4	379.2	386.1	386.1
(% yoy)	7.9	14.7	1.9	5.5	-1.9	0.0

Source: Hong Kong authorities; CEIC

Appendix 3. Balance of Payments

	2013	2014	2015	2016	2017	2018	2019
	(In percent of GDP)						
Current account	1.5	1.4	3.3	4.0	4.6	3.7	6.1
Goods	-10.1	-11.1	-7.4	-5.2	-6.7	-8.9	-4.4
Total exports of goods	183.6	176.4	162.2	156.3	158.4	157.1	149.8
Imports of goods	193.7	187.5	169.6	161.5	165.1	166.0	154.2
Services	10.7	11.3	9.8	7.5	7.7	8.7	6.1
Exports of services	38.0	36.7	33.7	30.7	30.5	31.3	27.7
Imports of services	27.3	25.4	23.9	23.2	22.8	22.6	21.6
Primary income	1.9	2.1	1.9	2.5	4.3	4.8	5.2
Secondary income	-1.0	-0.9	-0.9	-0.8	-0.8	-0.8	-0.7
Capital and financial account	-4.0	-3.3	-5.4	-4.1	-2.9	-6.2	-8.6
Capital account	-0.1	0.0	0.0	0.0	0.0	-0.1	0.0
Financial account	-4.0	-3.2	-5.4	-4.0	-2.9	-6.1	-8.6
Financial non-reserve assets	-1.3	2.9	6.4	-3.7	6.6	-5.9	-8.9
Direct investment	-2.4	-3.8	33.1	18.0	7.0	6.1	2.5
Portfolio investment	-18.1	-2.8	-40.5	-18.9	9.9	-21.7	-11.1
Financial derivatives	2.6	5.2	4.1	1.5	2.3	1.2	0.3
Other investment	16.6	4.3	9.6	-4.3	-12.7	8.6	-0.6
Reserve assets	-2.7	-6.2	-11.8	-0.4	-9.4	-0.3	0.3
Net errors and omissions	2.5	1.9	2.0	0.1	-1.7	2.4	2.5
Overall Balance of Payments	2.7	6.2	11.8	0.4	9.4	0.3	-0.3

Appendix 4. Statement of Central/General Government Operations

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/2019
	(In billions of HKD)					
Opening Balance	**734**	**756**	**829**	**843**	**954**	**1103**
Consolidated Revenue	**455**	**479**	**450**	**573**	**620**	**600**
General Revenue	348	396	384	436	444	465
Operating Revenue	345	394	382	412	443	454
Direct Tax	184	205	206	207	209	236
Stamp Duties 1/	42	75	63	62	95	80
Others	120	114	113	143	139	138
Capital Revenue	3	2	2	24	2	11
Land Premium	84	78	61	128	165	117
Others	12	5	5	9	11	18
Conslidated Expenditure	**434**	**396**	**436**	**462**	**471**	**532**
Operating Expenditure	338	316	347	353	371	432
Capital Expenditure	96	80	88	109	100	99
Consolidated Surplus 2/	**22**	**73**	**14**	**111**	**149**	**68**
Closing Balance	**756**	**829**	**843**	**954**	**1103**	**1171**
	(In percent of GDP)					
Opening Balance	34.3	33.4	34.5	33.8	35.9	38.9
Consolidated Revenue	21.3	21.2	18.8	23.0	23.3	21.2
General Revenue	16.8	17.5	16.0	17.5	16.7	16.4
Operating Revenue	16.6	17.4	15.9	16.5	16.6	16.0
Direct Tax	8.6	9.1	8.6	8.3	7.8	8.3
Stamp Duties 1/	1.9	3.3	2.6	2.5	3.0	2.8
Others	6.1	5.0	4.7	5.7	5.8	4.9
Capital Revenue	0.2	0.1	0.1	1.0	0.1	0.4
Land Premium	3.9	3.4	2.5	5.1	6.2	4.1
Others	0.6	0.2	0.2	0.4	0.4	0.6
Consolidated Expenditure	20.3	17.5	18.2	18.6	17.7	18.8
Operating Expenditure	15.8	14.0	14.5	14.2	13.9	15.3
Capital Expenditure	4.5	3.5	3.7	4.4	3.8	3.5
Consolidated Surplus 2/	1.0	3.2	0.6	4.5	5.6	2.4
Closing Balance	35.3	36.7	35.1	38.3	41.5	41.3
Memorandum Items:						
GDP in billions of HKD (Calendar Year)	2138.3	2260.0	2398.3	2490.4	2659.4	2835.2

Appendix 5. Monetary Survey

	2013	2014	2015	2016	2017	2018	2019
	(In percent of change, period end)						
Total money supply							
M1	9.7	13.1	15.4	12.3	9.8	-0.4	2.6
M2	12.4	9.5	5.5	7.7	10.0	4.3	2.8
M3	12.4	9.6	5.5	7.7	10.0	4.3	2.7
Hong Kong dollar money supply							
M1	8.6	11.6	12.2	14.0	11.8	-2.6	-1.5
M2	5.7	9.0	10.3	8.9	11.6	3.6	2.4
M3	5.7	9.0	10.4	8.9	11.6	3.7	2.3
Deposit							
Total	10.7	9.7	6.7	9.1	8.7	5.0	2.9
Hong Kong dollar	5.1	9.3	10.7	9.3	11.6	3.6	2.5
Foreign currency	16.2	10.1	3.1	8.8	5.9	6.4	3.2
Loans and advances							0.0
Total	16.0	12.7	3.5	6.5	16.1	4.4	6.7
Hong Kong dollar	8.2	10.9	3.8	7.9	19.7	8.9	6.6
Foreign currency	27.6	14.9	3.2	4.8	11.6	-1.7	7.0
Interest rates	(In percent, period average)						
Discount window base rate	0.50	0.50	0.75	1.00	1.75	2.75	2.25
HIBOR: 1 month	0.21	0.24	0.22	0.75	1.19	2.24	2.67
HIBOR: 3 month	0.38	0.38	0.39	1.02	1.31	2.33	2.43
Composite interest rate	0.39	0.39	0.26	0.31	0.38	0.89	1.09
HSBC's best lending rate	5.00	5.00	5.00	5.00	5.00	5.13	5.00

Appendix 6. Data Adequacy for Surveillance Purposes: 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	Yearly and quarterly data are available (for expenditure, production and income components)	Quarterly, about 1 month after the end of the reference quarter (for advance estimates data)	-	-	-
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 are available for public access by any means.

(ii) Reporting frequency refers to the periodicity that the available data are published. Timeliness refers to how up-to-date the published data are relative to the publication date.

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

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

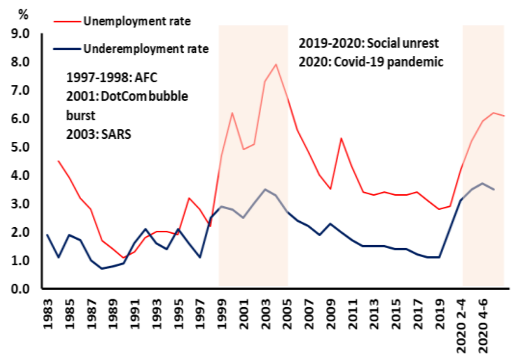
Annexes: Selected Issues

1. Scanning the Labor Market: Covid-19 Impact, Recovery Prospects, and Policy Suggestions

1. 1. This analysis seeks to highlight some key recent behaviors in Hong Kong's labor market, offer views about the prospects, and raise a few policy suggestions. Hong Kong's labor market has displayed a high degree of flexibility over many years, and part of that has been manifested in very quick wage decreases and unemployment increases during economic downturns. This time, job market conditions worsened only gradually for quite an extended period of time between H2 2019 and Q1 2020 amid large shocks, before a seemingly sudden sharp weakening in Q2 2020. Is this time different? Or does the sharp weakening which has transpired in the past three months the start of a prolonged and deep deterioration? This analysis explores these issues, and seeks to distil some implications as well as raise policy ideas.

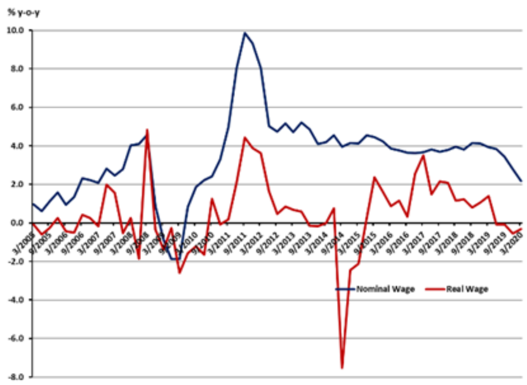
1. 2. Historically, Hong Kong's labor market has displayed both high flexibility and resilience – important characteristics in helping the economy recover from shocks and retrenched workers to transition back into jobs. Unemployment and wages respond fairly quickly to marked changes in economic growth and employment prospects. The overall labor force participation rate fluctuates considerably with labor market conditions, helping to lessen a rise in unemployment during economic downturns. These labor market behaviors reflect the following structural features: (i) a governance framework for the labor market that does not impose excessively onerous barriers for hiring and firing; (ii) a combination of sound macro fundamentals, well-run enterprises and generally well-skilled labor force that allow workers to maintain their employability even when they lose their jobs temporarily due to economic shocks; and (iii) a relatively sizeable segment of the working-age population not needing to be employed fulltime to meet financial commitments. As a result, strong recoveries after short periods of sharp spikes in unemployment have been observed throughout past crisis experiences (Figure 17).

Figure 17. Unemployment and Underemployment



Sources: Hong Kong authorities
Note: The unemployment rate figures for moving three-month periods are seasonally adjusted.

Figure 18. Nominal and Real Wage Growth



Sources: Hong Kong authorities

1. 3. **The current belated sharp weakening of labor market conditions can be explained by proactive actions of employers and the government.** Recognizing the big hit to confidence from the domestic social incidents, the government took measures very soon after the onset of recessionary forces at the start of H2 2019 and expanded the measures when Covid-19 pandemic hit in early 2020. Private sector enterprises also quickly became involved in helping to implement these measures, for instance by committing to retain workers for whom the government has provided wage subsidies, and by working with the government to creating tens of thousands of jobs. Between H2 2019 and H1 2020, four rounds of policy measures to stabilize the economy have focused heavily on preserving jobs and limiting the degree of wage reductions. As a result, the increase in the headline unemployment rate and the underemployment rate over successive quarters up till mid-Q1 2020 was significant but not too alarming (Figure 17). The fall in wages was also gentler than during the previous crisis period (Figure 18). The trends became more accentuated in recent months, especially for unemployment.

1. 4. **Policy measures have been large in scale and broad in scope, and rightly seek to work through three important strategies centering on businesses, jobs and livelihoods.** First, a significant support has been provided to SMEs to strengthen their capacity to retain workers, even if on part-time work arrangements and reduced wages. Second, job creation and matching programs have been enhanced to transition laid-off workers into new jobs as quickly as possible. Third, measures to help sustain livelihood have been taken to soften the impact of layoffs and wage cuts on workers' ability to meet basic expenses, and even to sustain some discretionary spending. (Figure 19) Overall, the policy package can be said to involve: comprehensive sectoral coverage; wide variety of policy tools; easing of near-term cash crunch while limiting the increase in long-term financial burdens; and harnessing of both fiscal and non-fiscal resources.

Figure 19. Key Thrusts of Hong Kong Authorities' Measures Which Impact on the Labor Market

Sustain Enterprises		Preserve Employment		Support Livelihoods	
Subsides	More than 70 measures over two rounds of the Anti-Epidemic Fund. Covers practically all sectors, with the hardest hit ones getting the strongest support.	Subsides	Comprehensive wage subsidy scheme, with condition to ensure that businesses retain workers for which the subsidies are intended. Quick disbursement. Assistance for persons not well covered by Mandatory Provident Fund (MPF). Creation of jobs in private and public sectors.	One-time cash pay-out	Provide direct and universal relief. Complemented by other measures such as grants and transport concessions.
Tax and fee cuts		Job creation schemes		Deferral of loan repayments	Ease cash crunch in near term. Limited increase of burden over medium to long term.
Credit guarantees	Low-interest bank loans with high-percentage guarantees to ease cash crunch	Job advancement	Training programs and subsidies to upskill labor force and boost prospects for taking on better jobs.	Reduction of taxes	Shifts sizeable financial burden from persons to government, leveraging on fiscal buffers.

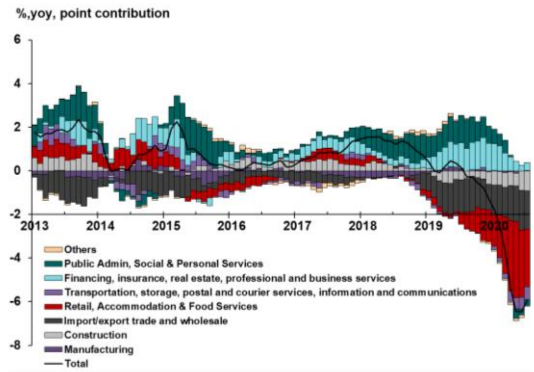
Sources: Hong Kong authorities

1. 5. **Implementation has been systematic, and important operational details taken care of.** Wage support measures have been rolled out for the most hard-hit sectors and then for other affected sectors. More vulnerable groups (such as elderly workers, the disabled, youngsters, and less highly-qualified seasoned professionals) have been identified, and subsidies have been sized according to the salaries they typically draw. For sectors where freelancers play an important role (e.g. tourism), these people have been included for support measures. Clarifications regarding the criteria and scope of coverage for wage support for elderly workers have been provided. The details ironed out have ensured that in total, more

than 110,000 employees aged 65 or above benefit from policy measures which fall under different schemes – this means strong coverage of above 90 percent.

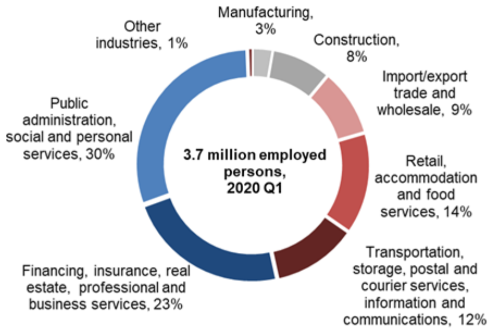
1\. 6. **However, after one full year of worsening economic conditions and heightened uncertainty about the growth recovery ahead, job destruction increased sharply** (Figure 20). The seasonally adjusted unemployment rate jumped 2.5 percentage points within four three-month moving average periods, from 3.7 percent in December 2019 – February 2020 to 6.2 percent in April – June 2020; and the underemployment rate likewise increased from 1.5 percent to 3.7 percent (Figure 17). Hard-hit sectors including retail, accommodation and food services; import/export trade and wholesale; and construction collectively account for nearly one-third of total employment (Figure 21). Job vacancies in these sectors have also decreased rapidly (Figure 22).

Figure 20. Employment Creation by Sector



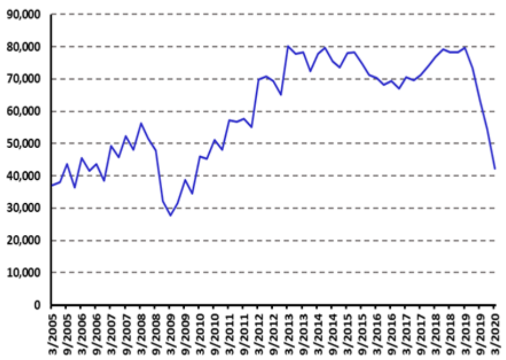
Sources: CEIC

Figure 21. Employment by Sector



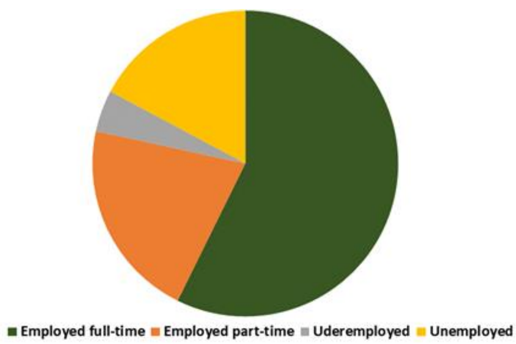
Sources: Hong Kong authorities

Figure 22. Total Job Vacancies



Sources: CEIC

Figure 23. Post-Intervention (Recurrent Cash) Poor Economically Active Population by Employment Status



Sources: Hong Kong authorities
Note: As at end-2019

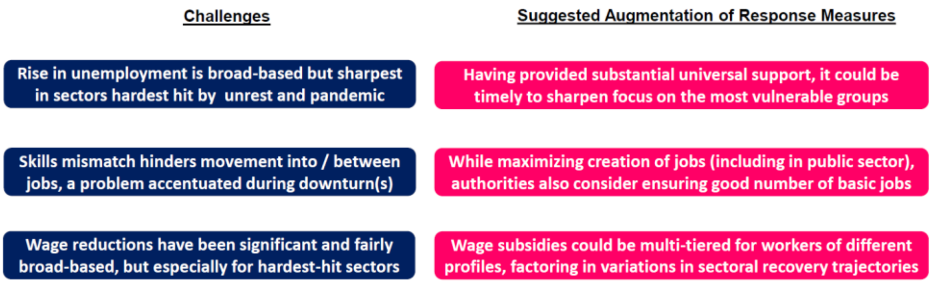
1\. 7. **Poor people have lost out disproportionately in the labor market in this recession.** Most of the sub-segments within this group have markedly lower educational and technical qualifications than other people in the labor force. Many of them may also have gone in and out of jobs more frequently than other workers, and therefore had more limited opportunities for consistent skills development and training. Over time, they become less suitable for the increasingly higher-skilled jobs created in an advanced economy like Hong Kong, even when job vacancies are ample. In 2018, the unemployment rate and underemployment rate for those below the official poverty line after recurrent cash policy intervention were much higher than that for the overall workforce (Figure 23)[16]; and feedback from enterprises suggests that layoffs during the 2019-2020 economic downturn have been much more severe for this group than for other groups.

1. 8. Looking ahead, the labor market recovery is likely to be protracted and sluggish and the most hard-hit sectors of the economy may not recover to pre-crisis levels. With pandemic control measures likely to be followed by further precautionary measures, the sectors that heavily depend on physical presence and face-to-face interactions such as retail, food services, hotel and accommodation will likely see subdued demand for an extended period of time. Tourist arrivals may not reach mid-2019 levels even in the medium term. Job creation is a challenging and intricate process. Besides, it can be challenging to shift laid-off workers from these sectors to work in the new economy or other emerging sectors that require new skillsets.

1. 9. Efforts to support the labor market are crucial in the challenging environment ahead, and the following suggestions could help improve effectiveness (Figure 24).

- First, the authorities could focus on the most vulnerable workers. For example, workers employed by the financially weakest micro enterprises and workers below the poverty line are two of the groups facing much higher risk of losing their jobs or suffering steep pay cuts. For them, one possibility is to combine full wage subsidies with larger livelihood support packages.
- Second, while a key policy focus is maximizing overall job creation, it is important for a good number of these jobs to be basic ones which can be taken on quickly by retrenched workers upon fulfilling a few months of solid training. The idea is to strike a judicious balance between high-quality jobs which will bring greater benefits in the long term, and a bigger pool of more basic jobs, which will help to stabilize the labor market and instill confidence in the near term. For Hong Kong, opportunities to increase the number of basic but also upgradable jobs may be quite significant, and lie in sectors such as information and communications, business services, and healthcare.
- Third, the authorities could consider sliding scales for wage subsidies for workers of different profiles in different sectors, and communicate policy commitment upfront. The reason is that the recovery trajectories would vary and end-points are uncertain. This approach would give workers confidence to perform well and continue training; enable businesses to retain workers and encourage them to hire more as the recovery gains traction; and help consumption and investment activity to resume.

Figure 24. Improving Policy Effectiveness: A Few Possibilities



Sources: AMRO

[16] Compiled based on the official poverty line analytical framework. Figures refer to 2018 [instead of 2019 which are not yet available.]

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