AMRO Country Report
ACR/20-03

AMRO Annual Consultation Report

Hong Kong, China - 2019

The ASEAN+3 Macroeconomic Research Office (AMRO)

February 2020

Acknowledgments

1. This Annual Consultation Report on Hong Kong, China has been prepared in accordance with the functions of AMRO to monitor and assess the macroeconomic status and financial soundness of its members; identify relevant risks and vulnerabilities; report these to member authorities; and if requested, assist them in mitigating these risks through the timely formulation of policy recommendations. This is being done in accordance with Article 3(a) and (b) of the AMRO Agreement.

2. This Report is drafted on the basis of the Annual Consultation Visit of AMRO to Hong Kong, China during July 29 to August 2, 2019 (Article 5 (b) of AMRO Agreement). The mission team was headed by Dr Chaipat Poonpatpibul, AMRO's Group Head and Lead Economist. The team members included Mr Foo Suan Yong (Senior Expert and Desk Economist for Hong Kong, China), Mr Yang Yang-Hyeon (Senior Economist and Back-up), Dr Jerry Xianguo Huang (Economist and Back-up), and Dr Simon Liu Xinyi (Economist and Back-up Economist). AMRO Director Mr 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, China was prepared by Dr Chaipat Poonpatpibul, Mr Foo Suan Yong, Mr Yang Yang-Hyeon, Dr Jerry Xianguo Huang and Dr Simon Liu Xinyi; peer reviewed by Dr Matthew Yiu and Mr Justin Lim; and approved by Dr Hoe Ee Khor.

3. The analysis in this Report is based on information available up to February 5, 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. For brevity, in the remainder of this report, "Hong Kong, China" will be referred to as "Hong Kong".

5. On behalf of AMRO, the Mission team wishes to thank the Hong Kong, China authorities for their candid comments on this Report, as well as their excellent meeting arrangements and warm hospitality during our visit.

Table of Contents

Executive Summary

1. **Hong Kong's GDP growth has decelerated sharply, as the US-China trade conflict weighed on regional trade flows and business sentiments.** Growth deceleration became sharper through 2019, with growth coming in at -1.2 percent for the year. Increasingly, weakening external demand has spilled over to domestic activity, with private consumption and investment both sharply weaker.

2. **The growth outlook for 2020 is weak, due to external headwinds and domestic sociopolitical tensions, as well as the outbreak of the COVID-19 virus.** Uncertainty related to the US-China trade conflict continues to cast a shadow over the regional and domestic economies and asset prices. Sociopolitical tensions are weighing heavily on economic sentiments and exerting a drag on both consumption and investment, which would likely remain subdued into 2020. Accordingly, AMRO has revised its 2020 baseline growth forecast for Hong Kong to -0.2 percent.

3. **Overall labor market conditions still remain fairly tight for now, although employment growth has weakened.** The seasonally-adjusted unemployment rate has edged up to 3.3 percent and employment growth has turned negative as a few key sectors, especially trade and wholesale, have been shedding jobs.

4. **Inflationary pressures have increased moderately due to supply-side factors, but remain contained.** CPI inflation rose from 2.4 percent in 2018 to an average of 3.0 percent for Q1-Q3 2019 and 2.9 percent in December 2019, due to a spike in pork prices. Looking ahead, inflation pressures should remain contained.

5. **As Hong Kong is an open economy and highly exposed to both the US and China, it is vulnerable to a continued contraction of cross-border trade and a sharp slowdown in Mainland China.**

- If the unresolved US-China trade conflict were to escalate further, Hong Kong could be affected because of its large and growing trade-related services. These include offshore trade and services exports, which depend significantly on demand from China and the US. For merchandise trade, all trade between Mainland China and the US via Hong Kong China accounted for around 9% of total exports of Hong Kong in 2018.
- If Mainland China's growth momentum falters, it could exert a drag on Hong Kong's economy. Mainland China is a key source of demand for Hong Kong's services exports, including trade-related services, logistics, financial services, and tourism.

6. **If the sociopolitical tensions were to heighten or the spread of the COVID-19 virus were to be prolonged or more extensive, it would likely drag growth down further**, by dampening sentiments and economic activity even more than it already has.

7. **The combination of external headwinds and domestic challenges – which now includes how to sustain economic activity despite concerns over the spread of the**

COVID-19 virus coming on top of the still-lingering socio-political unrest – could weigh on the property market, especially since the market is quite sensitive to shifts in sentiment.

8. **Hong Kong is well equipped to address growth and structural challenges.** Confidence in the Linked Exchange Rate System (LERS) remains solid. The banking sector's strong capital position and liquidity buffers serve as an anchor of resilience. Healthy fiscal reserves mean ample room for policy measures to address longer-term issues.

9. **Policymakers should continue to take measures to mitigate the impact of near-term headwinds while pressing on with efforts to address structural challenges and socioeconomic inequality.**

a. For the property market, the authorities should continue with stepped-up efforts to increase the supply of land and provision of housing – including affordable housing for lower-income groups, while standing ready to adjust macroprudential policy.
b. The authorities should consider enhancing fiscal and other measures to support firms and workers affected by the economic downturn.
c. Efforts to address longer-term challenges should also continue. The ample fiscal reserves allow the authorities to step up efforts to diversify the economy, spur technology development, keep the labor market flexible, and also further strengthen social welfare and healthcare support amid rising challenges from an ageing population.
d. It is a matter of urgency to deliver comprehensive plans for enhancing socioeconomic and intergenerational upward mobility. Adjustments of minimum wages should keep pace with rising inflation.

10. **Hong Kong should continue to play an important role in facilitating China's further reform and opening-up** as well as its outreach to other emerging market economies (EMEs). The Greater Bay Area (GBA) development and the Belt and Road Initiative (BRI) both provide good opportunities for Hong Kong to contribute and to benefit.

11. **The recent introduction of virtual banking and continued development of fin-tech will help the financial sector to leverage on the digital technology to improve and expand its services and enhance its competitiveness.**

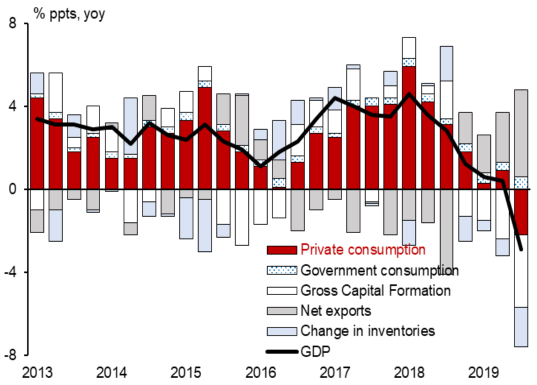
12. **Hong Kong should continue to support the development of green finance,** leveraging on its strengths as a leading green finance hub in the region. The recent introduction of HKMA's key measures on sustainable banking and green finance will boost awareness and development of Hong Kong's green finance market.

A. Recent Developments and Outlook

A.1 Real Sector Developments and Outlook

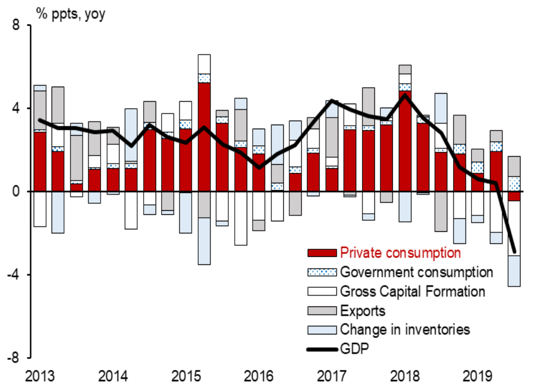
1. **Hong Kong's GDP growth has decelerated sharply, reflecting weakening external demand and a considerable dip in business sentiments due to the US-China trade conflict and more recently, the outbreak of the COVID-19 virus.** Growth was strong at 4.1 percent in H1 2018. However, it fell to 2.0 percent in H2, resulting in full-year growth of 2.9 percent. The deceleration became sharper through 2019, with growth coming in at -1.2 percent for the year, according to advance estimates (Figure 1). Key sectors of the economy – particularly external trade, wholesale and retail trade and construction – have slowed. Financial services and tourism remain relatively firm, but not to the extent of offsetting the slowdown elsewhere. More recently, tourism has also weakened, with the escalation of socio-political tensions leading to a dip in tourist arrivals.

Figure 1. GDP Growth: Conventional Approach



Source: Hong Kong authorities

Figure 2. GDP Growth: Import-Adjusted Approach



Source: Hong Kong authorities, AMRO calculations

2. **Weakening external demand has spilled over to domestic activity, with socio-political tensions exerting an additional drag.** Both private consumption and investment have weakened sharply. The expansion of consumption has been on a decelerating trend since Q1 2018, eventually contracting by 1.1 percent for the full year 2019. Investment has plunged, contracting by 12.2 percent for 2019. On an import-adjusted basis (Figure 2), consumption is also shown to have been on a pronounced decelerating trend, and although still the key underpinning of overall growth, has been insufficient to offset the decline in investment. Higher-frequency indicators – including the Purchasing Manager's Index (PMI) – point to continued sluggishness and the prospect of a technical recession ahead.

3. **While overall labor market conditions remain fairly tight, employment growth has turned negative.** The unemployment rate has increased moderately to 3.3 percent, and employment growth has turned negative as a few key sectors especially trade and wholesale have been shedding jobs. For the trade and wholesale sector, the trend may not be reversed even when the economy picks up, as employment in this sector has been on a general downtrend since 2012, alongside technological and productivity improvement.

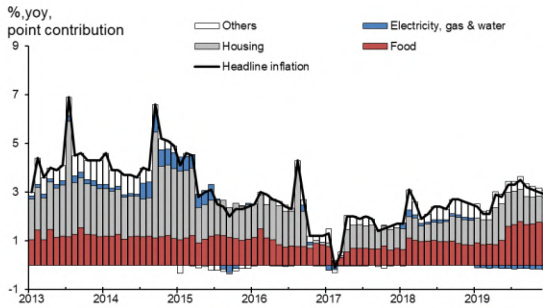
4. **The growth outlook has weakened sharply due to rising external headwinds and continuing socio-political tensions, and more recently, the COVID-19 outbreak.** Cross-border trade has contracted, with the contraction in imports being more pronounced than exports. Alongside the decline of imports of consumer and capital goods, there has also been a marked contraction of imported goods which are meant for re-exports including to Mainland China. China's growth is contained but downward pressures are expected to persist. And if the socio-political tensions heighten further, they could dampen business sentiment and economic activity even more than they have already done. Considering these factors, AMRO has revised its baseline growth forecast for Hong Kong for 2020 to -0.2 percent (Table 1).

5. **Inflation pressures have increased moderately due to supply-side factors, but remain contained.** CPI inflation rose from 2.4 percent in 2018 to an average of 3.0 percent for Q1-Q3 2019 and in November, due to pork prices pushing up the CPI from Q2 onward (Figure 3). Looking ahead, inflation pressures should remain contained. With the economy decelerating to a near stall and business and consumer sentiments weighed on by the socio-political tensions, there is little or no demand pressure on prices. Inflation is expected to be 2.9 percent in 2019 and 2.7 percent in 2020, with continued high pork prices and base effects being important factors.

Table 1. Growth Forecasts: Snapshots

	2019	2019	2020	2020
Scenario	Baseline	Adverse	Baseline	Adverse
Apr '19	2.7	1.9	2.7	2.1
Jul '19	1.3	0.8	1.9	1.2
Aug '19	0.5	-0.2	0.8	0.4
Jan '20	-1.2*	-1.3	-0.2	-2.0

Figure 3. Inflation



Source: CEIC

Note: The baseline scenario factors in the US and China keeping the phase one deal in place, but making quite limited progress in working towards a phase two deal and a continued but moderating level of unrest. The adverse scenario involves a rollback of some of the elements agreed on for the phase one deal, and efforts towards a phase two deal being shelved, and concerns mounting over renewed heightening of tensions; and importantly, a heightening of domestic unrest within Hong Kong and a significant impact of the prolonged COVID-19 epidemic on Hong Kong through a further decline in Chinese tourists and a sharp slowdown in China's growth.

Authorities' Views

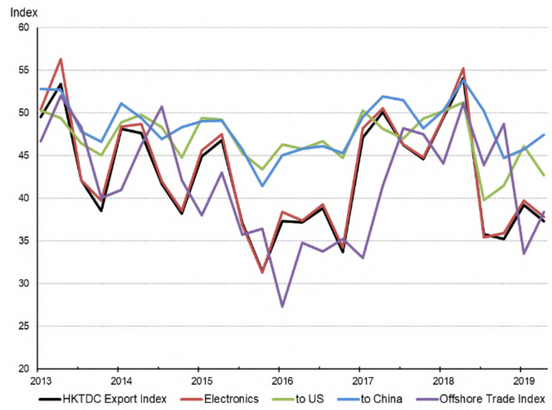
6. **Overall economic performance has been subdued, and there are increasing downside risks facing the global economy.** Economic conditions for Hong Kong in H1 2019 were the weakest since the 2009 recession, and there are multiple risk factors affecting the outlook ahead, including: the US-China trade conflict, Brexit, geopolitical tensions in the Middle East, and the socio-political tensions. Major central banks' monetary policy easing is unlikely to offset these various headwinds completely. So Hong Kong's economic performance

should remain sluggish or even weaken further. These challenges have prompted the government to announce three rounds of measures amounting to more than HK$25.1 billion during August to early December 2019 to support overall growth, and importantly, enterprises and workers affected by the current downturn.

A.2 External Sector

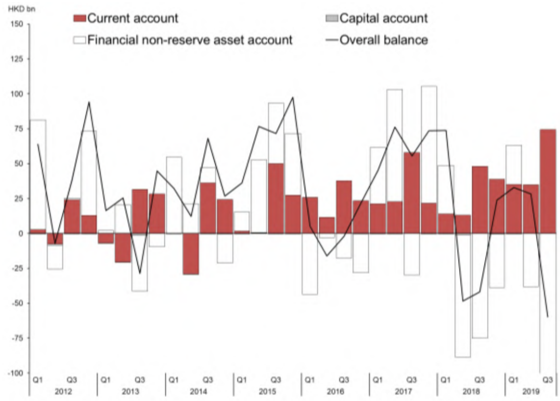
7. **Exports have contracted amid softening global demand, while imports have shrunk even more markedly, partly reflecting subdued domestic demand.** Exports of both goods and services have trended down since H2 2018. Exports of goods contracted by 4.7 percent in 2019. This contraction has been sharp and broad-based, by both destinations and commodities. Exports of services shrank by 2.4 percent in 2019, having weakened markedly through succesive quarters. Sentiments and expectations are well below levels seen during earlier quarters (Figure 4). Financial services and tourism remain relatively firm, but not to the extent of offsetting the slowdown elsewhere – and tourism has now been affected adversely by more recent incidents of tensions. Reflecting the improvement in the trade balance, the current account has continued to register a significant surplus (Figure 5).

Figure 4. HKTDC Export Index



Source: HKTDC

Figure 5. Balance of Payments



Source: Hong Kong authorities

A.3 Monetary Conditions and Financial Sector

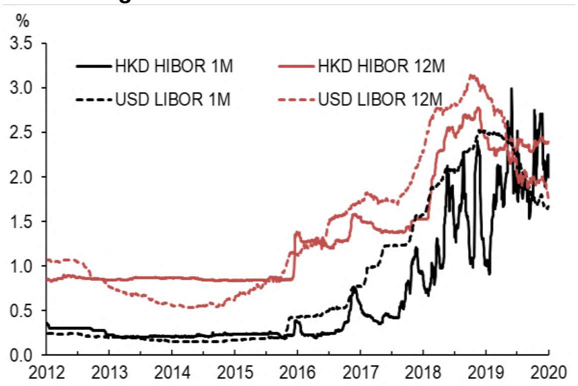
8. **Overall domestic financial conditions remain accommodative, albeit with some signs of tightening.** Bank credit growth has slowed from a high of 16 percent in 2017 to 3.3 percent y-o-y in June 2019. While HKD Hibor rates have increased somewhat from very low levels (Figure 6), HKD long-term interest rates have fallen recently, reflecting easing global financial conditions. The US Federal Reserve's easing bias is expected to help keep monetary conditions in Hong Kong accommodative. As at 5 February 2020, the Hang Seng Index is down 4.98 percent year to date, weighed down by socio-political tensions, continuing uncertainty over the US-China trade conflict, the COVID-19 virus, and dimming growth prospects.

9. **The moderation of bank credit expansion is in line with the slowdown of Hong Kong's economy as well as growth headwinds in Mainland China** (Figure 7). For onshore

lending, moderation in demand has been a key factor behind the credit slowdown with lending to manufacturing, wholesale and retail trade, and also for trade financing, turning negative. Mortgages and credit to developers which account for about 14 and 15 percent of total loans, have continued to grow, albeit at a more gradual pace.

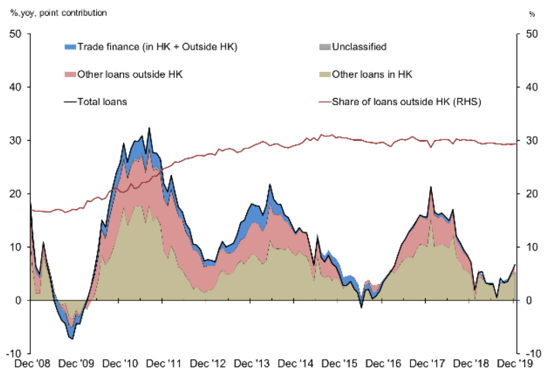
10. **Banks have maintained strong financial positions and buffers.** Overall, Hong Kong banks have refrained from moving down the credit quality ladder even as a more subdued pace of loan growth raises the prospect of downward pressure on profits. This also applies to cross-border lending to Mainland China. Mainland firms which borrow from Hong Kong banks have tended to be of higher credit rating, and have developed more sophisticated knowhow and risk management for their cross-border operations, although some could have come under more stress as China's growth slowdown continues, and warrant closer monitoring. On the whole, banks have maintained strong capital and liquidity buffers, and healthy asset quality (Figure 8), although there has been an increase in the special-mention loans (SML) ratio from a low base in recent quarters. The non-performing loan (NPL) ratio remains very low at around 0.5 percent; the overall capital adequacy ratio (CAR) is a strong 20.6 percent; and the liquidity coverage ratio (LCR) of key banks in Hong Kong are well above the statutory minimum requirement of 100 percent.

Figure 6. HKD Hibor vs USD Libor



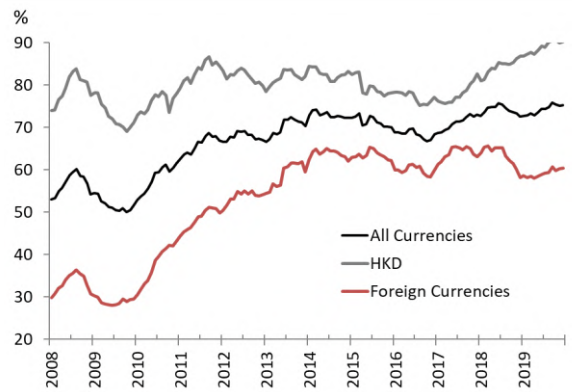
Source: Hong Kong Association of Banks, Global Rates

Figure 7. Credit Growth



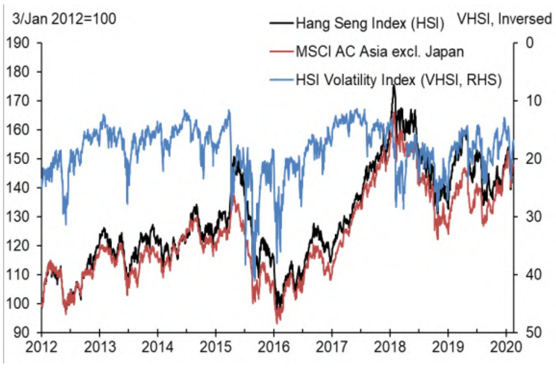
Source: Hong Kong Authorities

Figure 8. Capital Buffer and Loan Quality



Source: CEIC

Figure 9. Stock Market Index and Volatility



Source: Reuters

11. **The stock market has underperformed amid heightened volatility** (Figure 9). Year to date, the Hang Seng Index is down by 4.98 percent[1], given the socio-political tensions and continuing uncertainty over the US-China trade conflict. Bouts of heightened volatility have been due to shifts in sentiment about Mainland China's growth prospects and the US-China trade conflict – a large portion of the Hong Kong stock market capitalization is accounted for by Mainland firms. Overall, Hong Kong's stock market has underperformed regional peers in 2019.

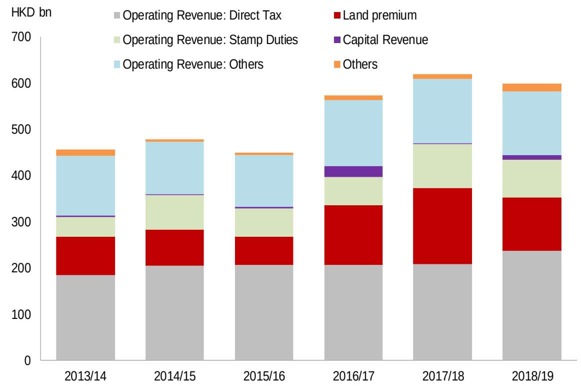
12. **The property market weakened in H2 2018, recovered in the first five months of 2019, and then came under downward pressure thereafter.** Residential property prices fell by nearly 5 percent during the dip, due to uncertainties over the growth outlook and the US-China trade conflict, and earlier expectations that the US Federal Reserve would hike rates. When several of those uncertainties receded and the Fed moved to a dovish bias, property prices recovered, driven by strong underlying demand. However, property prices moderated again in June and July 2019 amid heightened external headwinds, the start of the socio-political tensions, and the sharply-weakened domestic economic environment. At the current juncture, investor sentiments for different segments of the real estate market remain somewhat guarded. There is a sense that Hong Kong's weakening economic growth will likely continue, and this will exert a drag on rentals and prices across different segments of the property market.[2] Provided that the socio-political tensions and the spread of the COVID-19 virus are contained, residential property prices are expected to hold up better than those in the above segments, on account of strong demand and supply shortage.

A.4 Fiscal Sector

13. **Hong Kong's fiscal position remains strong, although surpluses are narrowing.** Government revenue declined in FY2018/2019 (Figure 10) and would have remained weak in FY2019/2020 given sluggish economic growth. Government revenue decreased by 3.2 percent in FY 2018/19 as growth slowed. On the other hand, government spending increased significantly in FY2018/19, and has remained strong in FY2019/2020 to support growth. Overall, total government spending in FY2018/2019 grew by 12.9 percent y-o-y, with a focus on supporting growth and diversification of the economy, and enhancing social welfare. As a result, the fiscal surplus narrowed from 5.6 percent of GDP to 2.4 percent of GDP. For FY2019/2020, revenue might have fallen due to markedly slower growth; but expenditure would have risen by more than the originally-planned 14 percent y-o-y given the announcement of fiscal stimulus measures between August and December 2019. Therefore, the fiscal balance is expected to undershoot the originally-envisaged 0.6 percent of GDP surplus, and may turn out to be a slight deficit. Nevertheless, the fiscal position remains strong, as fiscal reserves currently stand at about 39 percent of GDP (Figure 11), equivalent to about two years of government spending.

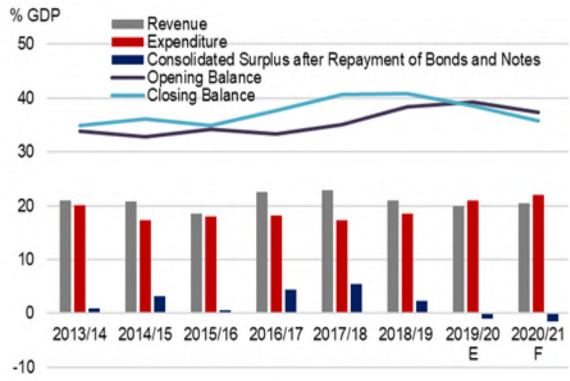
[1] As of 5 February 2020
[2] The effects may vary in different segments. For example, if retail sales for the full year undershoot earlier expectations, retail rentals could fall significantly, with the luxury segment falling more than the mass market segment. And if the economy's overall growth momentum deteriorates, investment and rental demand for office spaces, especially Grade A offices, could also weaken significantly, as firms across the corporate sector become more cautious about business costs.

Figure 10. Budget: Revenue



Source: Financial Services and the Treasury Bureau

Figure 11. Revenue, Expenditure, Closing Balance, and Consolidated Surplus



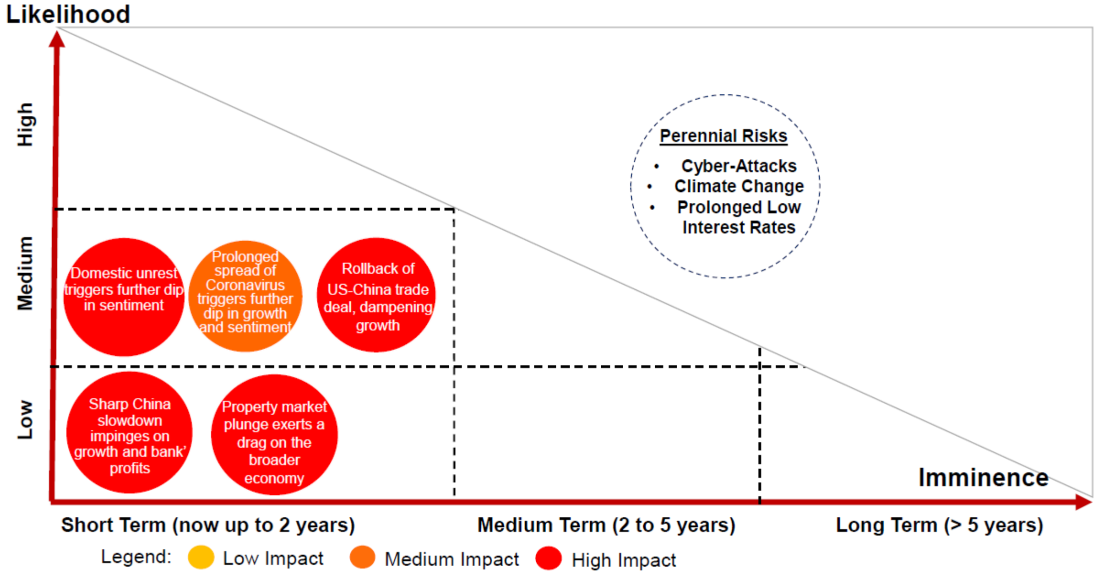
Source: Financial Services and the Treasury Bureau

B. Risks, Vulnerabilities and Challenges

B.1 Near-Term Risks and Vulnerabilities

14. **Risks to growth and confidence have heightened markedly compared to 2018 (Figure 12).** The risk of socio-political tensions heightening remains, while a new risk has emerged in the form of the COVID-19 virus outbreak, raising the prospect of a sharper decline in business sentiment and a bigger drag across trade-related services, tourism, construction activity and real estate as well as overall economic growth. If Mainland China's growth momentum falters because of the prolonged COVID-19 epidemic and/or the US-China trade deal is rolled back, Hong Kong's growth could decelerate more sharply moving forward.

Figure 12. Risk Map for Hong Kong



Source: AMRO

15. **Should growth decelerate further, Hong Kong's labor market conditions could worsen, and domestic consumption could weaken further.** While the unemployment rate has increased moderately to a still-low 3.3 percent, and the underemployment rate remains at a very low 1.2 percent, there have been more anecdotal accounts of companies in some sectors reaching agreements with employees to cut working hours and / or take unpaid leave.

16. **The external headwinds and domestic challenges could bring about a downshift in the property market, with a knock-on impact on the broader economy.** (Please see Selected Issue 1 for a brief exposition of the various channels through which the property market affects economic growth.) The risk is rising, notwithstanding sound macro fundamentals, strong underlying demand for properties, limited supply in the near term, and the strong balance sheets of property developers and the household sector.

17. **Notwithstanding, Hong Kong's banking sector is likely to remain resilient** even in the event of a sharp growth slowdown in Mainland China and Hong Kong. Credit quality has remained sound overall. Banks have very strong capital and liquidity buffers with the capital adequacy ratio (CAR) at 20.4 percent and the average liquidity coverage ratio (LCR) well above a high threshold of 150 percent.

18. **In an adverse scenario, growth could fall more sharply than it already has.** Our adverse scenario involves several elements: a rollback of some of the elements agreed on for the phase one deal and shelving of efforts towards a phase two deal; a prolonged domestic unrest within Hong Kong; and prolongation of the COVID-19 epidemic having significant impact on Hong Kong's growth through a further decline in Chinese tourist arrivals and a sharp slowdown in Mainland China's growth. For this adverse scenario, AMRO projects that Hong Kong's growth could come in at -2.0 percent in 2020, with Hong Kong authorities further increasing fiscal support for the economy.

Authorities' Views

19. **Authorities hold the view that economic fundamentals of Hong Kong remain sound.** Despite the recent local social incidents, Hong Kong's core competitiveness in such areas as the free movement of capital, goods, information and people, a simple tax system with low tax rates, a sound regulatory system, rule of law, and an independent judiciary and quality professional services has remained intact. To counter the challenging external and local economic environment, the Government has announced various measures to support enterprises and relieve people's financial burden. The financial sector would remain resilient, and there would be sufficient confidence in Hong Kong's economic resilience, asset values, and financial system stability. Hong Kong banks' capital and liquidity buffers are strong. Confidence in the LERS is high, there are no signs of buildup of speculative activity against the Hong Kong dollar, and the weak side of the Convertibility Undertaking (CU) has not been triggered since March 2019. Even when triggers occur – as they have from time to time in 2018 and early 2019, the HKMA is fully capable of maintaining the stability of the Hong Kong

dollar and managing large-scale outflows, and there is no cause for concern. Just as importantly, the transparency with which HKMA has conducted its policies and operations, as well as its vast FX reserves, will continue to be a key anchor of confidence.

20. **In response to the COVID-19 virus outbreak, the Hong Kong government has taken measures to cushion the impact on the economy.** The government has launched a HKD $25 billion Anti-epidemic Fund[3] to provide assistance to affected sectors and workers and to enhance anti-epidemic measures. To alleviate potential cash flow problems facing small and medium sized enterprises amid the difficult economic environment, many banks have responded to the HKMA's call and introduced a slew of relief measures to help personal and corporate customers who are adversely affected. The authorities will continue to monitor the situation and be ready to roll out further support measures when needed.

[3] Announced in mid-February 2020

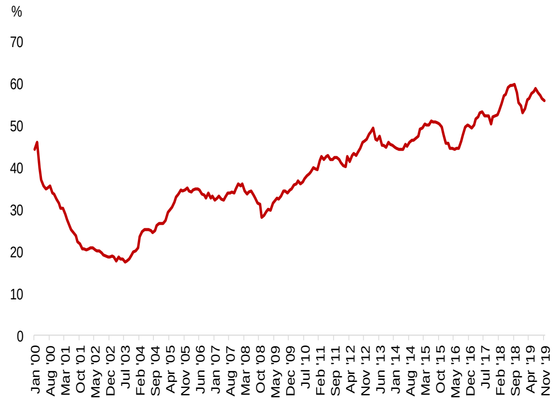
B.2 Longer-Term Challenges

21. **Hong Kong needs to find ways to sustain its long-term growth potential against the backdrop of population ageing and the challenge of technological change.** Alongside the trend of population ageing becoming more accentuated in recent years, Hong Kong's overall labor force participation rate has fallen moderately. At its current 60.7 percent, it is considerably lower than that of many advanced economies, many of which have angled their policies to attract and keep people in the workforce – including continuous education and training, boosting tax incentives, reducing early retirement incentives, and helping individuals and families get not just better work-life balance but importantly better work-life flexibility on a day-to-day basis. This suggests that there is some scope for Hong Kong to increase its labor force participation alongside further gains in labor productivity, and pursuing the two together should be a key priority. Concurrently, rapid technological change and the inevitable disruptions to business models across different services sub-sectors will test the capacity of private sector enterprises to upgrade their technological capacity, innovate, and stay competitive. These must be done while also addressing the underlying socio-economic issues which have driven the recent surfacing of tensions – and which, importantly, has also raised the prospect of significant brain drain from Hong Kong, thereby hurting Hong Kong's longer-term growth potential.

22. **Insufficient housing supply, which has worsened housing affordability significantly, will continue to be a stiff challenge for policymakers.** Figure 13 shows that housing affordability has deteriorated for the past decade or so. It will likely take several more years of concerted effort by the authorities to resolve this challenge. The authorities aim to increase total housing supply by 450,000 units over the next ten years from 2019-20 to 2028-29, with a 70-30 split between public housing and private housing. This will entail addressing multiple challenges, including more efficient use of current land and stepping up land reclamation and the building of housing on the reclaimed land.

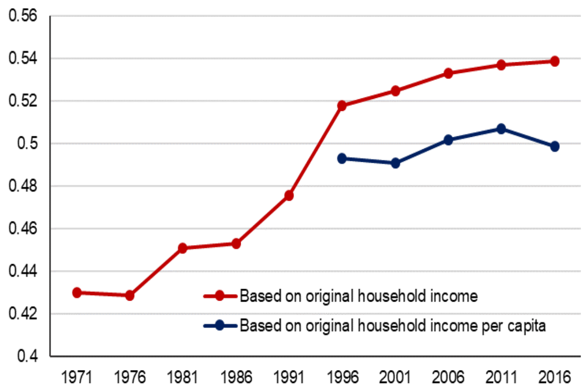
23. **Socioeconomic inequalities have come to the fore and emerged as a complex challenge ahead.** While Hong Kong has achieved an impressively high level of per capita income, it has come at the expense of widening income gaps and social disparities as indicated by the Gini coefficient (based on original household income), which at 0.539, is at its highest in 45 years (Figure 14). The issues are multifaceted and complex. While housing affordability is an issue, (perceptions of) limited socioeconomic and intergenerational upward mobility is also a significant factor. In addition, there are other factors, including: the quality of jobs created by Hong Kong's shift to the "new economy", and the impact of these big structural changes on the security of people's livelihoods.

Figure 13. Affordability Ratio: All Household (Small & Medium Units)



Source: Centaline Property Agency Limited

Figure 14. Gini Coefficient Index



Source: Hong Kong authorities, AMRO calculations
Note: "Original" means before tax and social benefits

C. Policy Discussion

C.1 Shore up growth in the near term

24. In the near term, on top of the stimulus measures announced between August and December 2019, the authorities could consider further enhancing fiscal and other measures to support firms and workers affected by the economic downturn. On the external front, the government has stepped up its efforts to support exporters. These include: enhancing information flows, strengthening export credit insurance, exploring new export destinations, and improving market access by negotiating free trade agreements. It is important to ensure that measures to help firms retain and hire workers are effective, and workers maintain their employability. The small and medium-sized enterprise (SMEs) sector in particular may need more targeted support. . The HKMA has introduced a new relief measure in September 2019 for the 80% Guarantee Product of the SME Financing Guarantee Scheme through HKMC Insurance Limited, allowing the repayment of only the interest and not the principal temporarily. The HKMA has also reduced countercyclical capital buffer (CCyB) to 2.0% from 2.5% in October 2019, allowing banks to be more supportive to the domestic economy and help mitigate the economic cycle. In addition, a banking sector SME lending coordination mechanism has been established to support SMEs. Furthermore, there are already plans to spend more than HK$100 billion on infrastructure building annually. Some of this spending could be frontloaded to FY2019/2020 without compromising the government's fiscal prudence over the medium term.

C.2 Prepare to mitigate the impact of a sharp property market dip and urgently ramp up housing supply

25. **The authorities should relax macroprudential policy if a downward cycle in the property market is confirmed (especially for residential property) and urgently step up efforts to increase the supply of housing significantly**, especially affordable housing for lower-income groups. Over the past several years, the shortage of housing has remained acute, and affordability has deteriorated. The government has announced a raft of measures, and has started to implement several of them. Stepping up the pace of increasing supply needs to be a key priority. (Please see Selected Issue 1 for a more extensive analysis.)

C.3 Lift growth potential and ensure sustainability in the long term

26. **For the long term, fiscal resources should be further deployed to lift Hong Kong's growth potential.** Ample fiscal reserves allow the authorities to step up efforts to diversify the economy, spur technology development, and keep the labor market flexible. There have been incentives to promote new start-ups in the high-technology sectors. For the labor market, retraining programs have been a key focus. Looking ahead, spending on boosting research and development (R&D) and productivity can be increased further.

27. **More should be done to improve healthcare services and to support the elderly.** The 2019/2020 Budget saw the government take several positive steps, including: the inclusion of 19 projects under the second 10-year hospital development plan, providing about 9000 additional hospital beds; tax deductions for eligible voluntary health insurance products, deferred annuity premiums and Mandatory Provident Fund (MPF) voluntary contributions; and the allocation of HK$10 billion to establish an innovative cluster in the Science Park to develop healthcare technologies. The Hong Kong government's expenditure on public healthcare services and social welfare combined, already accounts for a sizeable 35.6 percent of its recurrent public expenditure (2019-20 estimate). But there is scope to do more, given that: the population is ageing, demand for healthcare services is strong; and its public health expenditure as a share of GDP remains much lower than many advanced countries. To address the shortage of doctors in public hospitals, steps should be taken to increase the supply of doctors and healthcare professionals, including possibly bringing in expatriates.

28. **Just as importantly as driving growth, the authorities and people of Hong Kong need to work together to address crucial structural challenges and socioeconomic inequalities.** Hong Kong's status as an advanced economy, its relatively high per capita GDP, and a general sense that the people are well taken care of, with good jobs and good pay, belie several fault lines which have become more pronounced over the years. In particular, income inequality has become worse with households in the top ten percent having incomes which are more than 30 times that of households in the bottom 10 percent. From this perspective, on top of further enhancing public healthcare and social welfare, the government needs to start spending on programs to enhance socioeconomic and intergenerational upward

mobility as well – education, vocational training, and even basic incomes for those who are unable to find jobs despite their best efforts. In addition, the policy makers should ensure that minimum wage adjustments continue to keep pace with inflation.

Authorities' Views

29. **Hong Kong is taking a long-term view in stepping up efforts to diversify its economy, boost technology development, enhance its labor market resilience, and improve healthcare over multiple years – all of which will help to sustain growth and resilience.** Diversification efforts for the economy extend to services sub-sectors such as professional services (e.g. accounting; arbitration). For technology development, there are incentives for new start-ups in the more high-technology sectors. For the labor market, retraining is important, even though for now, practically every sub-sector of the economy is reporting strong demand for workers and tight supply. For the wholesale trade and retail sector which has been shedding jobs, besides the drag from the pullback of cross-border trade, the sector could be undergoing structural downsizing due to the emergence of e-commerce, and workers displaced from their retail jobs could be finding other jobs which support e-commerce. For healthcare, the government recognizes that there are surges in demand, manpower shortages, and facility constraints – all of which call for the allocation of more resources to support the operation and development of the public healthcare system. Long-term plans have been designed and are being implemented, and dialogue between the government and the people has started.

30. For the property market, authorities are well in the process of using a multipronged approach to increase housing supply and improve affordability, especially for those with more modest financial means. Land reclamation is an important measure. The authorities, having made a careful assessment that it is a necessity, will remain committed to this initiative, devote fiscal resources to it as needed on a recurrent basis, and ensure that it is making good progress. This is an important part of the effort – by some estimates, over the next 20-30 years, about 50-70 percent of Hong Kong's current fiscal reserves may be used for land projects including land reclamation. Land reclamation, together with the use of the Land Resumption Ordinance to acquire land from property developers at reasonable prices, can go a long way towards boosting the supply of land and housing substantially. Policy actions on these fronts will be expedited. On the public housing front, other key measures include: (i) allowing more intense development of public housing units by increasing domestic plot ratio to maximize the number of public units that can be developed; (iii) reallocation of nine private housing sites in 2018, which were originally intended for sale in the coming few years, for public housing development; (iv) facilitation of the transitional housing projects by support financing and introducing new schemes to reduce waiting time for applicants for public

housing; and (v) enriching the housing ladder to suit the needs of different income groups; (vi) revision of the pricing mechanism of the subsidised sale flats to make them more affordable and introducing new schemes to reduce waiting time for applicants for public housing. For the private residential property market, the government has also introduced several rounds of demand-side management measures (such as targeted stamp duties) to combat short-term speculative activities, curb external demand, and reduce investment demand. The government also proposed to introduce "Special Rates" on vacant first-hand private residential units so as to encourage more timely supply of these units. The authorities aim to increase total housing supply by 450,000 units over the next ten years from 2019-20 to 2028-29, with a 70-30 split between public housing and private housing.

C.4 Facilitate China's further reform and opening-up

31. **Hong Kong should continue to play an important role in facilitating Mainland China's further reform and opening-up, including the further modernization of its regulatory frameworks and liberalization of its financial sector.** The Greater Bay Area (GBA) development[4] provides good opportunities for Hong Kong to contribute. Many cities in the Area have significant potential for further development but they are still behind in terms of some key hard and soft infrastructures. Hong Kong can share its development experience with the other cities in the Greater Bay Area. It can offer a range of professional services, trade-related services, as well as different types of cross-border banking and capital market financial solutions. More broadly, Hong Kong can play a role in promoting freer flows of goods, services, and people in the GBA. In turn, Hong Kong will benefit from more growth opportunities, improvements in productivity, and over time, easing of supply-side constraints.

32. **Hong Kong should continue to play a key facilitation role in infrastructure financing globally, particularly the Belt and Road Initiative (BRI)** through the work of its Infrastructure Financing Facilitation Office (IFFO). IFFO should continue to leverage on its strong network of partners including international investors, banks, professional service firms, Mainland enterprises, and multilateral financial institutions, as well as its expertise in financing facilitation to help connect China with overseas markets other developing economies. (See Selected Issue 2 for a more extensive analysis of how Hong Kong can contribute to and benefit the development of the GBA, including by connecting the GBA with other economic hubs in Asia.).

Authorities' Views

33. The GBA boasts the economically most vibrant and outward looking region in China with a budding innovative technology sector, and Hong Kong as a mature and leading international financial center. The "Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area" promulgated in February 2019 set out the directions guiding the

[4] Conceptually, China's GBA project is similar to past "bay area" projects by other countries (for example the US' San Francisco Bay Area), whereby efforts are made to spur the economic growth of several cities in a pre-defined geographical area through the execution of a coherent blueprint for developing economic sectors and building infrastructure.

development of the GBA. With the region comprising two systems, three legal jurisdictions, three tax zones and three currencies, a key objective is to promote the flows of factors of production, such as people, goods and capital, to support the growth of the underlying economy. The Outline Development Plan also reaffirms and supports Hong Kong as an international financial center, the global offshore RMB business hub and its role as an international asset management center and a risk management center. At the initial phase, financial facilitation measures have been rolled out for individuals living and doing business in the region, such as cross-border use of mobile payment and pilot scheme to open Mainland bank accounts across the border from Hong Kong. In future, we will continue to work with the Mainland authorities to proactively study and implement other financial facilitation measures.

C.5 Push forward virtual banking, fin-tech, and green finance

34. **The recent introduction of virtual banking and continued development of fin-tech will help the financial sector to leverage on digital technology to improve and expand its services and enhance its competitiveness.** They will help to widen the range of services, lower costs, and provide more customized financial solutions as well as seamless payments, further entrenching Hong Kong as a key financial center. (See Box A.) The HKMA's Fintech Supervisory Sandbox approach, which encompasses virtual banking, offers financial institutions room to develop and grow their business models within well-defined boundaries.

Box A. Development of Virtual Banking in Hong Kong

Virtual banking – whereby financial institutions provide financial services without the use of physical branches – seeks to boost efficiency, enhance banking services, and strengthen risk management. Virtual banks interface with customers online, and also use digital channels to reach out to prospective customers and build up their clientele base. At the same time, they typically use advanced technologies to manage risks, including gauging credit risks posed by different customer segments, and to perform anti-money laundering (AML) and "know your client" (KYC) functions. Instead of rendering "traditional" banking irrelevant, virtual banking can build on the knowhow of existing banks, and applies new higher-technology methods to improve front-, middle- and back office processes to achieve better outcomes.

Hong Kong has moved quickly as a leading financial center to introduce virtual banking more formally, as virtual banking is taking off briskly in advanced economies and also some rapidly-developing emerging economies. In Asia, internet tech firms in Mainland China have a successful track record of attracting deposits and offering loans in the past five years. In Korea, two virtual banks – K bank and Kakao Bank – have been operating for the past three years. In Japan, Net bank and Seven banks have been branchless since the 2000s. And in Singapore, the authorities plan to issue up to five virtual banking licenses.

For Hong Kong, the objectives of introducing virtual banks are to promote fin-tech development and innovation, offer better customer experiences, and promote financial inclusion. One example is opening up more possibilities for both traditional banks and virtual banks to compete on both the deposit side and lending side by offering more attractive services. To this end, Hong Kong's authorities have speeded up its transition to a new era of smart banking by issuing guidelines on the authorization of virtual banks in H1 2018[5], and followed up by issuing eight licenses[6] as of May 2019 – with some of the licensees having started trial operations at the end of 2019. HKMA expects virtual banks to focus on the retail segment including SMEs initially, before broadening the scope of their business activities.

HKMA has played a constructive role in the building of sector-wide enabling infrastructure, which creates immediate benefits and can have longer-term catalyzing effects. As a case in point, to promote fin-tech, the HKMA published the guidelines on the Open API Framework in July 2018, paving the way for the deployment of Open API Phase I by banks in early 2019, followed by Phase II in the later part of 2019. This is now benefiting virtual banks alongside traditional players. Using this infrastructure, around 130 sets of financial data held by banks could be obtained by third parties to develop related applications and provide services. This creates and diffuses benefits, as virtual banks and other fin-tech companies can access more data to make well-informed business decisions, develop more agile applications, and provide customized services. Over the longer term, the benefits brought about by such "for sharing" infrastructure can attract more entrants, make the virtual banking space in Hong Kong more diversified, and prompt "traditional" banks to "think out of the box" more than before, reengineer business processes, and deliver better services.

There are important challenges that virtual banks need to overcome. First, trust and track record. While branchless operations help to lower operational costs significantly, the absence of face-to-face interactions can make the establishment of trust and the creation of a recognized track record in delivering on promised services a more challenging and time-consuming process. Second, averting a "race to the bottom". While HKMA has made it clear that it would frown on (excessive) price competition, especially "price only" competition, in the initial stages, some elements of this can be expected as new entrants seek to build up their customer base. Third, success of joint ventures. Many virtual banks are joint ventures between banking and tech entrepreneurs, and the marked differences in backgrounds and views can present significant obstacles for the start-ups.

Virtual banking also poses challenges for the authorities. First, level playing field. It is important for the authorities to ensure that the new rules allowing for the entry of new players do not inadvertently disadvantage existing players. To this end, HKMA will apply the same regulations and supervision for all virtual banks, and calibrate them as stringently as they should be, with the key principles being "risk-based" and "tech-neutral"[7]. Second, room for innovation by banks, and need for the authorities to keep up. The rules allow for sufficient flexibility in risk management by each bank, including leveraging on technology and using modelling techniques. However this also poses challenges to HKMA itself, not least in the expanded capacity and resources it now needs to supervise and regulate virtual banks effectively. For this, HKMA has started by setting up a dedicated team to conduct prudential supervision of virtual banks. Third, dealing with a gradual increase in systemic effects over time. The total capital of virtual banks accounts for just a small portion of the banking sector's total, and therefore the extent to which they can be price-setters should be limited to begin with. That said, over time, these virtual banks will scale up, more may enter the market, and the scope of financial activities of this group as a whole will broaden – and so, their systemic importance will increase. This would in turn necessitate a commensurate strengthening in risk management capacity and attention on the part of banks and the HKMA.

Hong Kong is well placed to address all of these challenges and develop further as a leading financial center. Hong Kong can understand and tackle the various challenges because of the strong technical capacity, sound governance, and market knowledge built up by the banking sector and HKMA over the past decades. With this as a foundation, the accelerated development of virtual banking in Hong Kong reflects its continuous adaptation amid rapidly-changing conditions in the domestic and external economic landscape.

35. **Hong Kong should further enhance the development of green finance.** The successful issuance of the government's inaugural green bond demonstrates Hong Kong's strengths as a leading green finance hub in the region and signifies the support of the government for sustainable development and determination to combat climate change. The recent introduction of HKMA's key measures on sustainable banking and green finance will further drive the awareness and development of Hong Kong's green finance market.

[5] HKMA published a revised Guideline on Authorization of Virtual Banks for public consultation during the period of 6 February and 15 March 2018, and a revised guideline was issued on 30 May, 2018.

[6] These eight virtual banks include Livi VB Limited, SC Digital Solutions Limited, ZA Bank Limited, Welab Bank Limited, Ant Bank (Hong Kong) Limited, Fusion Bank Limited, Airstar Bank Limited, and Ping An OneConnect Bank (Hong Kong) Limited.

[7] That the tightness of the rules correspond to the risks facing or posed by the regulated virtual banks, and that the rules do not inadvertently favor virtual banks even when they are undertaking the same activities as traditional banks.

Authorities' Views

36. **Hong Kong is working on having virtual banking and fin-tech improve the banking sector's efficiency and competitiveness while safeguarding stability.** In the earlier stages, virtual banks' entry will likely have limited impact on the banking sector as a whole, partly because they will focus more on smaller-scale retail and SME banking and will still be relatively small players in the Hong Kong banking sector. While it will likely take some time for these virtual banks to scale up and their financial activities to diversify, the authorities have increased their supervisory capacities for this new banking area to ensure consumer protection and strengthen safeguards against financial stability risks.

37. **HKMA has also been promoting green finance and sustainable banking.** Initiatives include: development of green principles for sustainable banking, Environmental Social Governance (ESG) standards for investments, setting regulation and supervisory requirement in banking industry, providing capacity building and upgrading expertise. Hong Kong can be a green finance center for the GBA, and go on to become a leading global green finance hub.

C.6 Overall Macroeconomic and Financial Stability

38. **The Hong Kong authorities and AMRO have broadly-aligned views about Hong Kong's sound macro fundamentals, strong financial reserves, and careful governance which enable it to address long-term challenges.** Confidence in the LERS remains solid. Even during episodes of heightened socio-political tensions, the HKD exchange rate has remained well-behaved within the CU band. The banking sector's strong capital and liquidity buffers also serve as an anchor of resilience. Hong Kong's healthy fiscal reserves mean that there is ample room for policy measures to address longer-term issues. Solid governance, prudence in using available resources, and at the same time, being bold in taking new steps when necessary, are all critical for Hong Kong to retain its competitiveness and resilience over the long term.

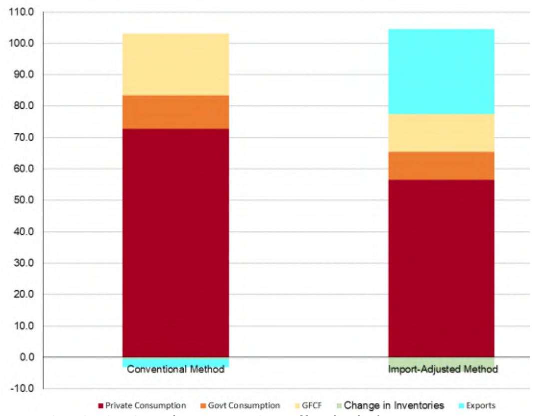
Appendices

Appendix 1. Selected Figures for Major Economic Indicators

Figure 1.1: Economic Growth and the Real Sector

In import-adjusted terms, consumption's share of GDP is the largest, followed by exports

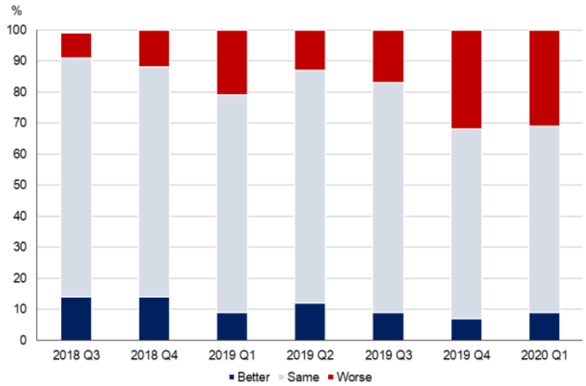
GDP Breakdown in Import-Adjusted Terms [2019 Snapshot]



Source: CEIC, OECD TiVA, AMRO staff calculations

Alongside the broad-based growth slowdown in the past few quarters, business expectations have become more cautious

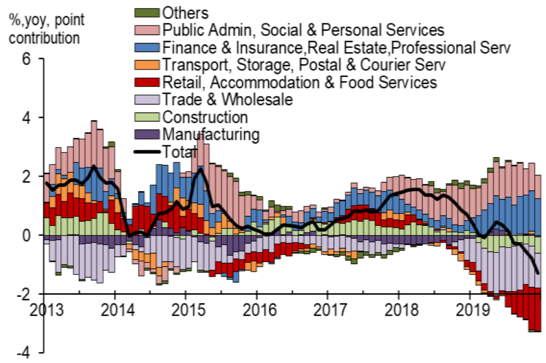
Views on Expected Changes in Business Situation



Source: Hong Kong authorities

Overall employment growth has turned negative, with a few key sectors losing significant numbers of jobs – especially trade & wholesale and retail

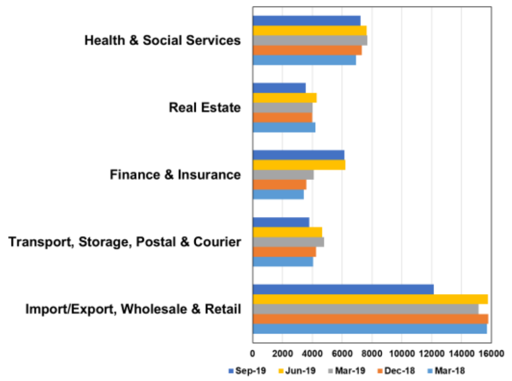
Employment Growth: Contribution by Sector



Source: CEIC

.. and there remain substantial job vacancies across services, led by wholesale & retail, accommodation & food services, and health & social services

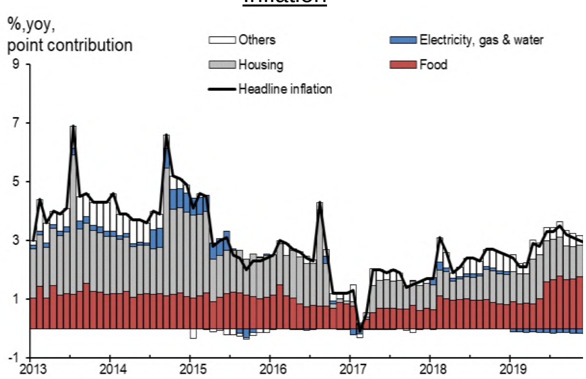
Job Vacancies: Selected Sectors



Source: Hong Kong authorities

Inflation pressures have increased moderately due to supply-side factors, but remain contained as underlying demand is subdued.

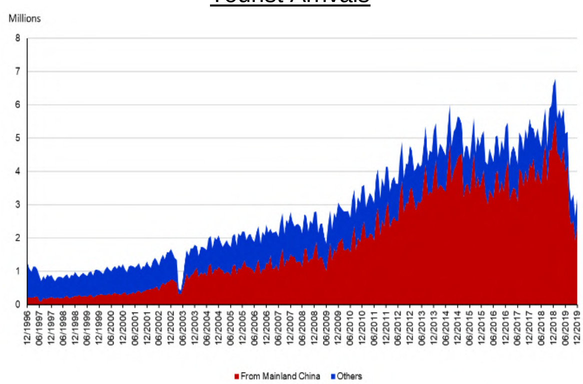
Inflation



Source: Hong Kong authorities

Tourism held up in the earlier part of 2019, with strong inflows from Mainland China, but arrivals dipped from May onward as socio-political tensions escalated.

Tourist Arrivals

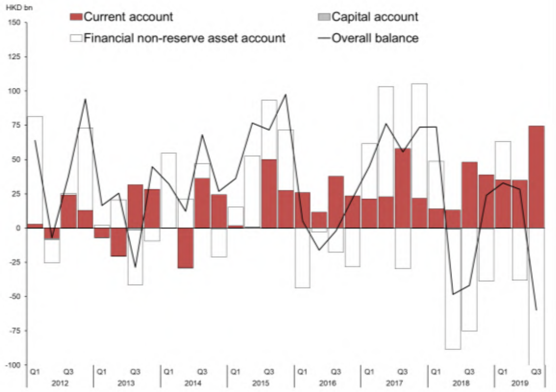


Source: Hong Kong authorities

Figure 1.2: External Sector

The overall balance of payments has remained in surplus for most quarters …

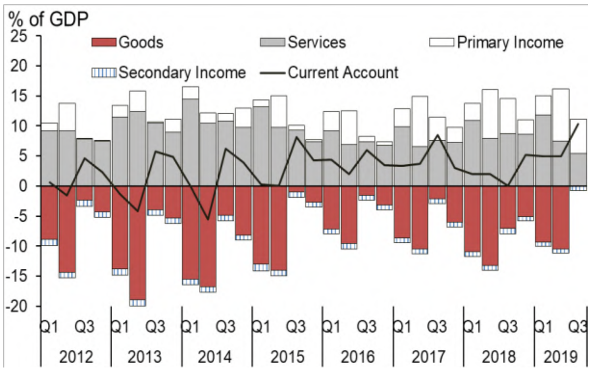
Balance of Payments



Source: CEIC

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

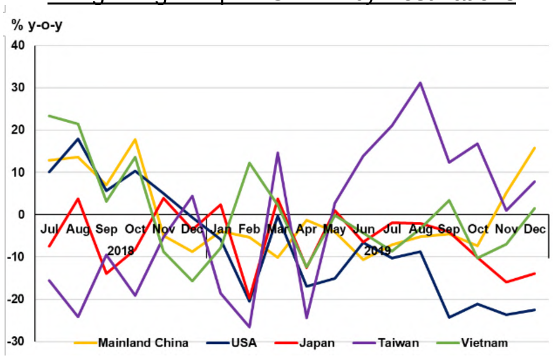
Current Account Balance



Source: CEIC

Goods exports deceleration was sharp and broad-based, but recent months saw early signs of recovery – before the COVID-19 virus outbreak.

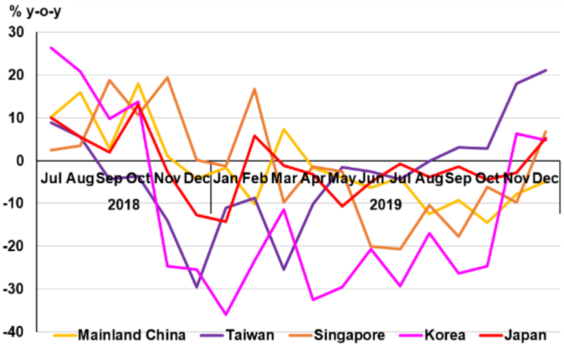
Hong Kong's Export Growth by Destinations



Source: Hong Kong authorities

Likewise, goods imports contraction, which was even sharper than goods export contraction, exhibited signs of a turnaround – before the virus struck.

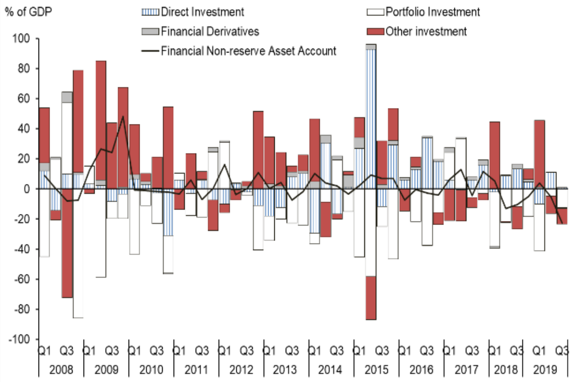
Hong Kong's Import Growth by Destinations



Source: Hong Kong authorities

Given Hong Kong's status as a financial center, all components of its financial account have been volatile

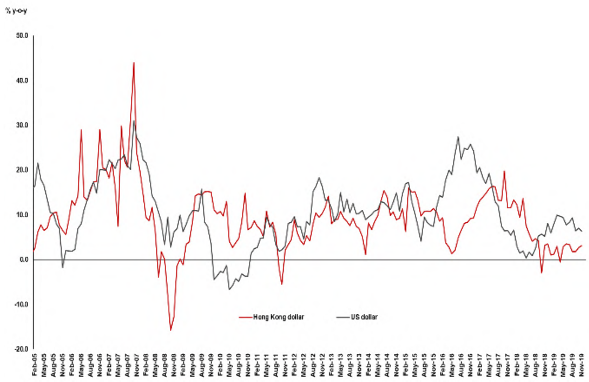
Financial Account Balance



Source: CEIC

Capital outflows have been limited, with Hong Kong dollar deposits and US dollar deposits both increasing on a year-on-year basis.

Deposits with Authorized Institutions (AIs)

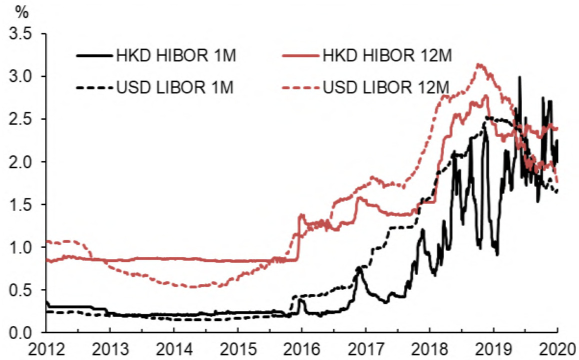


Source: CEIC

Figure 1.3: Monetary and Financial Sector

In recent months, the HKD HIBOR - USD LIBOR gap narrowed before HKD HIBOR rose above USD LIBOR, reflecting moderate reduction in liquidity between end-2019 and Chinese New Year 2020.

HKD Libor vs USD Libor



Source: Hong Kong Association of Banks, Global Rates

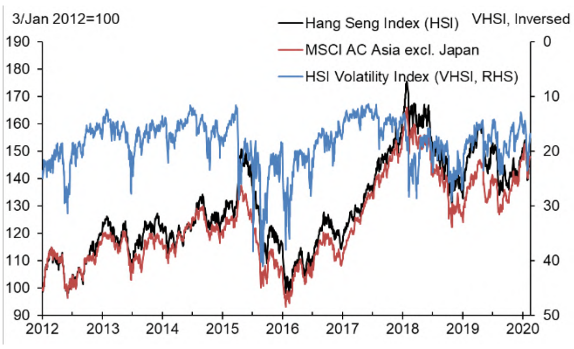
As limited-scale concerns over Hong Kong's status as an economic- and financial hub eased, the Hong Kong dollar moved to the strong end of the Convertibility Undertaking band despite the murky growth outlook.

USD-HKD Convertibility Undertaking

Source: Reuters

The stock market is up a marginal 0.42 percent year to date, with sell-offs and heightened volatility due to dimming of sentiment related to earnings, growth and social tensions.

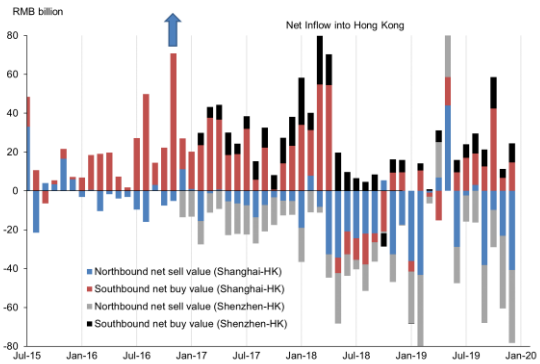
Stock Market Index and Volatility



Source: Reuters

Flows to Mainland China have increased as major international indices included or increased weights of A-shares.

Stock Connect Flows

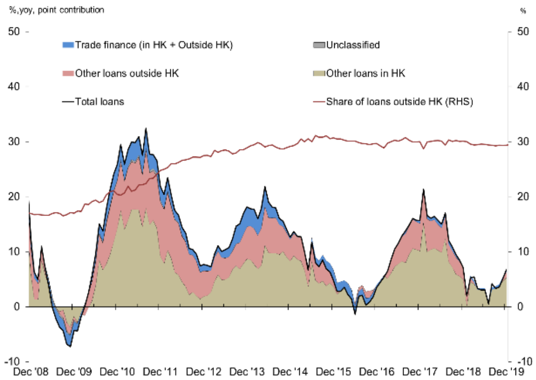


Source: CEIC

Figure 1.4: Banking Sector and Property Sector

The moderation of credit expansion in Hong Kong is in line with the slowdown of economic growth …

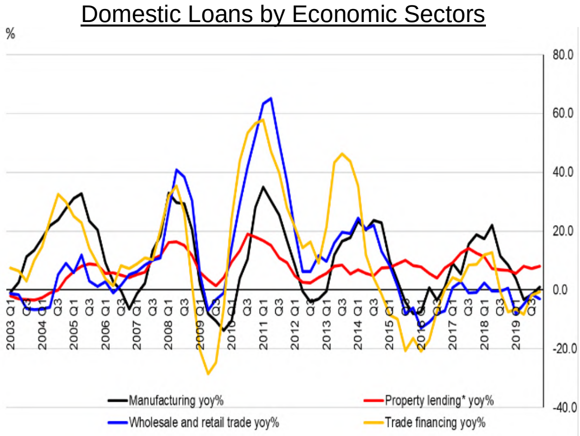
Bank Credit Expansion by Type



Source: Hong Kong authorities

… with trade-related sectors dipping into negative territory, whereas property lending remains positive.

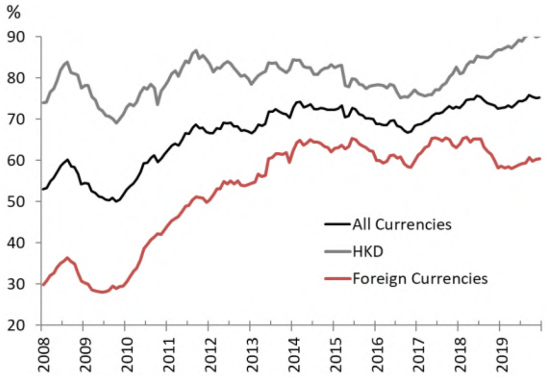
Domestic Loans by Economic Sectors



Source: Hong Kong authorities

Loan-to-deposit ratios for both Hong Kong dollar- and foreign currency-denominated loans are well below 100%, with the increase in the former due to modest deposit growth.

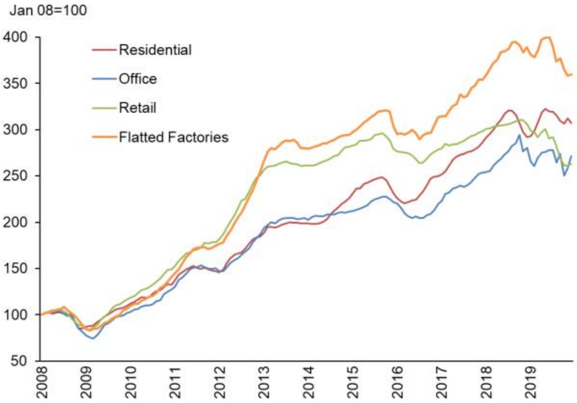
Loan-to-Deposit Ratios: Hong Kong Dollar Loans and Foreign Currency-Denominated Loans



Source: CEIC

Property prices recovered in the first five months of 2019 after a dip during H2 2018, before moderating again in June and July; not likely to rise buoyantly in H2 2019 and in 2020.

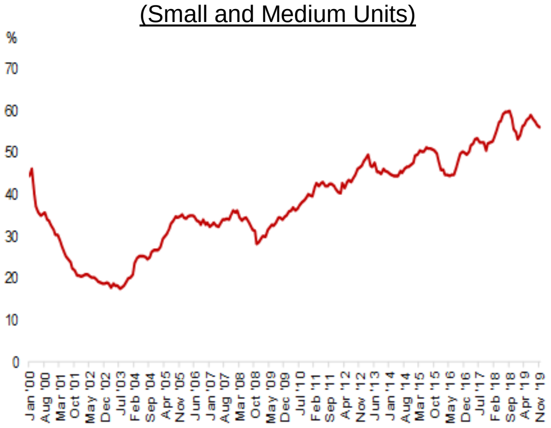
Property Price Indices



Source: CEIC

Housing affordability has deteriorated since 2009, although much more manageable than in the 1990s.

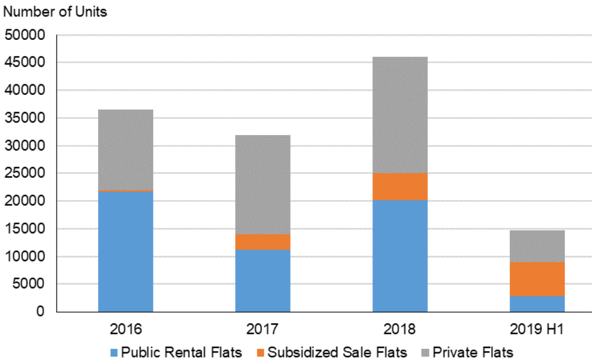
Affordability Ratio: All Households (Small and Medium Units)



Source: Centaline Property Agency Limited

Authorities' efforts to boost housing supply have added 129000 newly-completed residential flats between 2016 and H1 2019, but the target of adding 450,000 units over the next ten years remains challenging.

Newly-Completed Residential Flats

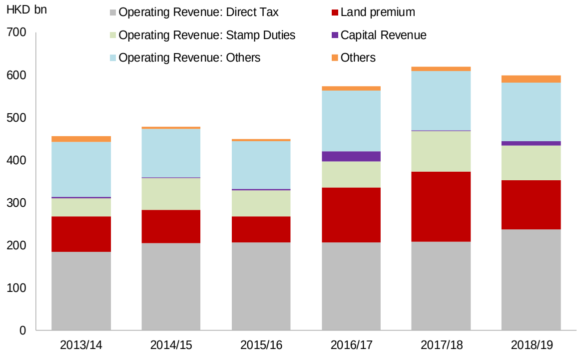


Source: Hong Kong authorities

Figure 1.5: Fiscal Sector

Fiscal revenue in FY 2018/19 was modestly lower than in the previous year, due to a significantly smaller contribution from land premium and stamp duties.

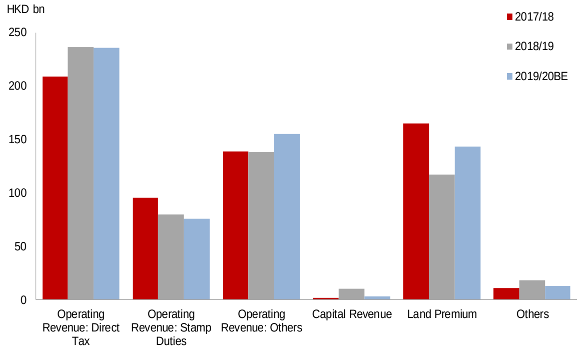
Hong Kong Budget: Revenue



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

Direct tax growth was expected to be buoyant in 2019/20, but that has to be weighed against the now sharp and broad-based growth slowdown.

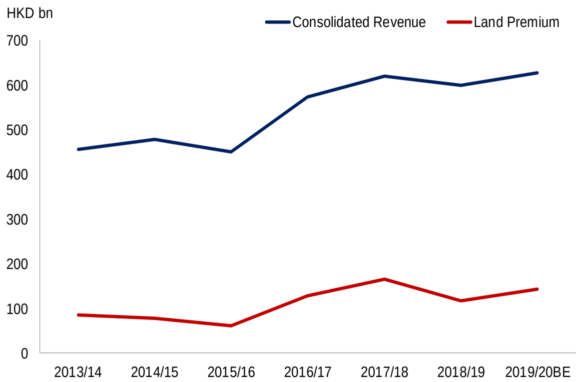
Increase in Taxes vs Other Revenue Sources



Note: RE and BE refer to revised estimates and budget estimates, respectively.
Source: Financial Services and the Treasury Bureau

Land premium will continue to be an important contributor to total government revenue

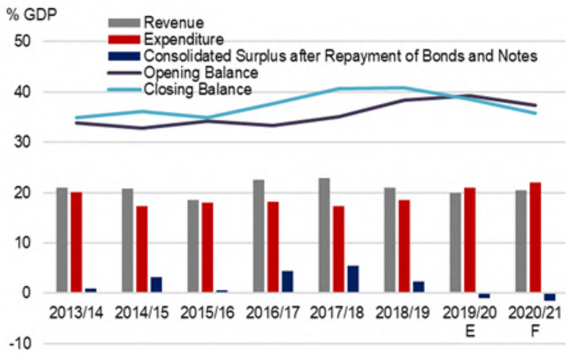
Land Premium vs Consolidated Revenue



Source: Financial Services and the Treasury Bureau

Revised estimates suggest that the government will run a small budget deficit for 2019/20 and 2020/21.

Revenue, Expenditure, Closing Balance, and Consolidated Surplus



Source: Financial Services and the Treasury Bureau

Appendix 2. Selected Major Economic Indicators for Hong Kong

	2015	2016	2017	2018	2019 p/	2020 p/
Real Sector and Prices	(in annual percentage change)					
Real GDP	2.4	2.2	3.8	2.9	-1.2	-0.2
Private consumption	4.8	2.0	5.6	5.5	-1.1	-0.3
Government consumption	3.4	3.4	2.8	4.2	5.1	10.2
Gross domestic fixed capital formation	-3.2	-0.1	2.9	2.0	-12.2	-9.7
Exports	-1.4	0.7	5.9	3.8	-4.6	2.2
Goods	-1.7	1.6	6.5	3.6	-4.7	1.8
Services	0.3	-3.5	2.9	4.9	-10.4	1.5
Imports	-1.8	0.9	6.6	4.6	-6.8	2.8
Goods	-2.7	0.7	7.3	4.9	-7.4	3.0
Services	5.0	2.0	2.1	2.3	-2.3	3.5
GDP deflator	3.6	1.6	3.0	3.6	2.5	2.5
Labor Market						
Unemployment rate (In percent, period average)	3.3	3.4	3.1	2.8	3.0	3.3
Prices						
Headline inflation (Period average)	3.0	2.4	1.5	2.4	3.0	2.5
Underlying inflation (Period average)	2.5	2.3	1.7	2.6	3.0	2.5
External Sector	(in billions of U.S. dollars, unless otherwise specified)					
Current account balance (In percent of GDP)	3.3	4.0	4.7	4.3	5.2	4.2
Trade balance (In percent of GDP)	2.4	2.3	1.1	0.1	3.8	-0.1
Exports, f.o.b	465	462	497	530	506	517
Imports, cif	522	516	559	601	560	576
Overall balance	36.4	1.1	32.1	1.0	-	-
(In percent of GDP)	11.8	0.4	9.4	0.3	-	-
Gross official reserves excluding net forward position	359	386	432	424	441	-
(In months of retained imports of goods)	32.2	35.7	36.6	32.5	32.0	-
Total external debt	1,300	1,356	1,575	1,692	-	-
Short-term external debt (% of international reserves)	251	237	245	266.0	-	-
Fiscal Sector (General Government)	(in percent of FY GDP)					
Revenue	18.6	22.6	22.8	20.9	20.0	20.2
Expenditure	18.0	18.2	17.3	18.5	21.0	21.5
Consolidated budget balance	0.6	4.4	5.5	2.4	-1.0	-1.3
Public debt	0.1	0.1	0.1	0.1	0.1	0.1
Monetary and Financial Sector	(in annual percentage change, period end)					
Total loans	3.5	6.5	16.1	4.4	3.5	5.0
Total loans (In percent of GDP)	314.2	322.1	349.8	342.0	340.0	341.5
Loan to deposit ratio (In percent)	70.1	68.4	73.0	72.6	75.4	73.50
Classified loan ratio (In percent)	0.7	0.7	0.6	0.5	0.5	0.60
Capital adequacy ratio (In percent)	18.3	19.2	19.1	20.6	20.6	20.50
Three-month Hibor (In percent, end of period)	0.4	1.0	1.3	2.3	2.3	2.30
Memorandum Items						
Exchange rate (LCY per USD, average)	7.75	7.76	7.79	7.84	7.84	7.78
GDP in billions of HKD	2,398.3	2,490.6	2,662.8	2,842.9	2,879.9	2,944.7
GDP in billions of U.S. dollars	309.4	320.9	341.7	362.7	367.6	378.5
GDP per capita (USD)	42,432	43,736	46,222	48,675	48,851	50,304
Interest rates (%, end-period)						
Three-month Hibor	0.4	1.0	1.3	2.3	2.3	2.5
10Y Govt' bond yield	1.7	1.9	1.8	1.8	1.8	1.8
Asset prices						
Hang Seng Index (end of period, 1964=100)	21,914	22,001	29,919	25,846	28,190	
(% yoy)	-7.2	0.4	36.0	-13.6	9.1	
Residential property prices (end of period, 1999=100)	285	307	353	359.4	378.5	
(% yoy)	2.4	7.9	14.7	1.9	5.3	

Source: Authorities, CEIC, AMRO staff calculations

Appendix 3. Balance of Payments

	2013	2014	2015	2016	2017	2018
	(In percent of GDP)					
Current account	1.5	1.4	3.3	4.0	4.7	4.3
Goods	-10.1	-11.1	-7.4	-5.2	-6.7	-8.9
Total exports of goods	183.6	176.4	162.2	156.3	158.2	156.9
Imports of goods	193.7	187.5	169.6	161.5	164.9	165.9
Services	10.7	11.3	9.8	7.5	7.8	9
Exports of services	38.0	36.7	33.7	30.7	30.5	31.4
Imports of services	27.3	25.4	23.9	23.2	22.7	22.3
Primary income	1.9	2.1	1.9	2.5	4.3	5.0
Secondary income	-1.0	-0.9	-0.9	-0.8	-0.8	-0.8
Capital and financial account	-4.0	-3.3	-5.4	-4.1	-2.9	-6.5
Capital account	-0.1	0.0	0.0	0.0	0.0	-0.1
Financial account	-4.0	-3.2	-5.4	-4.0	-0.3	-6.4
Financial non-reserve assets	-1.3	2.9	6.4	-3.7	6.6	-6.2
Direct investment	-2.3	-3.8	33.1	18.0	7.0	8.4
Portfolio investment	-18.1	-2.8	-40.5	-18.9	9.9	-20.7
Financial derivatives	2.6	5.2	4.1	1.5	2.3	0.5
Other investment	16.6	4.3	9.6	-4.3	-12.7	5.6
Reserve assets	-2.7	-6.2	-11.8	-0.4	-9.4	-0.3
Net errors and omissions	2.5	1.9	2.0	0.1	-18.0	2.2
Overall Balance of Payments	2.7	6.2	11.8	0.4	9.4	0.3

Source: Authorities, CEIC, AMRO staff calculations

Appendix 4. Statement of Central / General Government Operations

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	(In billions of HKD)					
Opening Balance	**734**	**756**	**829**	**843**	**954**	**1,103**
Consolidated Revenue	**455**	**479**	**450**	**573**	**620**	**600**
General Revenue	359	396	384	436	444	465
Operating Revenue	355	394	382	412	443	454
Direct Tax	184	205	206	207	209	236
Stamp Duties 1/	42	75	63	62	95	80
Others	130	114	113	143	139	138
Capital Revenue	3	2	3	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**	**1,103**	**1,171**
	(In percent of GDP)					
Opening Balance	**34.3**	**33.4**	**34.5**	**33.8**	**35.8**	**38.8**
Consolidated Revenue	**21.3**	**21.2**	**18.8**	**23.0**	**23.3**	**21.1**
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	3.6	2.8
Others	6.1	5.0	4.7	5.7	5.2	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**	**18.7**
Operating Expenditure	15.8	14.0	14.5	14.2	13.9	15.2
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**	**41.4**	**41.2**
Memorandum Items:						
GDP in billions of HKD (Calendar Year)	**2,138**	**2,260**	**2,398**	**2,491**	**2,663**	**2,843**

Notes:
(a) General revenue include operating revenue and capital revenue under the General Revenue Account (GRA).
(b) Operating revenue – direct tax includes the receipt on profits tax, personal assessment, property tax and salaries tax.
(c) Capital revenue represents the capital revenue under the GRA.
(d) Others include all capital revenue other than land premium and capital revenue under the GRA.
(e) There was a repayment of bonds and notes in FY 2014 – 15 surplus after repayment.
Source: Hong Kong authorities, AMRO staff estimates

Appendix 5. Monetary Survey

	2013	2014	2015	2016	2017	2018
	(In percent of change, period end)					
Total money supply						
M1	9.7	13.1	15.4	12.3	9.8	-0.4
M2	12.4	9.5	5.5	7.7	10.0	4.3
M3	12.4	9.6	5.5	7.7	10.0	4.3
Hong Kong dollar money supply						
M1	8.6	11.6	12.2	14.0	11.8	-2.6
M2	5.7	9.0	10.3	8.9	11.6	3.6
M3	5.7	9.0	10.4	8.9	11.6	3.7
Deposit						
Total	10.7	9.7	6.7	9.1	8.7	5
Hong Kong dollar	5.1	9.3	10.7	9.3	11.6	3.6
Foreign currency	16.2	10.1	3.1	8.8	5.9	6.4
Loans and advances						
Total	16.0	12.7	3.5	6.5	16.1	4.4
Hong Kong dollar	8.2	10.9	3.8	7.9	19.7	8.9
Foreign currency	27.6	14.9	3.2	4.8	11.6	-1.7
Interest rates	(In percent, period average)					
Discount window base rate	0.50	0.50	0.75	1.00	1.75	2.75
HIBOR: 1 month	0.21	0.24	0.22	0.75	1.19	2.24
HIBOR: 3 month	0.38	0.38	0.39	1.02	1.31	2.33
Composite interest rate	0.39	0.39	0.26	0.31	0.38	0.89
HSBC's best lending rate	5.00	5.00	5.00	5.00	5.00	5.125

Source: Authorities, CEIC, AMRO staff calculations

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 approach)	Quarterly, within 1 month after the end of the reference quarter (for advance estimate data)	-	-	-
Balance of payments (BOP) and external position	Monthly BOP data are available in detail	Quarterly, within three months after the end of the reference period	-	-	-
Central government budget/ external debt	Monthly central government public finance data are available, while quarterly external debt data available in detail	Budget: Monthly, within one month after the end of the reference period External debt: Same as the BOP	-	-	-
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 reference period	-	-	-
Financial sector soundness indicators	Available	Financial Soundness Indicators (FSIs) are available from the IMF website Quarterly, within three months after the end of the reference quarter	-	-	-
Housing market indicators	Available	Monthly data are released within one month after the end of the reference period	-	-	-

Annexes: Selected Issues

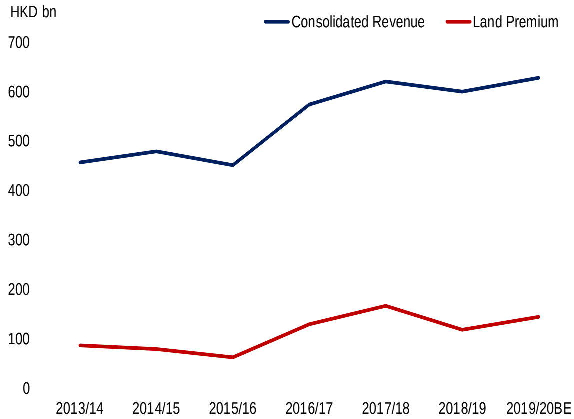
Annex 1. Hong Kong Real Estate: Managing Short-Term and Long-Term Challenges

1. **The importance of Hong Kong's property market for its economic growth and financial stability is well established and has grown over time.** Research by the HKMA and the IMF, has shown that increases in property prices have generated substantial wealth effects, thereby boosting private consumption. Furthermore, by virtue of the tendency of property prices in Hong Kong to rise in tandem with the stock market – and both have been on a steep uptrend (Figure A.1.1), these wealth effects have often been amplified.[8] On the corporate side, property price increases have meant valuation gains and higher profits for real estate developers, construction firms, as well as companies providing real estate-related services. This has in turn fed back into buoyant property-related investments, providing support for economic growth. Another channel through which property price increases have fed into economic growth is via credit. In Hong Kong, using properties as collateral for both consumer loans and business loans is quite common. So the balance sheet effects and credit effects of (higher) property prices have been even more pronounced than suggested by the share of property-related loans in total bank loans, which was about 29 percent as of June 2019. Adding to that is widespread expectation that property prices in Hong Kong will have a strong tendency to keep rising. Finally, land premium has contributed significantly to fiscal reserves accumulation (Figure A1.2), supporting government spending in areas which support near-term growth and lift long-term growth potential. Analyses by AMRO in recent years have pointed to risks of property price corrections imposing strains on borrowers, adversely affecting banks' asset quality, and exerting a drag on the broader economy.

Figure A1.1. Residential Property Price Index and the Hang Seng Index

Source: Hong Kong authorities, Haver

Figure A1.2. Land Premium vs Consolidated Revenue

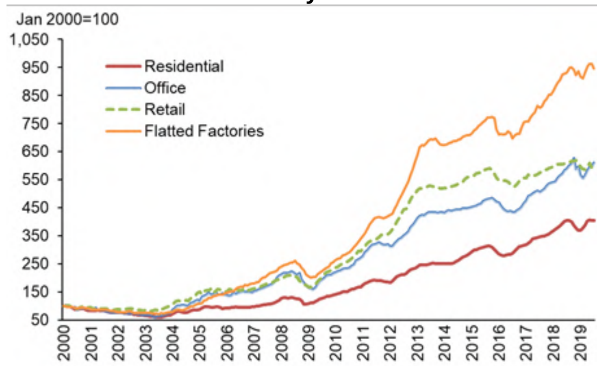


Source: Financial Services and the Treasury Bureau

[8] A recent study by Lo (2019), which estimates the magnitude of wealth effects from property and equity markets in Hong Kong suggests that private consumption expenditure (PCE) has exhibited a positive correlation with household wealth in terms of both property and equity assets, as well as with labor income. The results also indicate that property market wealth effects have been larger than equity market wealth effects, with a 10 percent q-o-q increase in real property wealth at an aggregate leading to a 1.1-1.2 percent q-o-q boost in PCE, and a 10 percent q-o-q increase in real stock wealth boosting PCE by 0.5 percent.

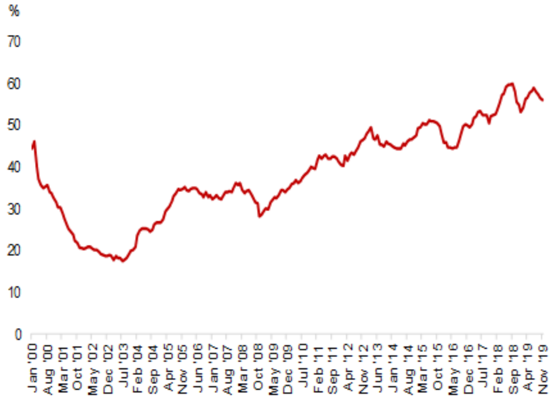
2. **Hong Kong authorities have managed fluctuations through what has essentially been a decade-long up-cycle, by adjusting the settings of macroprudential measures.** After a sharp correction of around 50 percent during the Asian Financial Crisis (AFC), Hong Kong's property prices continued to decline gradually for several years until mid-2003, followed by a recovery disrupted by the Global Financial Crisis (GFC), and then rose almost threefold between January 2009 and September 2015 – amid economic recovery, ultra-low interest rates globally, and investments by Mainland Chinese into Hong Kong's real estate sector. In comparison, property prices increased by 1.4 times in Singapore, 1.3 times in the UK, and 1.2 times in the US over the same period. That upward momentum has carried through to 2018/2019, albeit more gradually, where moderate price fluctuations in the past few quarters have kept prices at an all-time high. (Figure A1.3) Importantly, in the past decade or so, the authorities have responded quickly to significant changes in property price momentum by adjusting the settings of macroprudential measures. <u>Loan-to-value (LTV) caps</u> have for the most part been lowered. <u>Debt-servicing ratio (DSR) limits</u> have been introduced and likewise tightened. <u>Stamp duties</u> have been applied to certain categories of property buyers, especially non-resident foreigners, to help keep speculative activities in check – by working in tandem with the LTV rules and DSR rules. <u>Risk weights for bank loans</u> (both mortgage loans and property-related loans) have been applied and increased from time to time. These have compelled banks to hold more capital as buffer against potential losses; while on a system-wide basis, helping to moderate the pace at which bank credit has flowed to the property sector.

Figure A1.3. Hong Kong Property Price Indices by Sub-Sectors



Source: Hong Kong Rating and Valuation Department

Figure A1.4. Home Purchase Affordability Ratio: All Households (Small & Medium Units)

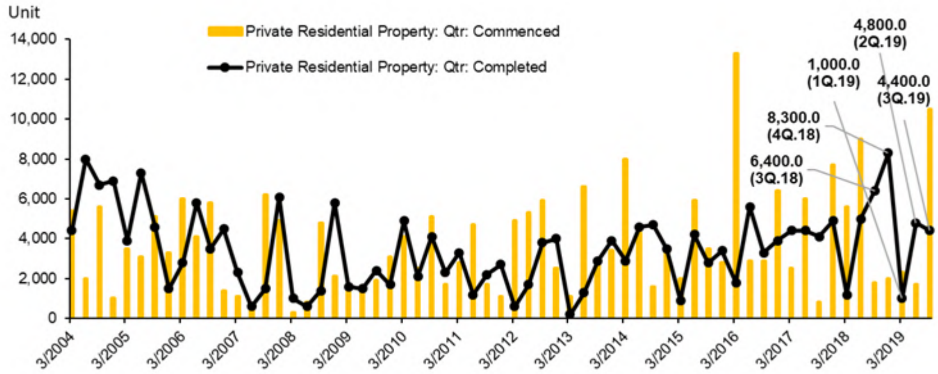


Source:Centaline Property Agency Limited

3. **The policy measures have been effective in safeguarding risks to financial stability.** As a result of the application of this policy framework, despite persistently strong demand and chronic shortage of supply, the credit risk posed by the property market to the banking sector, as reflected in low LTV ratios for outstanding mortgage loans, has been well mitigated. For banks, the aggregate LTV ratio for outstanding mortgage loans is at an all-time low of about 45 percent, and a 40-50 percent dip in property prices would still leave the market value of banks' collaterals exceeding the outstanding amounts owed by borrowers. Furthermore, the application of risk weights to not just mortgage loans but also other property-related loans have helped to limit and

mitigate credit risks to banks arising from their loans to property developers and construction firms too.

Figure A1.5. Private Residential Flats completion



Source: CEIC, Transport and Housing Bureau

4. **The series of short-term policy measures on the demand side has run ahead of challenging efforts to address fundamental supply-side imbalances, which has been a slowly building up over the years and is now threatening to come to a head.**

- Affordability: Housing affordability is now significantly worse than the long-term average between 1999 and 2018 (Figure A1.4), although macro-prudential measures, which mostly affect demand, have helped ameliorate the worsening pace of housing affordability to a certain extent. Hong Kong has the world's most expensive property market, measured by the ratio of price to household disposable income; the ratio stands at 19.4, much higher than many other global cities known to have high property prices.

- Demand-supply gap: Demand for residential properties has far outstripped supply over the past decade or so. Based on its own projections of the demand for housing, the government has set a policy target of increasing total housing supply by 450,000 units over the next ten years, with a 70-30 split between public housing and private housing. Yet, the pace at which supply can be increased remains too slow. Over the period 2019 to 2023, the annual completion rate of private residential flats is projected to be about 18,800 units, significantly brisker than the pace over the past fifteen years (Figure A1.5).

- Not just residential but also commercial: Office space prices and retail space prices have run up even more starkly than residential property prices over the past decade or so (Figure A.1.3). Since the trough after the GFC, prices of flatted factory space have increased by more than 3 times, while prices of office space and retail space have increased by over 2 times. Indeed, estimates by the Hong Kong Taskforce on Land Supply suggest that that the demand-supply gap for land for economic use is even more acute than that for land for residential use for the period up to 2026, and very similar for 2026-2046 (Table A1.1).

- Far from "equilibrium": Hence, in a "reasonable" steady state, property prices ought to be much lower than they are currently – which is both an economically-intuitive and much more socially-acceptable outcome. This is notwithstanding the strong demand from both domestic buyers and investors from Mainland China and other countries who have: (i) focused on Hong Kong's strong value proposition as China's gateway to the external world in many senses; (ii) continued purchasing properties in Hong Kong despite New Residential Stamp Duties and Additional Buyers' Stamp Duties; and have not turned away decisively even with the recent emergence and heightening of socio-political tensions.

Table A1.1. Estimates of Overall Land Supply and Demand in Hong Kong Up to Year 2026 and Year 2046

Land Use	Up to 2026			2026 to 2046			Total Shortfall
	Demand	Supply	Shortfall	Demand	Supply	Shortfall	
Residential	768	660	-108	902	780	-122	-230
Economic	196	61	-135	262	141	-121	-256
Infrasutructure and Facilities	1.661	1,089	-572	931	783	-148	-720

Source: Hong Kong Taskforce on Land Supply

5. **At the current juncture, policy makers should be prepared to ease macro-prudential measures should a sharp property market correction materialize, and urgently ramp up the supply of housing.**

- Preparing to address risk of a sharp price decline: Risks of residential property market corrections remain significant, given the slowdown of growth and worsened market sentiment. Uncertainties also remain for commercial property, for example as a plunge in retail sales weighs on retail space rentals and prices and as more caution about business costs likewise weighs on office space rentals and prices. Therefore, policy makers should be prepared to relax macro-prudential measures if a downward cycle in the property market is confirmed.

- Taking a long-term view and urgently increasing the supply of housing: Housing shortages and costs may be one of the key grievances underlying the socio-political tensions. Continuation of the tensions would dim Hong Kong's long-term growth prospects severely. So although it is very challenging now to ramp up the supply of housing, stepped-up policy plans and actions on this front must be pursued with urgency. Various initiatives, such as the use of the Land Resumption Ordinance to buy farmland from big property developers at reasonable prices and use these to build public housing, are steps in the right direction and further policy actions should be expeditiously pursued. More measures to free up land can make a more substantive difference.

Annex 2. Greater Bay Area Development: How Hong Kong Can Contribute and Benefit

1. **The GBA is an ambitious project which requires strong contributions from all the participating cities, and can benefit all these cities including Hong Kong.** Conceptually, it is similar to past projects by other countries (for example the US' San Francisco Bay Area), whereby efforts are made to spur the economic growth of several cities in a pre-defined

geographical area through the execution of a coherent blueprint for developing economic sectors and building infrastructure. China's GBA development seeks to promote collaboration among GBA cities and policy breakthroughs to create a more coherent economic entity which is stronger and more competitive than the sum of its parts. Hong Kong can contribute and benefit by using its advanced knowhow in various sectors. Where Hong Kong is more advanced than other GBA cities, the GBA Plan envisages adopting its best practices – and this will help Hong Kong to preserve its value propositions and economic competitiveness.

Envisaged outcome being more than the sum of parts

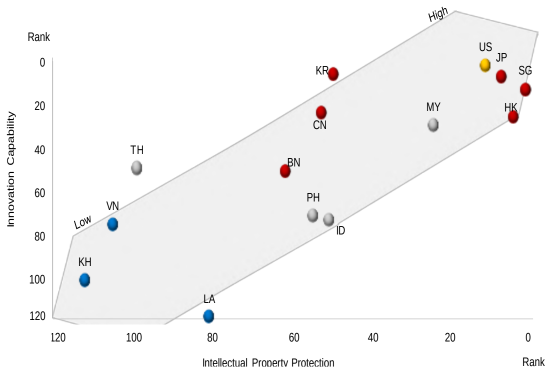
2. **The GBA has critical mass to start with.** In 2017, the GBA had a combined population of 70.7 million people, GDP of US$1.51 trillion, and a per capita GDP of US$21,750 (Table A.2.1). [Please see Attachment A2.1.1 for a fuller scan of how the 11 GBA cities compare to one another in terms of land mass, population, size of economy, competitive strengths and stage of development, and areas for growth according to the GBA Plan.] Compared with other Bay projects which have developed over many years, China's Greater Bay Area has plentiful land, a fairly large population, and ample scope for reaping economies of scale, pooling of human capital, and growth opportunities for businesses, including those (to be) involved in the building of infrastructure. In other words, there is a solid starting base for growth and development catch-up vis a vis the other Bay areas.

Table A.2.1. Current Population, Land, GDP, and GDP Per Capita: Selected Major Bay Area Economies

	Population / Land	GDP	GDP Per Capita
San Francisco Bay Area	7.6m / 17886 sq km	US$781.2b	US$102,230
New York Metropolitan Area	20.2m / 21479 sq km	US$1,657.5b	US$80,050
China's Greater Bay Area	70.7m / 55907 sq m	US$1,513.4b	US$21,750
Tokyo Bay Area	44m / 36898 sq km	US$1,774.2b	US$40,360

Source: HKTDC, South China Morning Post (SCMP)

Figure A.2.1. Innovation Capability and Intellectual Property Rights (IPR) Protection, 2019



Source: World Economic Forum (WEF)

Many ways for Hong Kong to contribute and benefit

3. **China has framed the Plan not only as an attempt to break new ground in pursuing opening-up on all fronts in a new era, but also a further step in taking forward the practice of "one country, two systems".** This means that where Hong Kong is more advanced than other GBA cities, the GBA Plan envisages adoption of Hong Kong's best practices – and this is important for Hong Kong to preserve its key value propositions and economic competitiveness, as well as to help spur the integration of soft infrastructure within the GBA. Hong Kong is ranked very high globally for its legal framework and intellectual property rights protection, alongside innovation capability (Figure A.2.1). Indeed, with the GBA Plan envisaging Hong Kong playing

a key role in activities such as trade intermediation, aviation, professional services, financial services, and legal & dispute resolution, it makes eminent sense that Hong Kong is allowed to preserve and apply its frameworks in dealing with Mainland and foreign businesses and investors. Over time, other GBA cities can learn from Hong Kong's best practices, adapt them to suit local needs, and work with Hong Kong to bring about greater and more seamless interoperability between different systems.

4. **Hong Kong can contribute and benefit by using its advanced knowhow in various sectors** including real estate building and investment, infrastructure development, financial services, professional services, tourism.

- Hong Kong is well-placed to provide financial services to mainland businesses, given the experience and expertise of its financial institutions. Cross-border loans account for about 30 percent of total banking system credit, with most of this going to higher-tier higher-credit quality Mainland firms from different economic sectors. Hong Kong has also been developing its professional services, including by attracting private equity funds and then meeting their demand for professional services such as management, accounting, and legal services. The GBA project opens up opportunities for Hong Kong to grow this sector. As the gateway for capital into and out of Mainland market, there is a lot of potential for Hong Kong's financial services sector to take advantage of the vast market and pilot liberalisation initiatives while servicing the burgeoning economic development in the Area. Furthermore, GBA has a strong innovation and technology sector, which Hong Kong is well positioned to serve when they expand globally and access international investors. For infrastructure development, Hong Kong has already been playing a key facilitation role in infrastructure financing globally, including the Belt and Road Initiative (BRI) through the work of its Infrastructure Financing Facilitation Office (IFFO).

- Real estate, by various estimates, accounts for well over a quarter of Hong Kong's GDP, with firms specializing in different parts of the value chain, ranging from property developers and consulting firms to commercial real estate management services providers and "smart building" solutions providers. As an indication of Hong Kong's competitive strength in real estate, in recent times, major international investment funds have approached property consultancy firms to explore setting up offshore companies based in Hong Kong for the purpose of investing in real estate in Guangzhou and Shenzhen.

- There are also niche areas which have potential to grow rapidly. Mini storage is one example. Hong Kong with its booming economy, dense population and high property prices, is one of the first cities to embrace the mini storage concept; and now Hong Kong firms are working to introduce this in other GBA cities including Guangzhou and Shenzhen. This could involve the use of technology solutions including online bookings, smart locks, and even landscape scanning (to identify the most suitable sites).

- Finally, tourism. Hong Kong's tourism sector has been developing robustly, with more than 60 million tourist arrivals in 2018 and expected in 2019. While China's outbound tourism has grown sharply, its inbound tourism has remained modest. As the GBA becomes more developed and integrated, and with several GBA cities designated to develop tourism, Hong Kong can contribute and benefit by sharing its tourism development knowhow and by providing a range of services – including professional services, real estate investment and infrastructure development, and transportation services.

Scope for Hong Kong to link GBA to other hubs

5. **Looking further ahead, while the GBA Plan is comprehensive and Hong Kong's envisaged role is already a very full one, there may be scope for Hong Kong to also play a key role in linking the GBA to other hubs, especially those in the ASEAN region**:

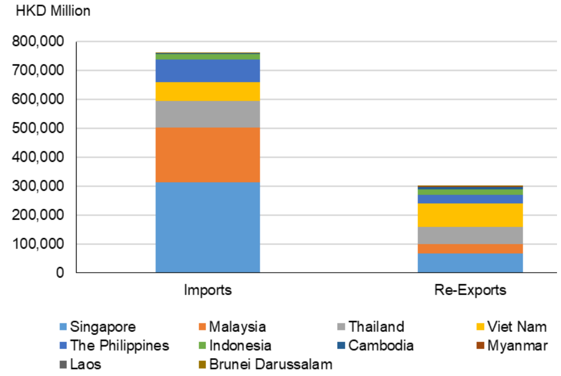
First, connectivity: Hong Kong can leverage on its status as a trade / transhipment and logistics hub to improve cross-border connectivity between leading cities in the GBA to rapidly-growing economies in ASEAN, possibly finding synergies with the Masterplan for ASEAN Connectivity (MPAC).

Second, trade: Hong Kong can work with ASEAN to enhance its free trade agreement (FTA) with ASEAN periodically, and find ways to use this to help grow China-ASEAN trade further. In 2018, ASEAN accounted for 16.1 percent of Hong Kong's imports and 7.3 percent of its re-exports (Figure A.2.2); Hong Kong is also an important entrepot for trade between Mainland China and ASEAN – in 2018, about HK$298.4 billion of Mainland China's import of goods from ASEAN were routed through Hong Kong, while re-exports of Mainland-origin goods to ASEAN through Hong Kong was about HK$209 billion.

Third, investment: Hong Kong intermediates substantial and increasing amounts of FDI from China into ASEAN economies, while also being a significant originating source of FDI itself into ASEAN economies, but the base is not yet very large. There is potential to ramp up much more, especially for FDI into (more) advanced manufacturing and services sectors in ASEAN – where the US and Europe still hold a sizeable lead over Mainland China.

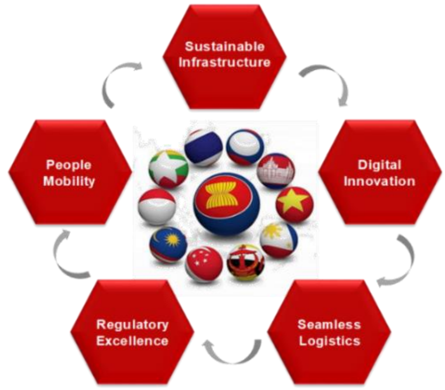
Fourth, finance: The vast majority of Hong Kong banks' cross-border lending has been to Mainland China so far. There is scope for a much larger part of this to be channelled towards ASEAN borrowers, or to Mainland Chinese enterprises operating in ASEAN. All these four areas can dovetail with, for example, the Master Plan for ASEAN Connectivity (MPAC) (Figure A2.3).

Figure A.2.2. Hong Kong-ASEAN Merchandise Trade



Source: Hong Kong Census and Statistics Department

Figure A.2.3. Master Plan for ASEAN Connectivity



Source: MPAC 2025

Requirements to address multiple challenges

11. **Hong Kong needs to address several challenges even as it works closely with other GBA cities and with Mainland China's central authorities to develop the GBA.** One issue is regulatory cooperation and coordination. The existence of two special administrative regions, three separate legal jurisdictions, tax regimes and custom territories in GBA give rise to challenges to flow of factors of production. This calls for innovative policy solution and greater regulatory cooperation and coordination. With broader and deeper collaboration among the GBA cities, ultimately, there may need to be an overarching framework above "one country two systems" to sustain Hong Kong's contribution to the GBA development. Another issue is balancing collaboration and competition. Notwithstanding the emphasis of the Plan on leveraging on complementarities and generating shared growth, it is natural that the sectors which are most high-tech and high growth will be most attractive to the leading GBA cities. Therefore, there needs to be close consultation between Mainland China's leading group for the development of the GBA and the top representatives from the participating cities to concretize the concept of collaboration over competition. A third issue has to do with generating sufficient fiscal resources to sustain Hong Kong's contribution to the GBA project, with some outlays – including those for "regional public goods" (RPGs) such as inter-city transport networks – possibly to bear fruit later rather than immediately. Last but not least, to preserve and enhance the role of Hong Kong in the further developments of the GBA, Hong Kong policymakers need to strengthen efforts to address socioeconomic inequality to mitigate spillovers from the tensions that could affect and derail Hong Kong's engagement.

Attachment 2.1.1: Greater Bay Area (GBA) Cities: Some Key Characteristics

City	Land Area (sq km)	Population (million)	GDP	GDP Per Capita	Strengths	Gaps
Hong Kong	1107	7.524	HK$2,843bn	HK$381,544	Trade-related services; tourism; financial sector; professional services; electronics (re-)exports; legal and regulatory framework; Infrastructure	Mature economy with slowing growth; Limited land; Population ageing; Does not have manufacturing base
Guangzhou	7434	14.404	RMB2285.9bn	RMB155,000	Capital of Guangdong; good transport network; Developing well in some advanced manufacturing activities (including automobiles, electronics and petrochemical), which are supported by six key production bases.	Lack of world-class universities and applied research institutions
Dongguan	2460	8.392	RMB827.9bn	RMB99,000	Solid manufacturing base which includes: electrical machinery and equipment; textile, garment, shoes and accessories; food and beverage processing, and papermaking and paper products. Cluster of emerging industries including LED lighting, new flat display, and photovoltaics; Fairly good cross-border transport connectivity.	Not among the most advanced GBA cities technologically
Foshan	3798	7.906	RMB993.6bn	RMB128,000	Has a solid medium-tech manufacturing base, including: machinery equipment, household appliances, ceramic building materials, metal products, textiles and garments, food & beverage, fine chemicals & pharmaceuticals, and household goods Good geographical location and cross-border transport connectivity	Needs to make a rather big leap to move up the value chain to higher-tech manufacturing such as optoelectronics, environmental protection, new materials, new medicines, and new energy vehicles.
Huizhou	11,347	4.830	RMB410.3bn	RMB85,000	Land mass and resources: second largest among GBA cities; rich land resources and tourism resources;	Its economy is relatively less-developed and also not as diversified as that of some other cities.

					Good geographical position: located at the South-eastern part of Guangdong Province, widely known as the "gateway of Eastern Guangdong"; Electronic information and petrochemicals are pillar industries, and Huizhou is a key production base for women's shoes and menswear.	Needs to find ways to acquire technologies needed to develop several target sectors incl: automobiles, electronic info, and petrochemicals – which are supposed to form its modern industrial system. Small population: needs to bring in human capital from elsewhere.
Zhaoqing	14891	4.151	RMB220.2bn	RMB53,000	Rich natural resources in plentiful land: Zhaoqing is the "home of gold" of Guangdong, and has a scenic environment. Good transport network, with several external ports and national expressways as well as intercity railways.	Much less developed than the other cities in the GBA on multiple counts: size of economy, per capita income, technological capacity. No industrial base Development plan looks more "scattered" than those of other GBA cities.
Zhongshan	1784	3.31	RMB363.3bn	RMB111,000	Strong geographical position: located at the south-central part of the Pearl River Delta, connecting Guangzhou on the north and is close to Hong Kong and Macao. Is a base for some advanced manufacturing and modern service industries, but not a very wide range Manufacturing base includes: household appliances, textiles and garment, electronics, lighting, healthcare and pharmaceuticals, furniture, small home appliances and hardware products Emerging sectors include modern service industry and yacht industry. The port-area equipment manufacturing base hosts many large SOEs.	Very small land mass and population size. Relatively high per capita GDP is due to its hosting of SOEs, rather than large profits and high wage incomes from private sector at the cutting edge of the "new economy". Manufacturing base is perhaps more aptly described as scattered rather than well-diversified.
Shenzhen	1997	13.027	RMB2422.2bn	RMB190,000	Large size of economy and GDP; high per capita GDP reflecting strong competitive edge across manufacturing & services Strong technological capacity positions it well to succeed in the "new economy": the four pillar industries are advanced technology, logistics, financial services and cultural industry. Good infrastructure incl strategic positions in transport networks.	Small land mass. Population may not be sufficient to provide the entire pool of human capital needed for it to succeed in all the target sectors, which include: biotech, Internet, new energy, new materials, cultural & creative industries, info technology; energy conservation and environment protection, plus future industries on life and health, marine, aerospace & aviation, and smart equipment.

Jiangmen	9507	4.598	RMB290.0bn	RMB63,000	Diversified industrial base incl: motorcycles & auto parts manufacturing, textiles and garments, shipbuilding, food, packaging materials, bathroom accessories and sanitary hardware, and electro-mechanics Is an important source of supply of agricultural products and by-products for the Pearl River Delta, Hong Kong and Macao. Is the first agricultural cooperation pilot zone with Taiwan in the Guangdong province. Good transportation network as well as good geographical position, sitting at the western part of the Pearl River Delta.	Needs to make a rather big leap to move up the value chain to higher-tech manufacturing. Population may not be sufficient to provide the entire pool of human capital needed for it to succeed in all the target sectors, which include: new energy, new lighting, new materials, high-end equipment manufacturing, as well as green household appliances.
Zhuhai	1736	1.891	RMB291.5bn	RMB159,000	Good geographical position: located at the south-central part of Guangdong Province and at the confluence of the Pearl River and South China Sea, adjoining Zhongshan on its north and Macao on its south. Has developed rapidly since its establishment as a special economic zone (SEZ) in 1980, and moved up technological ladder in recent years: its six key industries are electronic information, home appliances, electricity and energy, biopharmaceuticals and medical devices, petrochemicals and precision machinery.	Small land mass, and even smaller population. Need to draw in human capital from outside. For example, there are a number of preferential policies for Hong Kong people and enterprises in Hengqin – a 106.5 sq km island incorporated into the Zhuhai SEZ in 2009
Macao	33	0.667	MOP444.7bn	MOP673,000	Good geographical position: Macao is located in the Pearl River Delta in the southern Guangdong Province on the western side of the Pearl River estuary, adjoining the city of Zhuhai to the north, and 60km away from Hong Kong across the sea. Free economy: Macao pursues an open economic policy. Its tax rate is among the lowest in the region. It is a free port and has its own customs territory. Fiscal system is sound. Key driver of growth is tourism: gambling and junket activities account for 47.2% of GDP.	Very small land mass and population size impose severe constraints on plans for Macao to develop into a world-class tourism and leisure center; a commerce and trade cooperation service platform between China and Lusophone countries; and a platform for promotion of Chinese culture alongside other diverse cultures. Not easy to diversify from an economy heavily concentrated on tourism into other sectors.

[This page is left bank intentionally.]