AMRO Annual Consultation Report

Hong Kong, China - 2016

ASEAN+3 Macroeconomic Research Office (AMRO)

February 2017

Acknowledgements

1. This Annual Consultation Report on Hong Kong, China has been prepared in accordance with the functions of AMRO to monitor, assess and report to its members on their macroeconomic status and financial soundness and to identify the relevant risks and vulnerabilities, and assist them, if requested, in the timely formulation of policy recommendation to mitigate such risks (Article 3(a) and (b) of AMRO Agreement).

2. This Report is drafted on the basis of the Annual Consultation Visit of AMRO to Hong Kong, China from 19 to 23 September 2016 (Article 5 (b) of AMRO Agreement). The Mission team was headed by Ms Ng Chuin Hwei, Group Head and Lead Specialist. Members includes Dr Chaipat Poonpatpibul, Group Head and Lead Economist; Dr Li Wenlong, Senior Economist; Mr Yoichi Kadogawa, Specialist; Mr Enrico Tanuwidjaja, Specialist; and Dr Jerry Huang, Economist. AMRO Director Dr Junhong Chang 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 for 2016 was approved by Dr Hoe Ee Khor, AMRO Chief Economist.

3. The analysis in this Report is based on information available up to 16 December 2016.

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 judgements as to the legal or other status of any territory or area.

5. On behalf of AMRO, the Mission team wishes to thank the Hong Kong Monetary Authority (HKMA) and public agencies for their comments on this Report, as well as the HKMA's excellent meeting arrangements and hospitality during our visit.

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Executive Summary

*AMRO's **March 2016 Surveillance Report** emphasized that the growth momentum slowed owing to moderating growth in the mainland and the onset of the U.S. interest rate up-cycle. **Since March**, the economy has regained its momentum moderately on the back of recovery in private consumption as well as building and construction activities amid improved sentiment. However, external headwinds remain and the main growth drivers are fragile. While the property market has recovered, this has been mainly supported by extended accommodative monetary conditions that is now reversing. On the policy side, current macro-prudential and demand management measures that have curtailed households' high leverage and speculative capital inflows should be maintained, and mortgage loans provided by developers that do not conform to existing policy measures should be closely monitored. With ample fiscal space, there is room to deploy more fiscal measures to support growth, while taking into account the small fiscal multiplier due to high import leakage and the importance of maintaining fiscal soundness in anticipation of the expenditure needs for an aging population.*

1. **GDP growth rate in Hong Kong, China[1] for 2016 is estimated at around 1.4 percent, slowing down from 2.4 percent in 2015, with headwinds on both the external and domestic fronts.** Although Hong Kong's growth rate has rebounded since Q2 2016, the main growth drivers remain fragile. On the external front, merchandise and service exports are picking up but are likely to remain weak due to continued weak external demand. On the domestic front, growth in private consumption is recovering, but is likely to remain weak for the full year. Although unemployment remains low, labor market conditions are softening slightly. The recovery in equity and property prices, which may have supported sentiments, remains fragile and shows some signs of adjustment after announcements of the increase in the ad valorem stamp duty and the results of the U.S. presidential election in November 2016. Fixed capital formation is picking up, but the pace is expected to be moderate due to low business confidence amid uncertain global growth outlook. In 2017, the growth rate will be at around 1.7 percent as the global economy and trade activities recover at a gradual pace.

2. **Headline inflation is expected to decline to around 2.4 percent in 2016 from 3.0 percent in 2015, led by lower food price inflation and weakening housing rents.** In 2017, headline inflation is projected to ease further to around 1.8 percent with the Hong Kong Dollar (HKD) nominal effective exchange rate (NEER) appreciating and the remaining negative economic slacks as well as subdued housing rents. Meanwhile, in general, the recent oil price hike will support goods prices and moderate wage growth will limit any drop in services prices.

3. **While overall monetary and financial conditions remain accommodative, the risk of negative spillovers from the U.S. interest rate upcycle and the moderation in mainland growth remains.** HKD interest rates, which were kept low and stable, backed by ample liquidity in the domestic money market, have turned upward since late November 2016 with the hike in USD interest rates. Given the Linked Exchange Rate System (LERS), financial institutions should prepare for further funding cost increase ahead. The HKD spot exchange rate was broadly stable near the strong side of the Convertibility Undertaking, but it has depreciated moderately after the December FOMC meeting which signalled a

[1] For brevity, "Hong Kong, China" is referred to as "Hong Kong" in the text.

faster pace of U.S. interest rate hikes in 2017 and a temporary widening of the interest rate gaps between HKD and USD. Hong Kong's equity market is softening, while volatility has remained low after the Brexit referendum in June 2016. The Shenzhen-Hong Kong Stock Connect may provide a welcome boost.

4. **The banking system remains sound and well-capitalized although asset quality has deteriorated marginally, in particular loans to enterprises on the mainland.** Credit growth is recovering as domestic economic activities improve, but the momentum remains modest due to limited demand for trade finance as well as banks' prudent lending stance. Meanwhile, the asset quality of bank loans has continued to deteriorate, albeit marginally, and is unlikely to improve in the near term given the subdued domestic and external growth outlook, with the interest rate hike in USD and HKD raising debt servicing burdens. That said, banks are well-capitalized with the total capital adequacy ratio at 19.4 percent at the end of June 2016.

5. **Current macro-prudential and demand-side management measures should be maintained to curtail excessive borrowing by households, while aggressive promotional schemes provided by property developers that do not conform to these measures should be closely monitored.** The full impact of the increase in the ad valorem stamp duty in early November 2016 will take time to unfold, but transaction volumes and prices will adjust downward. This is welcome from the viewpoint of improving the affordability situation and curtailing risks of further exuberance, backed by low interest rates and aggressive promotional schemes provided by developers including mortgage loans with high LTV ratios. However, the recovery since Q2 2016 seemed to be driven by short-term factors such as the delay in the U.S. interest rate hike and the pent-up demand unleashed by developers' active launches of new projects. With the risks to the economic outlook tilted to the downside amid expected interest rate hikes, the adjustments in the property market may be significant, thereby negatively affecting the overall economy. While current policy measures should be maintained, policy re-calibration may be warranted should there be a sharp correction in the property market.

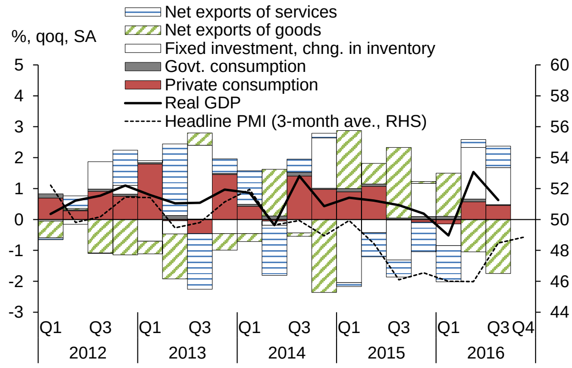
6. **As fiscal space remains ample, there is room to deploy more fiscal measures to support growth in the face of a challenging external outlook.** While the fiscal surplus in FY2015/16 has dipped to 0.6 percent of GDP, this 12-year consecutive surplus has brought fiscal reserves to 23.2 months of government expenditure as of March 2016. The Government has implemented its fiscal policy with one-off relief measures on both the revenue and expenditure side. Despite the relatively high import leakage reducing the fiscal multiplier, and the increasing expenditure in healthcare and social welfare amid an aging population, there is room for further fiscal measures through higher public investment and financial support to the lower-income groups affected by the economic slowdown.

A. Recent Developments and Outlook

A.1 Growth

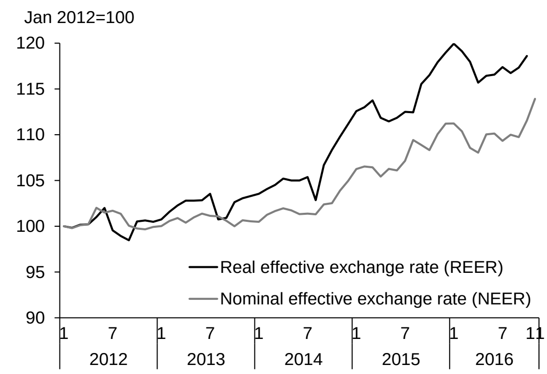
7. **The growth momentum — after weakening in Q1 2016 — has recovered moderately, mainly backed by improved domestic conditions.** Real GDP grew by 0.6 percent on a seasonally adjusted qoq basis in Q3 2016, confirming a mild but steady growth from its low base of a -0.5 percent decline in Q1 (Figure 1). In the domestic sector, private consumption marked a mild recovery of 0.7 percent in Q3 2016, following 0.8 percent in Q2 which is a positive growth rate for the first time since Q2 2015. Broadly stable labor market conditions and the receding negative wealth effect in equity and residential property markets, might have provided support for private consumption. Investment, increased by 6.0 percent on a year-on-year (yoy) basis in Q3 2016, after a relatively large drop in the previous four quarters. This is attributed to rebounding expenditures on machinery, equipment and intellectual property products, reflecting somewhat improved business sentiment, while building and construction activities remained stable. In the external sector, both goods and services exports regained some momentum due to a mild demand pick-up mainly from the mainland.

Figure 1. Real GDP Growth



Note: The figure for the PMI for Q4 2016 is the October to November average.
Source: CEIC, Markit

Figure 2. Effective Exchange Rates



Note: Data for the REER is available up to October 2016.
Source: CEIC

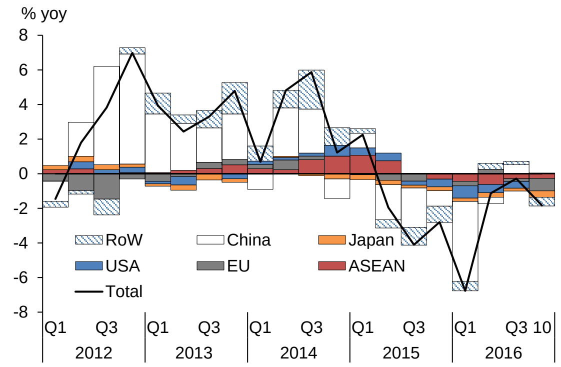
8. **Despite the recent recovery, growth is likely to moderate as the main growth drivers remain fragile.** AMRO staff estimate the real GDP growth rate for 2016 at around 1.4 percent, and at around 1.7 percent in 2017 as the global economy and trade activities recover at a gradual pace. On the external front, merchandise and service exports are stabilizing moderately but are likely to remain weak due to subdued external demand, especially from the mainland. In addition, the upward trend of HKD real effective exchange rate (REER), due to appreciation of the USD to which the HKD is pegged under the Linked Exchange Rate System (LERS), would dampen the contribution from net exports in the near term (Figure 2). Furthermore, policy uncertainty following Trump's victory in the U.S. presidential elections may push up global market volatility while concerns over protectionism will dampen trade activities. Meanwhile, the full impact of Brexit on the global

economy is still uncertain, although the direct impact on Hong Kong through trade channels would be limited given that the U.K. accounts for only 1.5 percent of Hong Kong's total goods exports in 2015 and 6.6 percent of total services exports in 2014.[2] On the domestic front, growth in private consumption is likely to remain weak. Although unemployment remains low, labor market conditions are softening slightly. The recovery in equity and property prices, which may have supported sentiment, remains fragile and shows some signs of adjustment after announcements of the increase in the ad valorem stamp duty and the results of the U.S. presidential elections. Meanwhile, the fixed capital formation is picking up, but the pace is expected to be moderate due to continuing low business confidence.

A.2 External Sector[3]

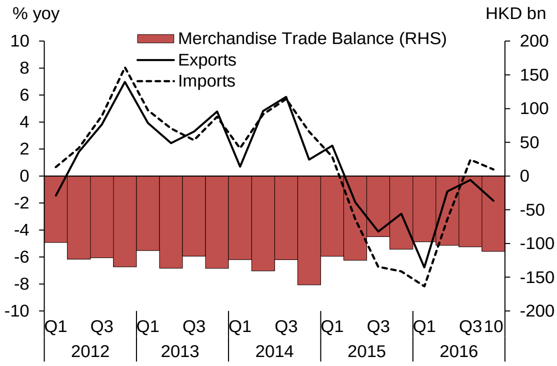
9. **Merchandise export growth remains negative due to weak demand and a strong currency despite recent encouraging trade figures in the mainland (Figure 3).** Exports[4] to the mainland, which account for more than 50 percent of total, are stabilizing but those to other regions remain weak due to subpar demand and HKD REER appreciation. Meanwhile, the merchandise trade deficit remained broadly unchanged as imports related to re-exports recovered moderately with the pick-up in manufacturing activities in the mainland while the pick-up in imports for domestic use was in tandem with domestic demand recovery (Figure 4).

Figure 3. Merchandise Exports by Destination



Note: Exports refer to total exports which include re-exports.
Source: CEIC

Figure 4. Merchandise Trade Balance



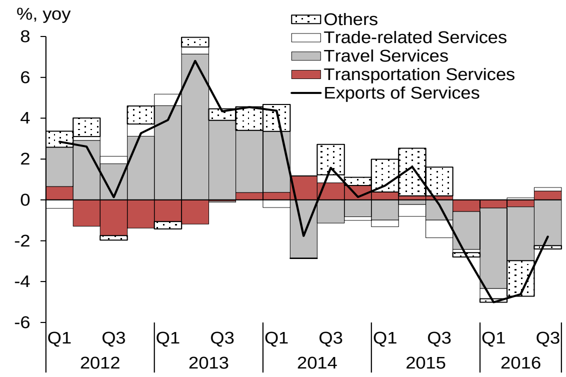
Note: Exports refer to total exports which include re-exports.
Source: CEIC

10. **Service export growth continued to decline, mainly due to the weakness in exports of travel services (Figure 5).[5]** Visitor arrivals from the mainland continue to decrease, albeit at a more moderate pace than before, due to strong HKD relative to the RMB (Figure 6), the one-trip-per-week cap policy for Shenzhen residents since April 2015, tightened mainland Customs surveillance at border point for import duty evasion since

[2] See the Government's "Half-yearly Economic Report 2016" released in August 2016 for analysis of the Brexit's impact on Hong Kong economy.
[3] See Appendix III.A for overall balance of payments positions.
[4] Exports in this report generally refer to total exports which include re-exports unless otherwise specified.
[5] Service exports other than travel services showed signs of stabilization in Q3 2016. Trade-related services increased slightly by 0.6 percent on yoy basis with improved trade and cargo flows in the region while transportation services growth rate turned positive of 1.8 percent after three consecutive quarters of decline. "Others" narrowed its negative growth rate to -0.7 percent as IPO activities regained momentum.

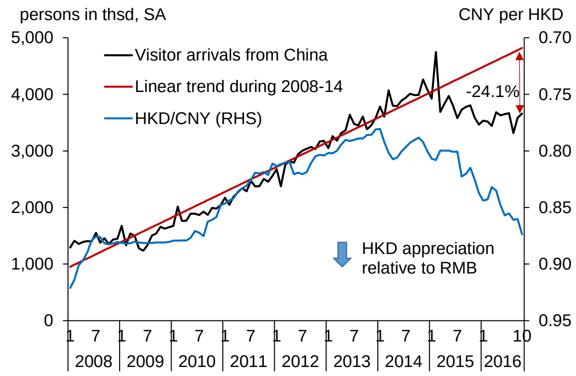
September 2015, and intensified competition for tourists with other countries. Retail sales have decreased in tandem, dragged to some extent by reduced tourist spending on some big-ticket items (Figure 7). The hotel occupancy rate has recovered although the average hotel room rate still stands at a historically low level (Figure 8).

Figure 5. Service Exports (Real Terms)



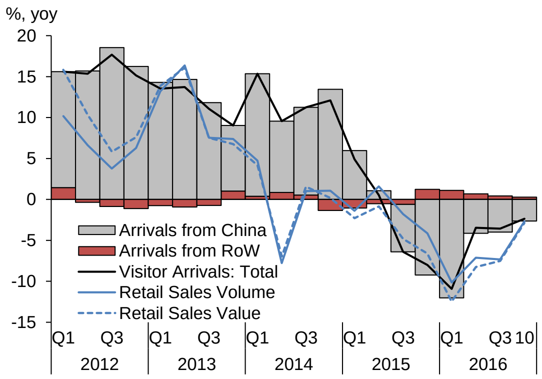
Source: CEIC

Figure 6. Visitor Arrivals and HKD/CNY



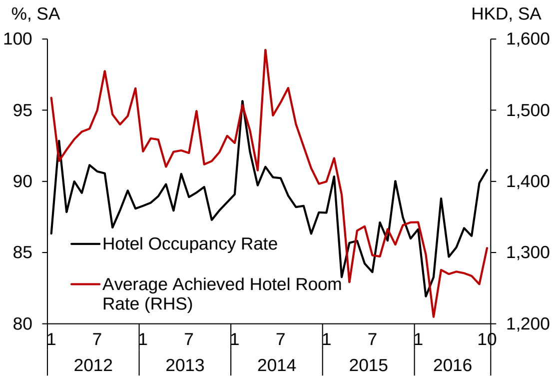
Source: CEIC, Bloomberg, AMRO staff calculations

Figure 7. Tourist Arrivals and Retail Sales



Source: CEIC

Figure 8. Hotel Occupancy Rate and Room Rate

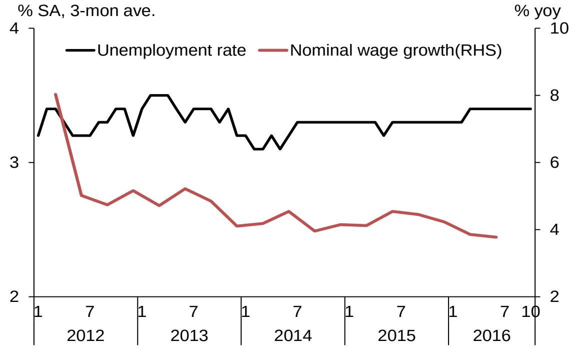


Source: CEIC, AMRO staff calculations

A.3 Labor Market and Inflation

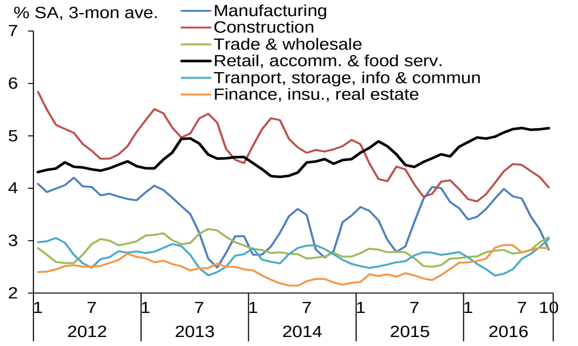
11. Labor market conditions are weakening marginally, but remain favorable as a whole. The unemployment rate in August-October was 3.4 percent, edging up from 3.3 percent in early 2016, although it is still low (Figure 9). By sector, the unemployment rates in retail, accommodation and food services, which accounted for 16.6 percent of total employment in 2015, are trending up due to weak tourism and consumption activity (Figure 10). On the other hand, those of manufacturing and construction are steadily declining. Nominal wage growth is slowing down accordingly.

Figure 9. Unemployment Rate and Nominal Wage



Source: CEIC

Figure 10. Unemployment Rates by Major Sectors

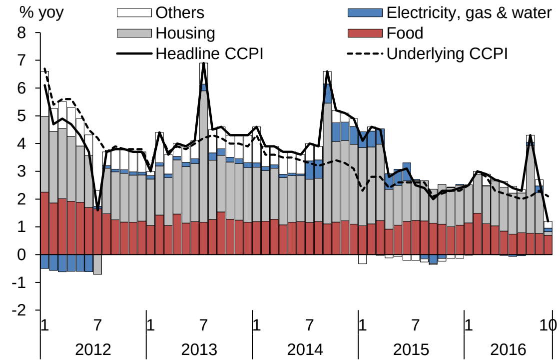


Note: Hong Kong's official unemployment rate data by sector are not seasonally adjusted. The figure is based on data calculated by AMRO staff.
Source: CEIC, AMRO staff calculations

12. **Inflationary pressure is moderating, mainly due to subdued domestic economic activities, currency appreciation, and stabilizing housing rents.** The Composite Consumer Price Index (CCPI) inflation was 2.1 percent in October compared with 2.8 percent in Q1, after excluding the effects of the Government's one-off relief measures (Figure 11).[6] Food price inflation, including meals outside the home, is subdued due to the appreciating HKD as well as slightly slower nominal wage growth. Meanwhile, housing rent showed a slower increase in line with price adjustments in residential property markets in early 2016.

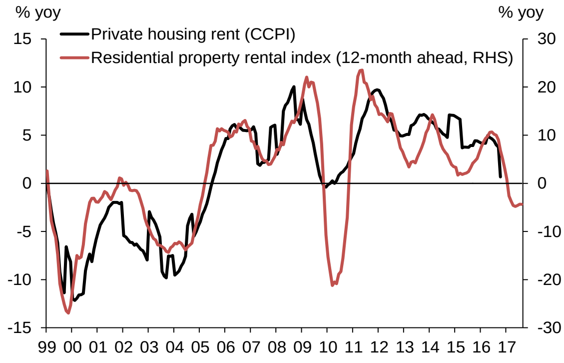
13. **Going forward, HKD NEER appreciation and negative output gap as well as subdued growth in housing rents will dampen inflationary pressure.** AMRO staff estimate the headline inflation for 2016 to be at around 2.4 percent. In particular, housing rent, which has a weight of 31.9 percent in the CCPI, is expected to be on a downward trend for a while, considering that it lags the residential property rental index by roughly one year (Figure 12). It is forecast that this lagged effect would drag the overall inflation in 2017 down to around 1.8 percent, although developments in the housing market are highly uncertain, depending on the pace of U.S. interest rate hikes and effectiveness of the new round of demand-side management measures. Meanwhile, the recent oil price increase will push inflation upward.

Figure 11. CCPI Inflation



Source: CEIC

Figure 12. CCPI housing rent



Source: CEIC

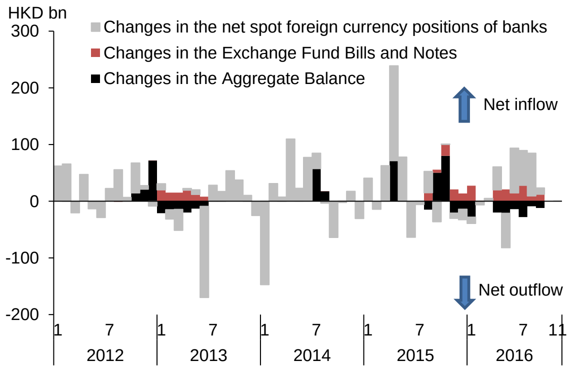
[6] Headline inflation in October 2016 was registered at 1.2 percent, down significantly from 2.7 percent in the previous month. This is mainly due to the continuation of rates concession implemented as from April 2016, while there was no rates concession in October 2015 (base month).

A.4 Monetary and Financial Conditions

14. **Since the March report, Hong Kong's financial market volatility has eased amid higher global risk appetite.** The last Surveillance Report suggested that the market was witnessing higher volatility due to the start of the U.S. interest rate normalization process in December 2015 and the renewed concern over capital outflows from the mainland in line with the slower growth outlook. The delay in the normalization process for most of 2016 and the overly pessimistic outlook for the mainland has receded, which has led to stabilizing global market sentiments and domestic financial markets. The heightened volatility after the Brexit referendum was short-lived, but uncertainty remains over trade deals between the U.K. and EU. On top of that, the details of policies by the new U.S. administration remain vague and implementation is uncertain. These factors may raise market volatility going forward.

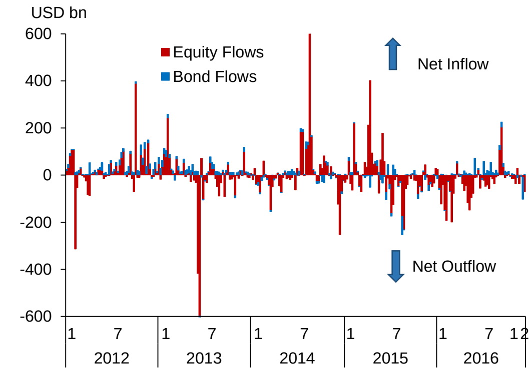
15. **In line with diminished market volatility, some capital inflows have been observed.** The Aggregate Balance[7] has declined since late 2015, but the decline has been offset by the increase in Exchange Fund Bills and Notes (Figure 13). This simply reflects the additional issuance of Exchange Fund Bills to meet the robust demand from banks for liquidity management, and the overall monetary base is still increasing. On the other hand, the net spot foreign currency positions showed capital inflows since June, indicating there were net capital inflows into the non-bank private sector. Moreover, weekly market survey data shows remarkable equity inflows in September amid the equity price rally and the record IPO of the Postal Savings Bank of China, while bond inflows are stable (Figure 14). However, since the Trump election win in November, some capital outflows were seen, in line with outflows from emerging economies in Asia.

Figure 13. Fund Flow Indicators



Note: Data for the net spot foreign currency positions of banks is available up to September 2016.
Source: CEIC

Figure 14. Weekly EPFR Fund Flows



Source: EPFR

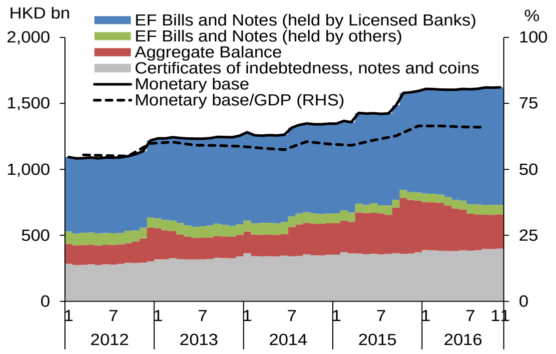
16. **Domestic liquidity conditions remain accommodative, but since late November, short-term interest rates have increased rapidly albeit from a low level.** The monetary

[7] Under the Linked Exchange Rate System, the HKMA commits to sell HKD unlimitedly at the fixed exchange rate. This means that capital inflow pressures would eventually be cleared through the increase in HKD deposits in the Hong Kong banking system, or the Aggregate Balance. However, if the inflow pressure were not so strong that Hong Kong banks would buy HKD from the HKMA, the Aggregate Balance is kept unchanged.

base has grown at a fast pace of around 10 percent on a yoy basis although the pace is moderating, and the ratio of the monetary base to GDP stands at a historically high level of roughly 65 percent (Figure 15). This ample money market liquidity helped to keep HKD interbank interest rates lower than its USD counterpart. However, since late November 2016, short-term HKD interest rates have jumped up and interest rate gaps between HKD and USD have narrowed. This is mainly due to expectations of a faster pace of Fed rate hike and concerns over capital outflows from emerging Asia including Hong Kong.[8]

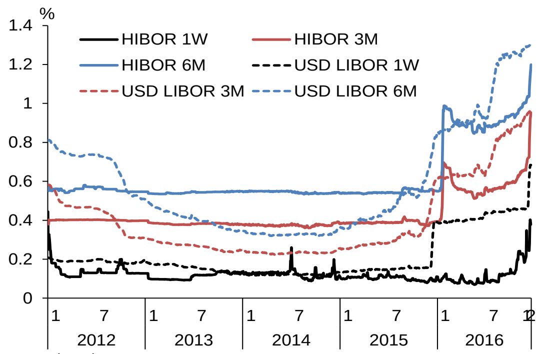
17. **Longer term HKD interest rates also jumped up after the U.S. presidential election, but remained lower than the USD equivalent, probably because of relatively ample liquidity, subdued inflation and long-term growth prospects (Figure 17).** The U.S. interest rates rose sharply on expectations of expansionary fiscal policies, and the steepening U.S. Treasury yield curve negatively affected global fixed income markets including Hong Kong. However, the slope of HKD yield curve was broadly unchanged in contrast to that of USD, which may continue to put downward pressure on banks' profitability (Figure 18).

Figure 15. Monetary Base



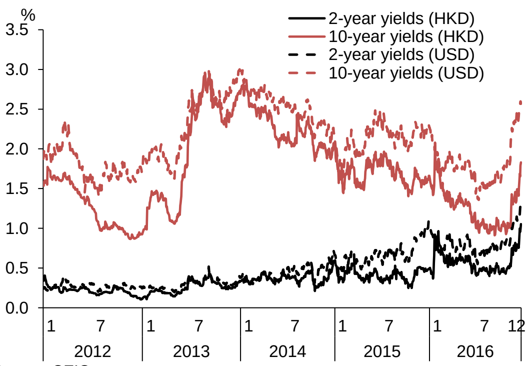
Source: CEIC

Figure 16. Interbank Interest Rates



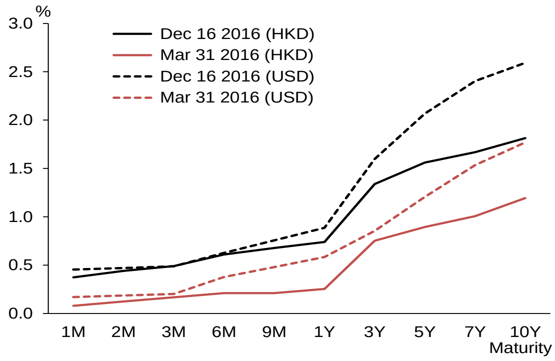
Source: Bloomberg

Figure 17. Medium- to Long-Term Interest Rates



Source: CEIC

Figure 18. HKD and USD Yield Curve



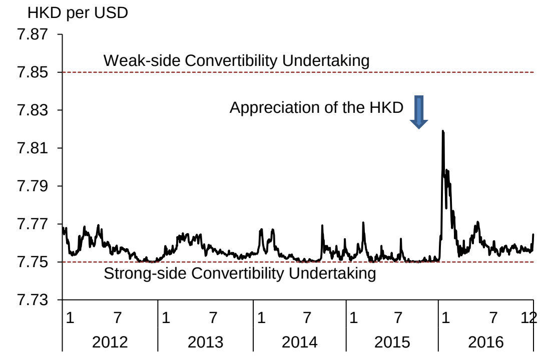
Source: Bloomberg

18. **Reflecting the LERS, the HKD spot exchange rate has remained broadly stable against the USD (Figure 19).** The FOMC's decision in June 2016 to keep the federal funds rate unchanged, together with the improved sentiment after the Brexit referendum

[8] Anecdotal information suggests that mainland-based banks repatriated offshore RMB to the mainland amid RMB outflows since late November 2016, and CNH HIBOR is increasing as shown in Appendix III. B. Such operations reduce HKD lending position in the interbank market for liquidity management, thereby putting upward pressure on HKD HIBOR.

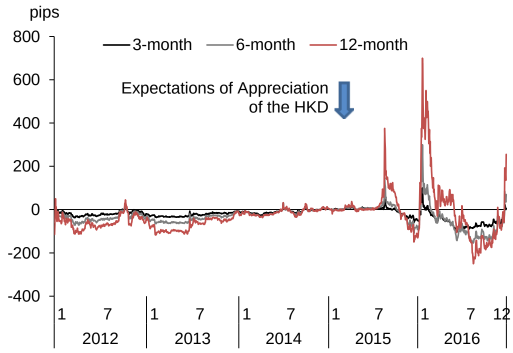
turned out to be short-lived, put some upward pressure on the HKD, and it had stabilized near the strong side the Convertibility Undertaking. However, after the December 2016 FOMC indicated a hawkish outlook for future federal funds rates, the forward discount against the USD turned into a premium and HKD spot exchange rate depreciated slightly (Figure 20).[9]

Figure 19. HKD/ USD Spot Exchange Rate



Source: Bloomberg

Figure 20. HKD Forward Point

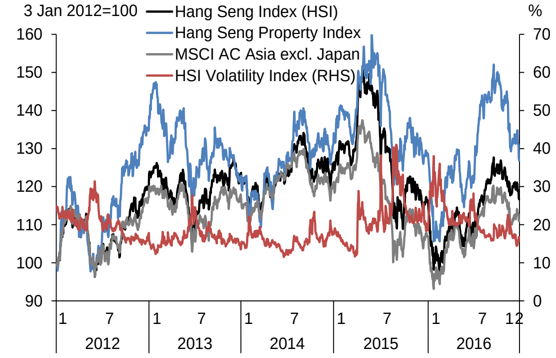


Note: Price Interest Points (pips) is a unit of the HKD/10000.
Source: Bloomberg

19. **Ample domestic liquidity coupled with the delay in the U.S. interest rate hike and capital inflows from China supported Hong Kong's equity price rally, but these drivers may now reverse (Figure 21).** Equity inflows via the Shanghai-Hong Kong Stock Connect shows that net southbound stock purchases have gained momentum, partly backed by mainland investors' investing in non-RMB assets to hedge against RMB depreciation (Figure 22). Together with newly opened Shenzhen-Hong Kong Stock Connect, capital inflows from the mainland will continue to support equity prices in Hong Kong, but these flows may reverse should tensions in the global financial markets surge. Looking at by sector, property developers' equity prices outperformed the market. However, after the announcement of increase in the ad valorem stamp duty in November, those equity prices plunged. The FOMC's decision in December 2016 put some downward pressure on overall Hong Kong equity prices. Meanwhile, bond inflows have increased as some multilateral development banks have increased HKD debt issuance in June for their infrastructural investment projects. The launch of the Infrastructure Finance Facilitation Office (IFFO) by HKMA in July 2016, and its collaboration with Asian Infrastructure Investment Bank (AIIB) in bond issues are welcome developments toward further deepening bond markets in Hong Kong.

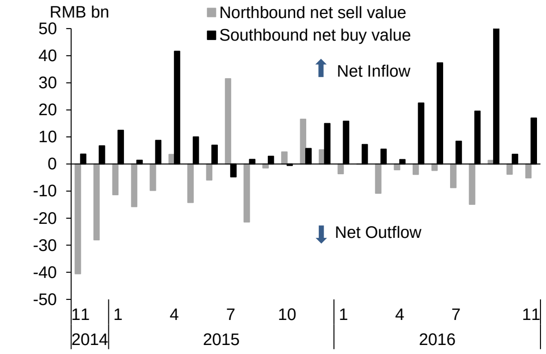
[9] On December 2016, the HKMA released a statement pointing that the widened interest rate differentials will lead to selling HKD/buying USD flows at some stage, and HKD exchange rate will depreciate against the USD and consequently reach the weak-side Convertibility of Undertaking of 7.8500.

Figure 21. Stock Market Indices



Source: Bloomberg

Figure 22. Capital Flows via the Shanghai-Hong Kong Stock Connect

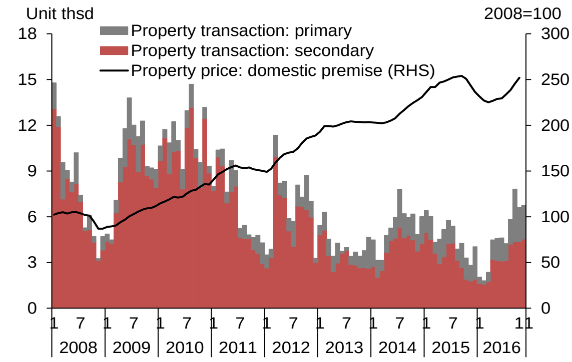


Source: CEIC

20. **The residential property market has rebounded, supported by several factors including the delay in the US interest rate hike during 2016, with risks tilted to the downside (Figure 23).** The residential property market was inactive after prices hit a new high in Q3 2015 as the overall economic conditions worsened while demand-side management measures by the government and macro-prudential measures by the HKMA successfully contained speculative transactions and maintained overall banking system soundness. The recent recovery seems to be driven by several factors: the delay in the U.S. interest rate hike for most of 2016, the pent-up demand unleashed by property developers' active launches of new projects, and the improved sentiment after the impact of the Brexit referendum turned out to be short-lived and meek. However, the government increased the ad valorem stamp duty for residential property transaction from a progressive scale of 1.5-8.5 percent depending on housing prices to a flat rate of 15 percent in early November, aiming to proactively address the overheated market and to guard against the risks of a housing bubble. Together with the faster pace of the Fed's interest rate up-cycle, risks in the property market are tilted to the downside.
21. **Developments in the non-residential property market have been uneven, reflecting divergent demand trends (Figure 24).** Office property prices have stopped declining partly due to demand from finance-related sectors from the mainland remaining steady in view of RMB business expansion in Hong Kong in the long-run. In contrast, retail premises prices are still likely to be on a downward trend albeit stabilizing with subdued tourism demand.[10]

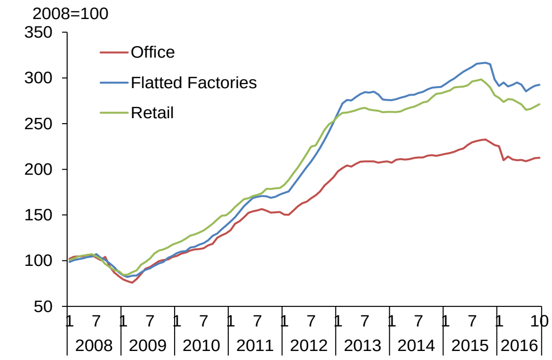
[10] In the rental market of retail premises, although headline rents remained stable, anecdotal evidence suggests some owners have been offering to extend the free-rent period to tenants, which is not reflected in the headline rents data.

Figure 23. Residential Property Price and Transactions



Note: Data for the property price is available up to October 2016.
Source: CEIC

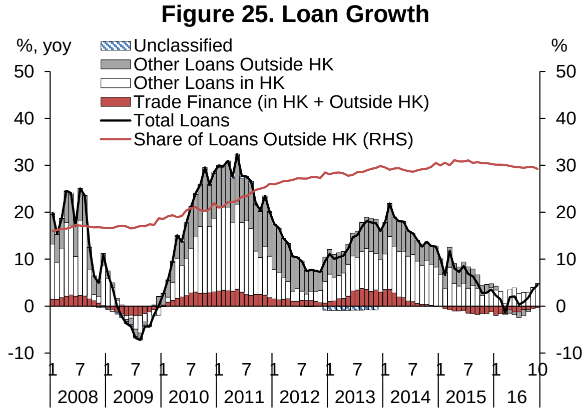
Figure 24. Non-Residential Property Prices



Source: CEIC

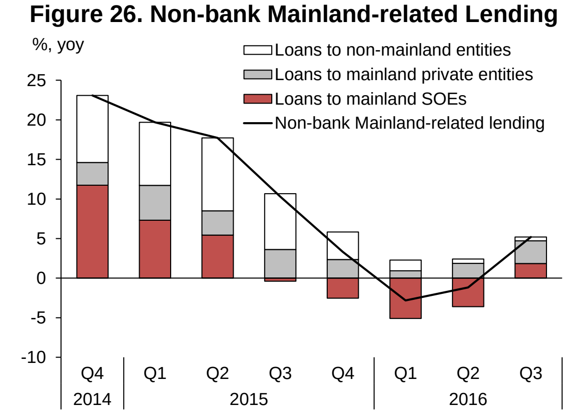
22. **Total loan growth is recovering amid robust domestic demand backed by low interest rates and stabilizing external demand (Figure 25).** Loans for use in Hong Kong have shown steady growth mainly to household, property and financial sectors while loans to the wholesale and retail trade sector have kept declining. On the external side, loans for trade finance continued to fall, but this fall was moderating. In terms of non-bank mainland-related lending (MRL) by borrower type, loans to state-owned-entities (SOEs) increased in 3Q 2016 for the first time in a year and those to other borrower types also picked up in accordance with improved economic activities in China while repayments of foreign currency loans continued in an environment of weaker RMB expectations (Figure 26).

Figure 25. Loan Growth



Source: CEIC

Figure 26. Non-bank Mainland-related Lending



Source: CEIC

A.5 Fiscal Position

23. **In FY2015/16, the government recorded 12 consecutive years of surplus of 0.6 percent of GDP, and fiscal reserves stood at a level equivalent to 23 months of government expenditure (Table 1).** That said, revenues amounted to 94 percent of the original estimate in the full-year budget, the lowest since FY2009/10, mainly due to the economic slowdown while expenditure stood at 99 percent of the estimate, the highest in

the same period, partly because of the frontloaded expenditure disbursements of short-term relief measures (Figure 27, 28).[11]

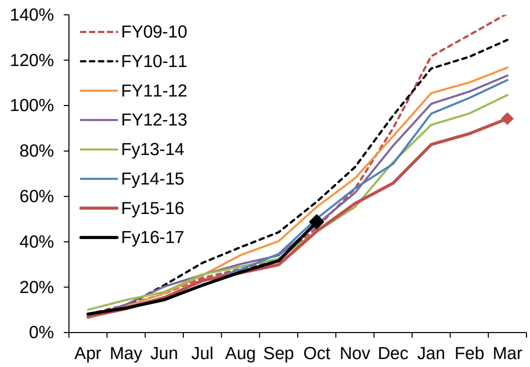
24. **In FY2016/17, the government scaled up its package of tax and relief measures from HKD34.0 billion to HKD38.8 billion to support the economy, but estimates the fiscal surplus will be maintained owing to robust revenue growth.** The collection rate of revenue, 48.8 percent as of October 2016, is roughly in line with historical average in this period, although most of revenue collection is usually in the second half of the fiscal year. Recently increased ad valorem stamp duty will push up the revenue, but its revenue contribution may be limited depending on what extent this tightening measure will cool down the housing market.[12]

Table 1. Consolidated Fiscal Account (HKD bn)

	FY2010/11	FY2011/12	FY2012/13	FY2013/14	FY2014/15	FY2015/16	FY2016/17
Revenue (a)	376.5	437.7	442.2	455.3	478.7	450.0	*498.3*
As of Oct	168.4	207.6	186.1	193.8	216.1	213.5	243.1
Expenditure (b)	301.4	364.0	377.3	433.5	396.2	435.6	*486.9*
As of Oct	172.7	185.0	222.6	233.0	219.7	246.5	264.8
(c) = (a)-(b)	75.1	73.7	64.8	21.8	82.5	14.4	*11.4*
As of Oct	-4.4	22.7	-36.5	-39.3	-3.6	-33.0	-21.7
(c) Share of GDP (%)	4.1	3.8	3.1	1.0	3.6	0.6	N.A.
Fiscal Reserve (d)	595.4	669.1	733.9	755.7	828.5	842.9	*854.3*
(d) in terms of number of months of expenditure	23.7	22.1	23.3	20.9	25.1	23.2	N.A.

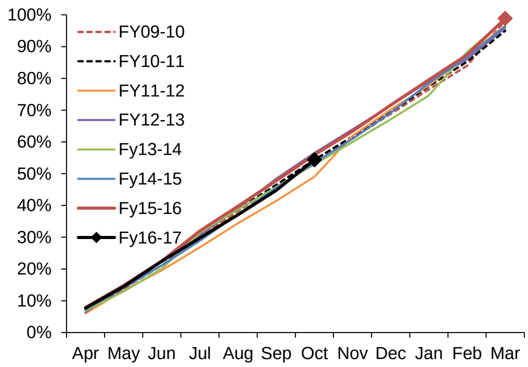
Note: Figures in italics for FY2016/17 are the government's estimates. Figures for fiscal reserves are as of end of March.
Source: CEIC

Figure 27. Collected Revenue to Original Estimate



Source: CEIC

Figure 28. Disbursed Expenditure to Original Estimate



Source: CEIC

[11] The collection rate of revenue/expenditure calculated here fluctuates depending on uncertainty of revenue and expenditure when the initial budget was planned, economic developments during the fiscal year, and other matters regarding execution, and would thereby need to be treated with caution.
[12] In 2016/17 budget, the government estimates revenue from all stamp duties (includes stamp duties charged not only on property transactions but also on stock transactions) at HKD50 billion, 10 percent of consolidated revenue.

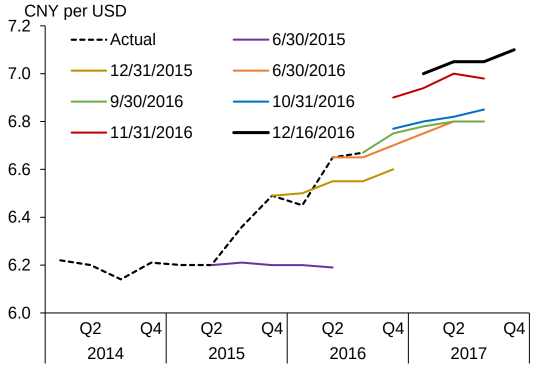
B. Risks and Vulnerabilities

B.1 Growth Risks

25. **The Hong Kong economy is exposed to downside risks from slower growth in the mainland.** Though the near-term outlook for the mainland has gradually stabilized with policy support, it is forecast that the growth rate in 2017 will decrease as structural reforms, especially in overcapacity sectors, make further progress. Such reforms and rebalancing from industry to services will open various opportunities for development of the services-led Hong Kong economy, particularly in financial intermediation and wholesale and retail trade sectors, while some sectors, especially manufacturing, may face challenges in the short run. However, negative spillovers from the mainland's growth slowdown and heightened uncertainty relating to the progress of the reform agenda should be carefully monitored. Market participants expect further RMB depreciation in 2017 (Figure 29), further reducing its purchasing power against HKD. Were such market expectations to materialize, sectors such as hotels, retail and trade services would face additional headwinds and labor market conditions would weaken further.
26. **Rising debt service burden amid the U.S. interest rate up-cycle should be closely monitored, while uncertainty over its pace may also pose downside risks through the confidence channel.** Elevated private sector leverage warrants continued vigilance on the impact of the U.S. monetary policy normalization on debt service costs and spending behavior of households and private firms. In addition, expectations are that the pace of interest rate normalization by the Fed has increased while global policy uncertainty has heightened. Business investment and construction activities will be constrained by tighter financial conditions and greater uncertainty over the external environment.
27. **While the incoming U.S. administration's economic policies are still uncertain, the authorities should be mindful of some possible downside risks.** The new U.S. administration is expected to pursue more expansionary fiscal policies, which could have positive spillovers on the global economy and Hong Kong, but could also have other adverse effects. First, a stronger U.S. economic outlook may be accompanied by higher USD interest rates to curb inflationary pressures, which implies higher HKD interest rates, and debt service costs. Second, HKD REER may appreciate further, which will erode external competitiveness including service exports. Third, the tail risk of severe trade tensions between the U.S. and China, including high U.S. import tariffs on Chinese goods, will reduce trade volume between two countries and will negatively affect Hong Kong's re-exports as well as trade-related services.
28. **Re-exports between China and the U.S. accounts for 10.2 percent of total exports of Hong Kong in 2015, and Hong Kong's trade sector will face further challenges if**

global trade protectionism rises sharply (Figure 30). The contribution rate have been halved since early 2000s due to increased ratio of re-exports coming from China and going back to China in tandem with increasing production capacity of mainland enterprises (Figure 31). That said, the share is still high, and a possible rise in tension between two countries will shrink global trade volume. Furthermore, in response to a lower corporate income tax and a special scheme for profit repatriation back to the U.S., U.S. enterprises—the second-largest with regional bases in Hong Kong—may repatriate their profits and become less expansionary. (Figure 32, 33)[13]

Figure 29. Forecast Median for CNY Spot Exchange Rate

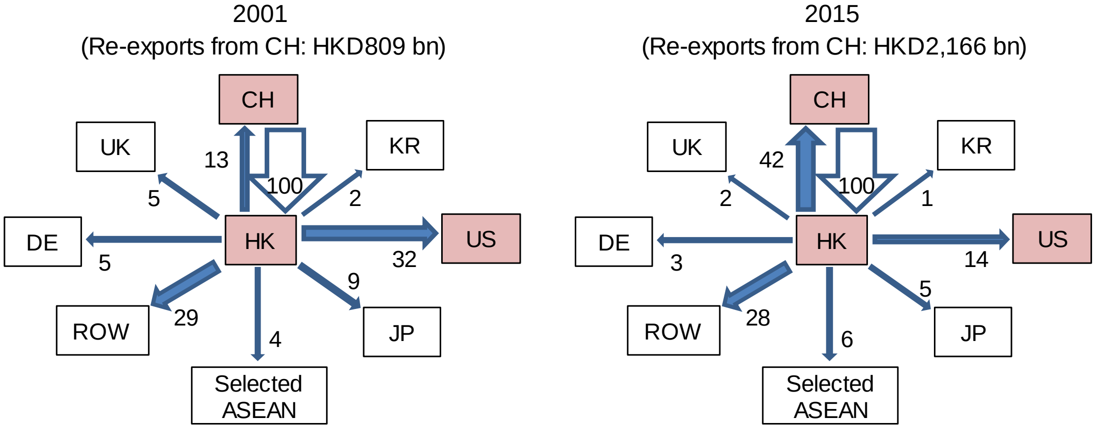


Note: Above figure shows historical transition of forecast median calculated by Bloomberg based on its survey results of roughly 70 contributors.
Source: Bloomberg

Figure 30. Re-exports of Hong Kong

Source: CEIC, AMRO staff calculations

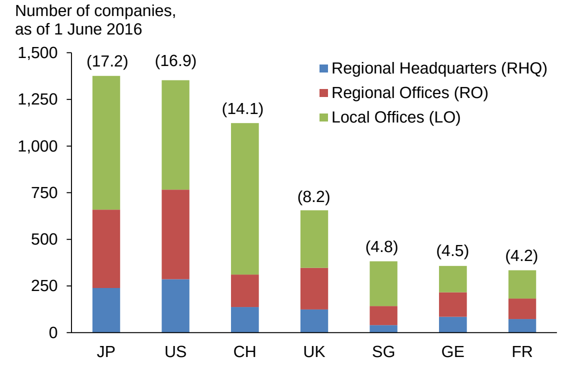
Figure 31. Re-exports from China to the U.S. and Other Selected Countries



Source: CEIC, AMRO staff calculations
Note: Figures next to arrows show relative amounts of re-exports from China to selected counties to total re-exports from China in each year. Due to rounding, numbers may not add up to 100. Arrows shows destinations of re-exports, and their thickness represent the relative amounts of re-exports. Selected ASEAN includes: Cambodia, Indonesia, Malaysia, Singapore and Vietnam.

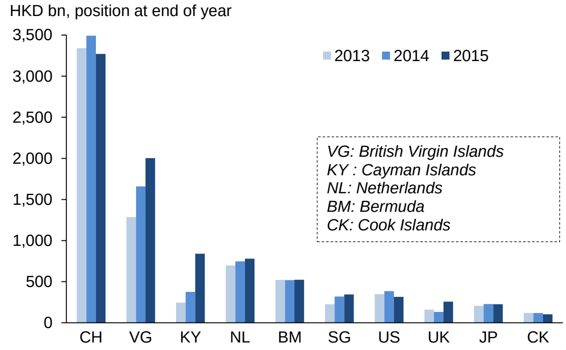
[13] A large part of inward direct investment recorded as coming from offshore financial centers would be sourced from institutions in advanced economies including the U.S.

Figure 32. Number of Regional Headquarters/Regional Offices/Local Offices by Location of Parent Company



Note: Figures in brackets show the percentages in respect of the total number of RHQ/RO/LO.
Source: Census and Statistics Department

Figure 33. Inward Direct Investment by Selected Major Investor Country/Territory



Note: Inward direct investments from non-operating enterprises set up by Hong Kong companies in offshore financial centers are excluded.
Source: Census and Statistics Department

B.2 Property Markets and Household Debt

29. **The sustainability of the recent property market recovery is uncertain given that it seems to be supported by short-lived factors prone to reversal, as well as the impact of the government's new round of the demand-side management measures.** As mentioned in section A, the recent recovery is led by the postponed U.S. interest rate hike for most of 2016, pent-up demand and better sentiments after the Brexit result, but all of these factors are transitory and prone to reversal. For example, the unanticipated U.S. presidential election outcome triggered capital outflows from the region including Hong Kong on "risk-off" market sentiment, and lifted HKD interest rates rapidly through the LERS mechanism. The local property markets will face strong headwinds with higher borrowing costs and subdued new demand. In addition, the increase in the ad valorem stamp duty in November is expected to cool down the property market, with its full impact still unfolding.[14]

30. **Continued low housing affordability and the government's strategy to increase housing supply could check further price hikes.** Due to the recent price recovery, housing affordability has again started to deteriorate although the ratio of flat price to income is already at a higher level (Figure 34). Additionally, the government plans to increase housing supply at a high pace to ease the chronic shortage. These factors also cast doubt on the sustainability of the recent recovery.

31. **That said, demand for new mortgage loans is reviving despite elevated household leverage, which requires continued vigilance (Figure 35, 36).** The pick-up in new mortgage loans is backed by the property market recovery, earlier expectations for prolonged low interest rate conditions, and fierce competition among banks leading to

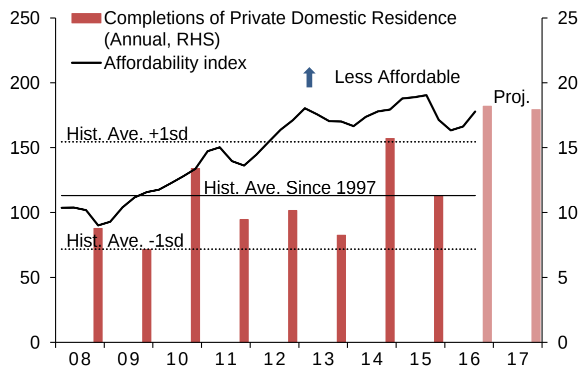
[14] Looking at the Centa-City Leading Index (CCL), which measures secondary private residential property price on a weekly basis, the pace of price increase somewhat moderated but continued to increase by 1.0 percent from the week of 24 October 2016 to the week of 5 December 2016. Given that the Hang Seng Property Index (HSP) dropped by 5.1 percent in the same period and that HSP leads CCL by roughly 6 weeks (with cross-correlation coefficient of 0.62 in 2008-16), CCL is expected to decline going forward. However, according to anecdotal information, outward investment demand from the mainland China into Hong Kong remained strong on expectations of RMB depreciation, even after the ad valorem stamp duty hike that is also imposed on foreign buyers.

lending rate cuts. However, the high level of household debt by historical standards, moderate income growth, concentration of base rate for new mortgage loans on HIBOR-based floating rate (94.8 percent in October 2016) and the USD and HKD interest rate hikes all suggest a future increase in households' debt service burden. The number of mortgage loans in negative equity decreased amid the recent housing price recovery, but this number is susceptible to increase in a housing price downturn (Figure 37). Even though the regulatory debt service ratio cap has successfully checked excessive household leverage, continued vigilance on the property market and household debt is appropriate.

32. **Anecdotal evidence suggests that property developers have recently been offering aggressive promotion schemes to home buyers, which do not conform to regulatory and macroprudential measures on the banks.** These include mortgage loans provided by developers with high loan-to-value (LTV) ratios of around 95 percent, by granting the full loan amount or topping up loans provided by banks that are subject to a regulatory LTV cap of 50-60 percent. The risks arising from these schemes seem to be limited so far because the loans incur a higher interest rates and are provided only to property buyers in primary markets, and only by cash-rich developers. However, this kind of loans do not conform to the macroprudential measures to discourage excessive borrowing and should be closely monitored.

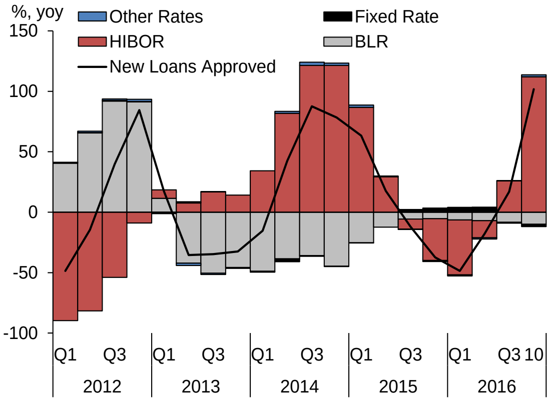
33. **While speculative activities are well curtailed, purchases of residential properties by non-local individuals are edging up and boosting prices (Figure 38, 39).** According to anecdotal information, mainland Chinese are the largest group of foreign buyers as they have an incentive to put funds outside the mainland in a weaker RMB environment and are helped by financial packages offered by Hong Kong property developers to offset the buyer's stamp duties imposed on non-residents. Recently introduced tightening measures in some mainland cities may also have increased the incentives to invest more in Hong Kong properties.

Figure 34. Housing Affordability Index



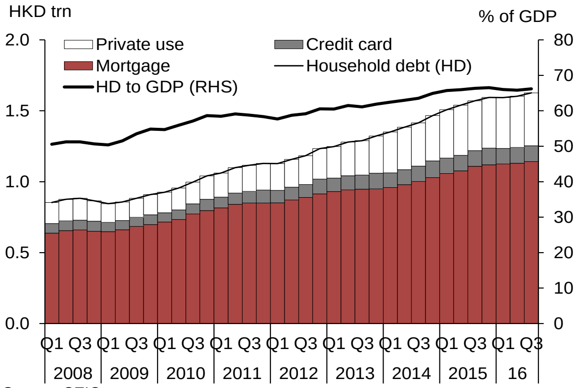
Note: The housing affordability index is calculated as the property price index for domestic premises divided by median monthly earnings.
Source: CEIC, Rating and Valuation Department, AMRO staff calculations

Figure 35. Newly Approved Mortgage Loans



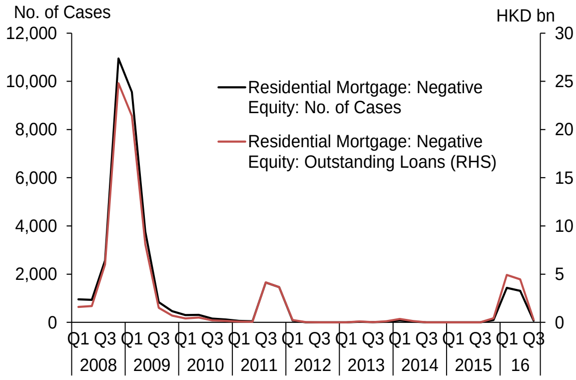
Source: CEIC

Figure 36. Household Debt



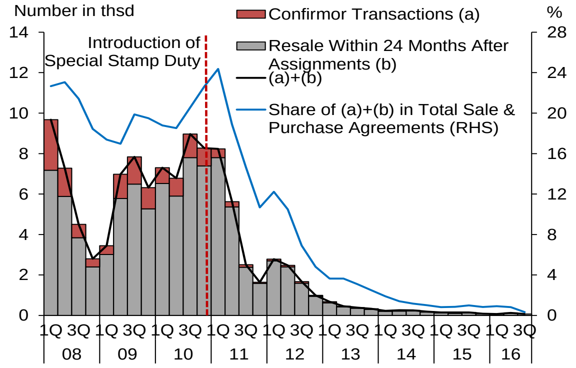
Source: CEIC

Figure 37. Mortgage Loans in Negative Equity



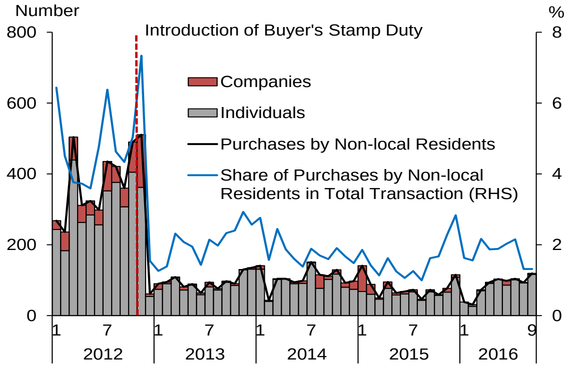
Source: CEIC

Figure 38. Number of Speculative Transactions in Residential Property Markets



Note: Confirmor transactions refer to resale before assignments.
Source: Inland Revenue Department, Economic Analysis and Business Facilitation Unit, Financial Secretary's Office

Figure 39. Number of Purchases by Non-residents of Housing Premises



Source: Inland Revenue Department, Economic Analysis and Business Facilitation Unit, Financial Secretary's Office

B.3 Banking Stability

34. **The net interest rate margin of banks has remained broadly unchanged at a low level (Figure 40).** Facing such a low interest margin, there is anecdotal evidence that major banks are eager to extend mortgage loan volumes further by slashing spreads on reference rates of Hibor. Looking ahead, if the flatter HKD yield curve environment lasts longer period, profitability of local banks will face further downward pressure. This might push banks to ease their lending stance and increase the risk of overall loan portfolio.

35. **The asset quality of banks has deteriorated somewhat, and continued vigilance of the negative impact from the mainland's structural reforms as well as the interest rate hike in USD and HKD would be advisable.** One of the contributing factors of asset quality deterioration is the mainland-related lending (MRL), and structural reforms in China may continue to add negative pressure on the asset quality of Hong Kong banks (Figure 41). Furthermore, the faster pace of U.S. interest rate up-cycle would raise the debt-servicing burden of households and corporate, which could negatively impact asset quality.

36. **Hong Kong banks' exposure to property-related sectors remains high and an area of vulnerability.** Banks' property-related exposure, measured by the sum of loans to

property developers and mortgage loans, accounts for roughly half of total domestic loans (Figure 42). As discussed above, the recent recovery in the residential property market may be short-lived, whereas the non-residential property market recovery has been uneven. This implies the property market may be subject to further corrections which could have negative impact on the banking system as well as the real economy.

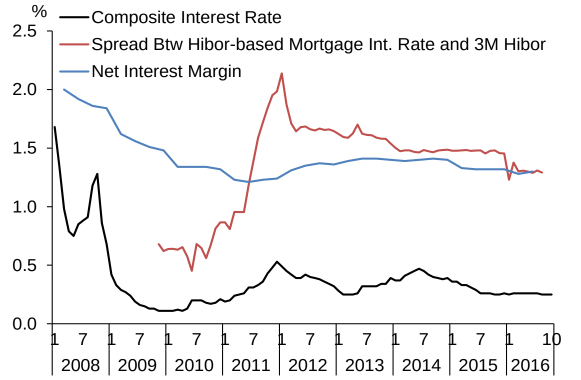
37. **Early warning signs of an increase in household defaults can be detected albeit at low levels, and may continue to edge up as HKD interest rate picks up (Figure 43).** Mortgage delinquency ratio as well as credit card charge-off ratio indicates a moderate deterioration in asset quality. Although their level remains low, given that these are prone to rise when interest rate goes up, and with the subdued economic outlook, continued monitoring is appropriate.

38. **Corporate debt from the domestic banking system picked up again in Q2 2016 after moderate consolidation (Figure 44).** This may partly reflect the recent economic upturn and the associated recovery in credit demand. However, impending interest rate hikes in an uncertain global economic environment, may put pressure on companies' interest payment capacity, which is on a mild downward trend (Figure 45).[15] Also, given the monetary policy divergence among major central banks, currency mismatches of corporates' debt profile could be a future risk as well.[16]

39. **Despite the above-mentioned risks, it is unlikely that Hong Kong's banking system as a whole will be faced with rapid asset quality deterioration in the short run, and the banking system is resilient with a high capital buffer.** Roughly 40 percent of MRLs are to SOEs which may receive state support. Moreover, the exposure to SOEs that are in trouble with overcapacity is limited as banks had maintained a prudent lending stance. In terms of non-SOE exposure, a large part of it is covered by collaterals and bank guarantees. Moreover, banks continue to hold a high capital adequacy ratio of 19.4 percent as of end-June 2016, and maintain a prudent lending stance. On the liquidity front, the average LCR of Category 1 institutions reached 158 percent in Q2 2016, well above the regulatory requirement of 70 percent this year and of 100 percent from 2019 onwards. However, banks should be vigilant about the recent increase in the net spot foreign currency position in keeping with capital inflows, given that global market volatility is still high.

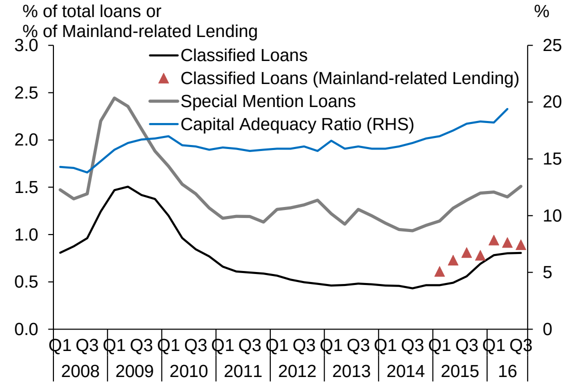
[15] The Interest Coverage Ratio (ICR) deteriorates even when corporates' risk appetite improves and they gain leverage for more investments. In that sense, a declining ICR should not necessarily viewed as a bad symptom.
[16] According to the HKMA's analysis, non-local corporates rather than local corporates have played a bigger role in driving up aggregate corporate leverage since the Global Financial Crisis. See "Half-yearly Monetary and Financial Stability Report in September 2016."

Figure 40. Commercial Interest Rates and Profitability



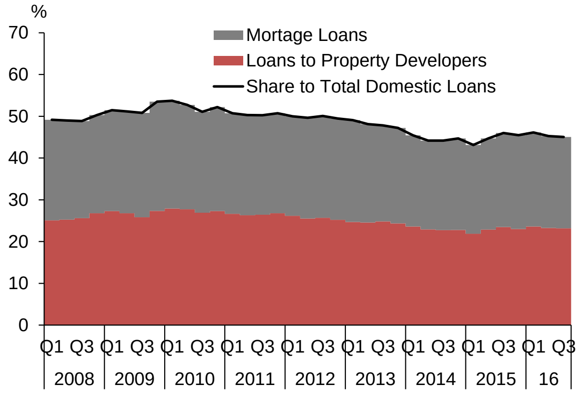
Note: Data for the net interest rate margin and the spread are available up to June 2016 and August 2016, respectively.
Source: CEIC, HKMA

Figure 41. Asset Quality and Capital Adequacy



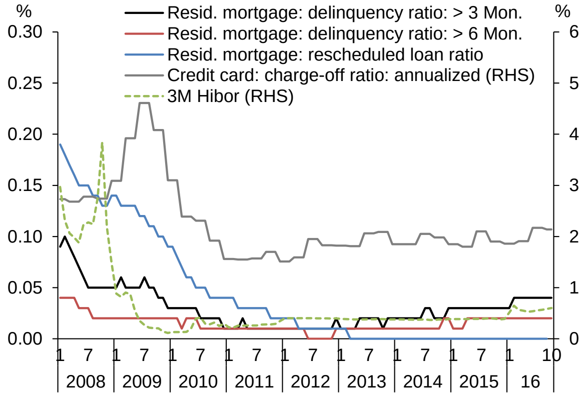
Note: Data for the capital adequacy ratio is available up to Q2 2016.
Source: CEIC

Figure 42 Banks' Exposure to Property Sector



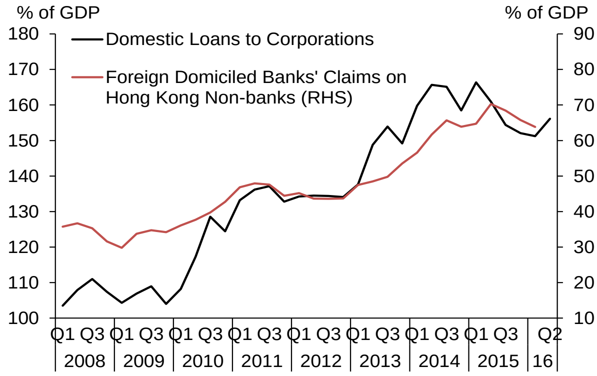
Source: CEIC

Figure 43. Asset Quality of Household Debt



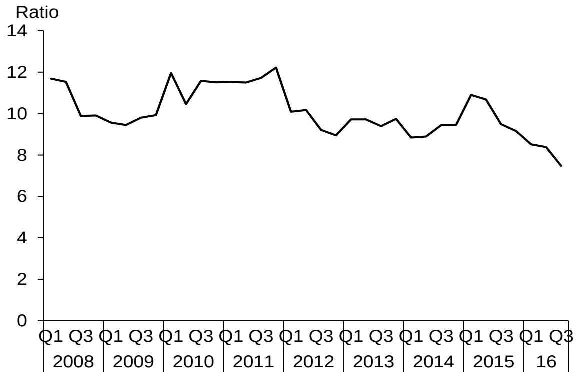
Source: CEIC

Figure 44. Corporate Debt to GDP Ratio



Note 1: "Domestic Loans to Corporations" is the sum of loans for use in Hong Kong and for trade finance. "Corporations" as a counterparty does not include interbank exposure and loans to "Professional and Private Individuals."
Note 2: "Non-banks" as a counterparty covers all entities other than those defined as "banks." General government and public corporations are part of the non-bank sector.
Source: CEIC, BIS

Figure 45. NFCs' Interest Coverage Ratio



Note: Interest Coverage Ratio is calculated by dividing earnings before interest and taxes (EBIT) by interest expenses, indicating how easily a company can meet its interest payments on outstanding debt.
Source: Thomson Reuters

C. Selected Issues

C.1 Financial Status of Property Developers

40. **Banks' still high exposure to property developers and their aggressive promotion schemes for home buyers warrant an understanding of their financial robustness**. In this section, the profitability and liquidity of 10 major property developers that comprise the Hang Seng Properties Index (HSP) will be reviewed from the viewpoint of stability in the property sector and the banking system.[17]

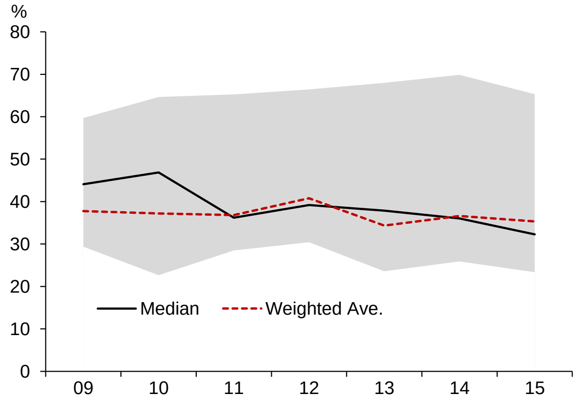
41. **Developers' profitability remains stable and their cash holdings are relatively high and still rising, which will safeguard their balance sheet soundness from potential financial stress (Figures S1, S2).** Anecdotally, such ample cash holdings enable developers to offer aggressive promotion schemes to home buyers. On the other hand, one can argue that they should maintain strong cash positions in anticipation of major corrections in the property markets. Developers' financial status is also seen to be robust in terms of debt service ability. The debt-to-EBITDA ratio has declined and stood at a historically low level while the dispersion among developers seen in 2000s has receded (Figure S3). In addition, EBIT-to-interest coverage ratio has been kept high on average, with some developers' ratios increasing from a relatively high base. Given a moderate positive correlation between the interest coverage ratio and the slope of the USD yield curve, interest rate developments since the U.S. presidential election may have some positive impact on the interest coverage. It is unlikely that credit and liquidity risks will materialize in the short run, taking into account the developers' robust financial status.

42. **Developers' equity prices have, however, fallen sharply since October 2016, reflecting market concerns over their profitability and the property market outlook, and hence, developers' financial health and implications on financial stability should be monitored (Figure S5).** During January to September 2016, a relatively clear relationship between changes in developers' equity prices and their share of revenue from Hong Kong were observed. A bearish outlook for mainland-related developers might reflect concerns over the sustainability of the property market exuberance in China and weaker cash inflow evaluated in HKD value amid RMB depreciation. However, the positive correlation has become less clear and all developers' equity prices have dropped since October 2016 as even Hong Kong-based property developers face challenges including concerns over the faster pace of interest rate hike and the increase in the ad valorem

[17] Property developers include: Sun Hung Kai Properties, Cheung Kong Property Holdings, Link REIT, China Overseas Land and Investment, Wharf Holdings, China Resources Land, New World Development, Sino Land, Henderson Land Development Company and Hang Lung Properties. The difference in their accounting periods of 12 months are not adjusted for simplicity.

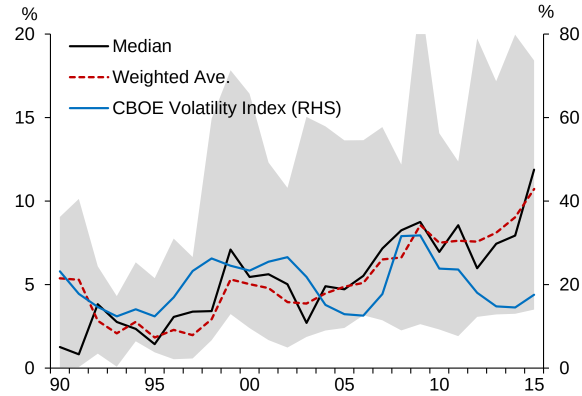
stamp duty rate. Given the importance of the property sector, repercussions to the real economy and the banking system should continue to be carefully monitored. [18]

Figure S1. Adjusted EBITDA Margin



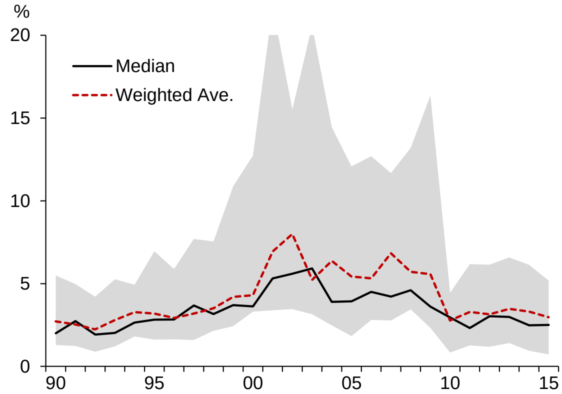
Note: The median is of 10 developers' and the shaded area shows the range, with the highest and the lowest figures excluded. The weighted average is calculated by using the total asset size of individual developers in each financial year. The same applies to Figures S2-S4.
Source: Bloomberg, AMRO staff calculations

Figure S2. Cash and Equivalents to Total Assets



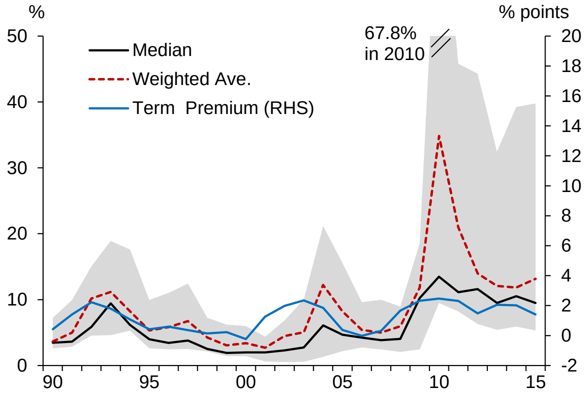
Source: Bloomberg, AMRO staff calculations

Figure S3. Debt-to-EBITDA



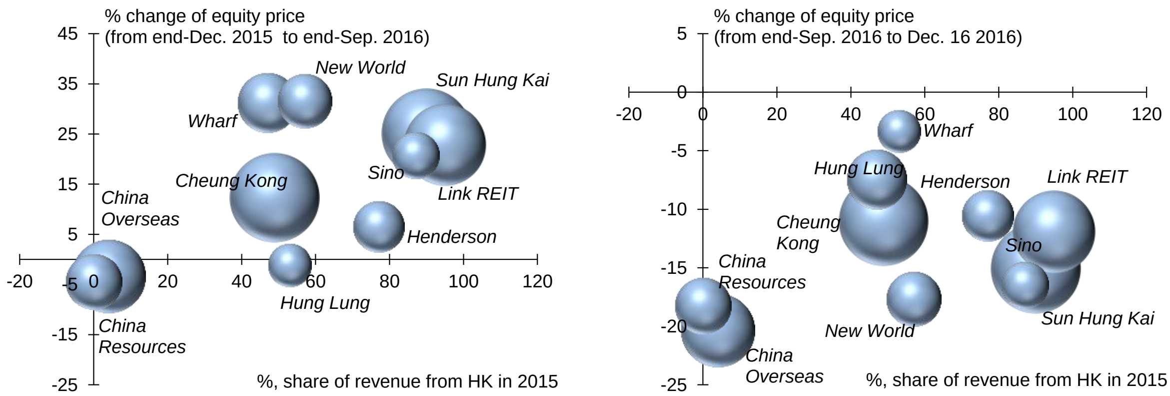
Source: Bloomberg, AMRO staff calculations

Figure S4. EBIT-to-Interest Coverage Ratio



Note: The term premium is the gap between 2Y and 10Y U.S. treasury note.
Source: Bloomberg, AMRO staff calculations

Figure S5. Changes in Developers' Equity Prices and Their Shares of Revenue from Hong Kong



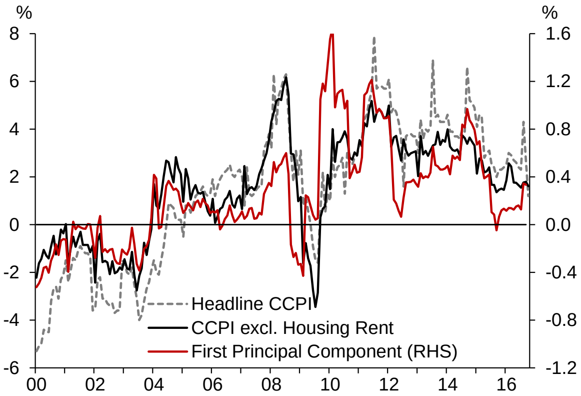
Note: The size of circles represents the share of market capitalization of 10 property developers as of end September 2016.
Source: Bloomberg, Financial Reports of Property Developers, AMRO staff calculations

[18] Construction and real estate services accounted for 9.3 percent of Hong Kong's GDP in 2015, while a wealth effect from changes in residential property prices and effects through the confidence channel cannot be ignored.

C.2 Trend Inflation

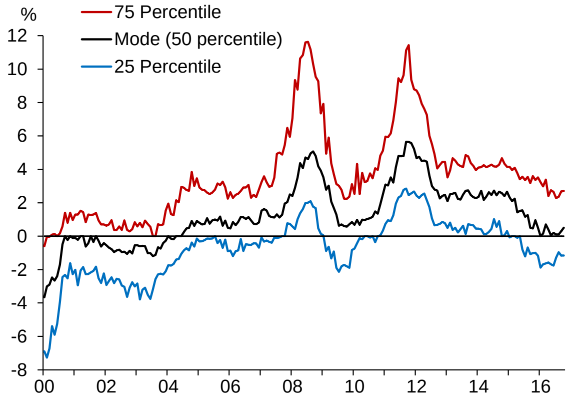
43. **Although the authorities do not adopt an inflation targeting regime, assessing the underlying trend of inflation is becoming more important given the recent deceleration in growth and lackluster economic outlook**. Given the moderate nominal wage growth and subdued consumption, developments in inflation trends would be particularly helpful to understand trends in purchasing power. The recent headline inflation is largely supported by the housing rent with a large weightage, and the outlook for the housing market is tilted to the downside. Keeping this in mind, this section studies some indicators that can measure the underlying trend of inflation by utilizing distributional information of individual items composing CCPI.
44. **All indicators implies the underlying trend of inflation in Hong Kong is not as high as the headline inflation suggests.** CCPI, excluding housing rent, has been contained below two percent since early 2015 and lacked momentum to accelerate (Figure S6). The first principal component remains weak, albeit recovering. In addition, the mode is approaching to zero percent while the diffusion index has also fallen with roughly 40 percent of items priced cheaper than the previous year (Figure S7, S8). These indicate that the overall distribution of price changes has shifted to the left although it is in better shape compared with that of early 2000s when the headline inflation was negative (Figure S9). Should such disinflationary price setting patterns continue, business sentiments would be negatively impacted and the labor market and nominal wage growth might weaken further.
45. **Weakness in the underlying trend seems to be caused by the stronger HKD and below-potential economic growth, imply continuing subdued inflationary pressures going forward (Figure S10).** According to the results of a simple VAR model, the recent oil price increase will duly push up the trend inflation, but the recovery is considered to be modest in the near future given the HKD NEER appreciation amid a faster pace of U.S. interest rate up-cycle and below-potential economic recovery. Although inflation is not a policy target, and oil prices and HKD NEER are largely exogenous for Hong Kong, measures to narrow a negative output gap would, among other goals, be helpful to minimize risks that deflationary price settings may prevail.

Figure S6. CCPI excl. Housing Rent



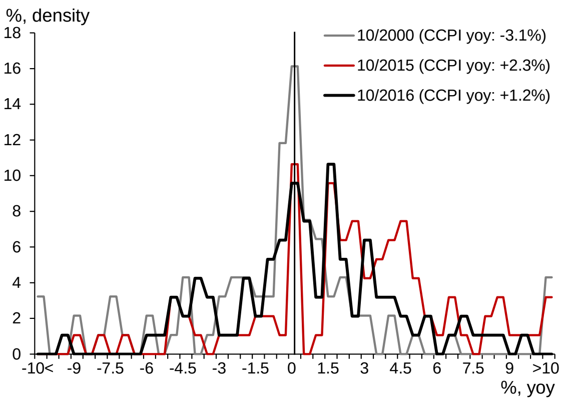
Note 1: The weight of housing rent is fixed with that of 10/14-9/15 base, 31.86 percent, throughout the period.
2: The first principal component is estimated based on the yoy percent changes of nine major sections commodity/service composing CCPI. The estimation period is Jan. 82-Sep. 2016.
Source: CEIC, AMRO Staff Calculations

Figure S7. Mode



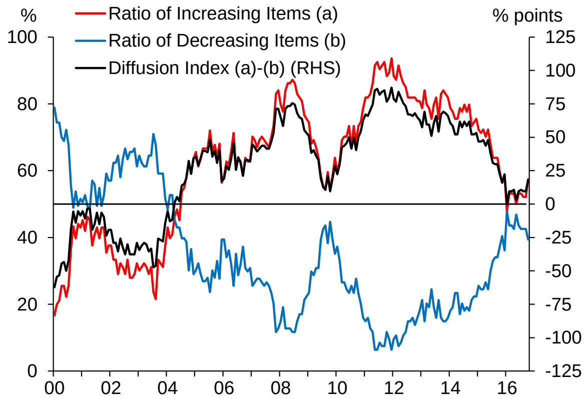
Note: Mode is simply calculated as the 50 percentile point of the distribution of the yoy percent changes of 94 commodity/service items composing CCPI.
Source: CEIC, AMRO Staff Calculations

Figure S8. Distribution of YoY Percent Changes of Individual CCPI Items



Note: The range of grid is set as 0.5 percent point.
Source: CEIC, AMRO Staff Calculations

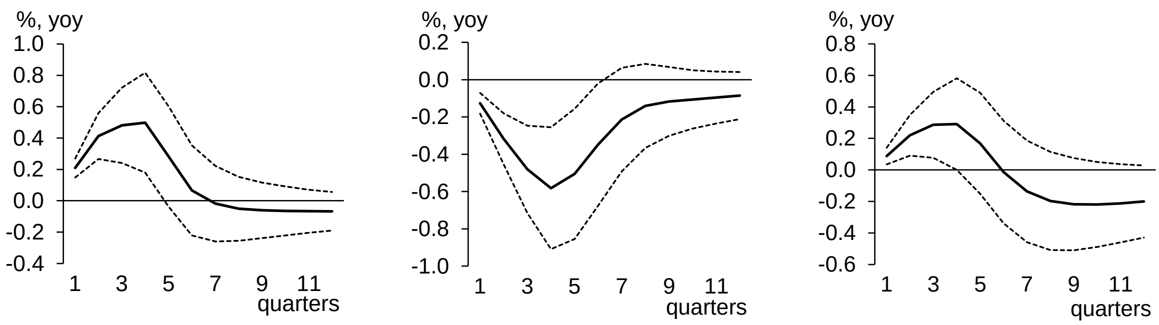
Figure S9. Diffusion Index



Note: The ratio of increasing (decreasing) items is calculated by dividing number of individual items whose yoy percent changes above (below) zero by total number.
Source: CEIC, AMRO Staff Calculations

Figure S10. Impulse Responses of CCPI (excluding Housing Rents) to Oil Prices, NEER and Output Gap

Real Oil (1σ=16.0%) HKD NEER (1σ=1.3%) Output Gap (1σ=2.2%)



Note: A simple four-variable VAR model, composed of real oil price (WTI oil price deflated by the U.S. CPI), HKD NEER, output gap (deviation from real GDP trend estimated by HP filter) and CCPI excl. housing rent, is estimated with shock identification based on Cholesky decomposition in this order. The estimation period is Q1/2000-Q2/2016. Except for the output gap, variables are firstly estimated with qoq change basis, and then converted to yoy basis. Dotted lines show 75 percentile bands.
Source: CEIC, AMRO Staff Calculations

D. Policy Discussions

46. **Current macro-prudential and demand-side management measures should be maintained to curtail excessive borrowing by households and speculative transactions, while promotional schemes provided by developers that do not conform to these measures should be closely monitored.** The full impact of the increase in the ad valorem stamp duty rate in early November 2016 will take time to unfold, and assessing whether the intended effect is achieved is of priority at this juncture. However, the recovery since Q2 2016 seems to have been driven by short-term factors such as the delay in the U.S. interest rate hike in most of 2016 and the pent-up demand unleashed by developers' active launches of new projects. However, the FOMC's decisions in December 2016 implies faster pace of rate hikes in 2017, thereby reversing the main driver of sentiment. With risks to the economic outlook tilted to the downside, the adjustments in the property market may be deeper and longer, negatively affecting the overall economy. While current policy measures should be maintained at least for the next few months, policy re-calibration may be warranted should there be a sharp correction in the property market.

47. **As fiscal space remains ample, there is room to deploy more fiscal measures to support growth in the face of a challenging external outlook.** External risks emanating from the growth slowdown in the mainland and the U.S. interest rate up-cycle remain, and the growth rate will be below potential through to 2017. Headwinds in tourism- and trade-related sectors have not receded yet while the construction and real estate sectors will cool down. Additional fiscal policy measures with one-off relief measures targeting groups affected by the economic slowdown are appropriate, and the steady implementation of current infrastructure projects which strengthen the growth potential is warranted. That said, the relatively high import leakage reducing the fiscal multiplier, and the increasing expenditure on healthcare and social welfare amid an aging population should be taken into account. As the government has emphasized, maintaining sound fiscal conditions in the medium-to long-run is important to maintain Hong Kong's unique position as a competitive international financial center. In this regard, the government maintains prudent fiscal stance through various measures including the establishment of the Future Funds, effective from January 2016.

48. **On the financial market front, timely communication with market participants continues to be important, while steps should be taken to secure Hong Kong's premier position as an international financial center.** In response to the U.S. presidential election result in November 2016, the HKMA immediately issued a press release, communicating with market participants that Hong Kong's banking system is

highly liquid and well prepared for volatile global markets. Just after the FOMC's decision in December 2016, it also released a statement calling for vigilance due to potential market volatility. Such proactive actions are effective to calm down the domestic market and to prevent a deterioration in sentiments. From a medium- to long-term perspective, financial initiatives taken by the HKMA and the Hong Kong Government, including the Shenzhen-Hong Kong Stock Connect, the launch of the Infrastructure Finance Facilitation Office (IFFO) and the Fintech Facilitation Office (FFO), to safeguard Hong Kong's unique position as an international financial center and to provide further growth opportunities going forward, are highly commendable.

Appendix I. Selected Economic Indicators for Hong Kong, China

	2013	2014	2015	2015				2016			2016	2017
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Est.	Proj.
National accounts												
Real GDP (% yoy)	3.1	2.7	2.4	2.4	3.1	2.3	1.9	0.8	1.7	1.9	1.4	1.7
(% qoq SA)				0.7	0.6	0.5	0.2	-0.5	1.5	0.6	-	-
Private consumption (% yoy)	4.6	3.3	4.7	5.0	6.8	4.4	2.7	1.2	0.5	1.2	1.0	1.5
(% qoq SA)				1.3	1.6	0.0	-0.1	-0.2	0.8	0.7	-	-
Govt' consumption (% yoy)	2.7	3.0	3.4	3.9	3.6	2.8	3.3	3.3	3.5	3.3	3.2	3.3
(% qoq SA)				1.0	0.8	0.5	1.0	1.0	0.9	0.3	-	-
Gross domestic fixed capital formation (% yoy)	2.6	-0.1	-2.0	5.6	3.9	-6.2	-9.4	-9.6	-5.0	6.0	-0.8	1.3
Building and construction (% yoy)	-4.3	9.3	2.9	-3.9	14.1	4.2	-0.9	0.2	3.5	3.4	-	-
Machinery, equipment and intellectual property products (% yoy)	11.3	-8.6	-5.8	10.4	-4.7	-10.7	-12.9	-11.9	-11.2	6.1	-	-
Exports (% yoy)	6.2	0.9	-1.5	0.3	-2.7	-2.5	-1.0	-3.9	0.6	1.1	-0.3	1.4
Goods (% yoy)	6.5	0.8	-1.9	0.2	-3.8	-3.1	-0.5	-3.6	2.0	1.9	-	-
(% qoq SA)				-1.9	-2.4	0.5	2.3	-3.9	3.3	0.4	-	-
Services (% yoy)	4.9	1.1	-0.2	0.7	1.6	-0.2	-2.7	-5.0	-4.6	-1.8	-	-
(% qoq SA)				0.6	-0.8	-1.1	-1.4	-1.9	-0.2	1.8	-	-
Imports (% yoy)	6.6	1.0	-1.9	0.5	-2.5	-3.2	-2.0	-4.3	0.4	2.3	-0.1	1.3
Goods (% yoy)	7.2	0.9	-2.7	-0.2	-3.3	-4.2	-2.8	-5.4	0.2	2.4	-	-
(% qoq SA)				-2.6	-2.4	-0.8	2.0	-4.2	3.5	1.3	-	-
Services (% yoy)	1.5	1.8	5.7	6.7	5.1	5.5	5.4	4.9	1.6	1.7	-	-
(% qoq SA)				1.8	1.9	0.2	1.4	1.4	-1.5	0.4	-	-
GDP deflator (% yoy)	1.8	2.9	3.6	4.3	4.2	3.4	2.8	2.3	2.1	1.5	-	-
(% qoq SA)				1.2	1.0	0.1	0.4	0.7	0.7	-0.2	-	-
Inflation (% yoy)												
Headline	4.3	4.4	3.0	4.4	3.0	2.3	2.3	2.8	2.6	3.1	2.4	1.8
Underlying	4.0	3.5	2.5	2.7	2.5	2.4	2.2	2.8	2.3	2.1	-	-
Labor markets												
Unemployment rate (%)	3.4	3.3	3.3	3.2	3.3	3.5	3.2	3.3	3.5	3.6	-	-
(% SA)				3.3	3.3	3.3	3.3	3.4	3.4	3.4	-	-
External balance (% of GDP)												
Overall BoP	2.7	6.2	11.8	6.3	13.6	11.6	15.1	0.9	-2.7	-	-	-
Current account	1.5	1.3	3.3	0.2	0.1	8.2	4.1	2.7	2.5	-	2.8	3.0
Financial non-reserve assets	-1.3	2.9	6.4	2.4	9.2	7.1	6.8	2.6	-1.2	-	-	-
Money and credit (end-period)												
M1 (% yoy)	9.7	13.1	15.4	27.5	17.7	20.3	15.4	7.0	9.0	10.7	-	-
M3 (% yoy)	12.4	9.6	5.5	11.8	7.9	4.9	5.5	3.6	3.1	8.3	-	-
Total loans (% yoy)	16.0	12.7	3.5	11.7	8.5	4.9	3.5	-1.4	0.3	3.5	-	-
Classified loan ratio (%)	0.5	0.5	0.7	0.5	0.5	0.6	0.7	0.8	0.8	-	-	-
Capital adequacy ratio (%)	15.9	16.8	18.3	17.0	17.5	18.1	18.3	18.2	19.4	-	-	-
Interest rates (%, end-period)												
HSBC's Best lending rate	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	-	-
Three-month Hibor	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.6	0.6	0.6	-	-
Asset prices												
Hang Seng stock index (end of period, 1964=100)	23,306	23,605	21,914	24,901	26,250	20,846	21,914	20,777	20,794	23,297	-	-
Residential property prices (end of period, 1999=100)	245.1	278.3	285.0	291.5	301.3	306.1	285.0	271.4	276.4	296.2	-	-
Spot exchange rate (HK$/US1$, period ave.)	7.756	7.755	7.752	7.794	7.778	7.781	7.777	7.763	7.755	7.762	-	-
Official reserve assets (US$bn, end-period)	311.2	328.5	358.8	332.1	340.8	345.8	358.8	362.1	360.6	-	-	-
Consolidated Budget Balance (as of end-Mar of the relevant fiscal year, % of GDP)	1.0	3.6	0.6	-	-	-	-	-	-	-	0.5	0.8

Source: Bloomberg, CEIC, Census and Statistics Department, AMRO staff projections

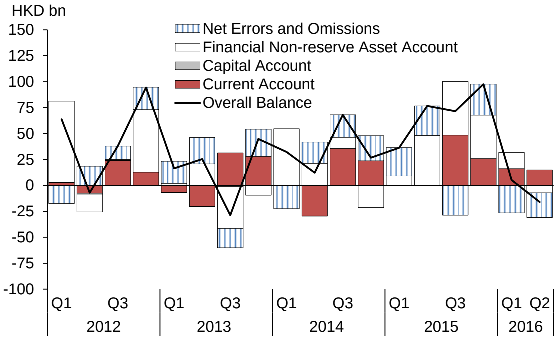
Appendix II. Data Adequacy for Surveillance Purposes: A Preliminary Assessment

Surveillance Areas	Data Availability(i)	Reporting Frequency/Timeliness(ii)	Data Quality(iii)	Consistency(iv)	Others, if Any(v)
National Accounts	Available	Quarterly, within 1.5 months after the end of the reference quarter (for preliminary data).	-	-	-
Balance of Payments (BOP) and External Position	Available	Quarterly, within 3 months after the end of the reference period.	-	-	-
State Budget and Government/ External Debt	Available	Budget: Monthly, within one month after the end of the reference period. External debt: Same as the BOP.	-	-	-
Money Supply and Credit Growth	Available	Money supply: Monthly, within one month after the end of the reference period. Credit growth: Monthly, within one month after the end of the reference period.	-	-	-
Financial Sector Soundness Indicators	Available	Financial Soundness Indicators (FSIs) are available from the IMF website. Quarterly, within 3 months after the end of the reference quarter.	-	-	-
SOE Statistics	-	-	-	-	-

Appendix III. Additional Figures

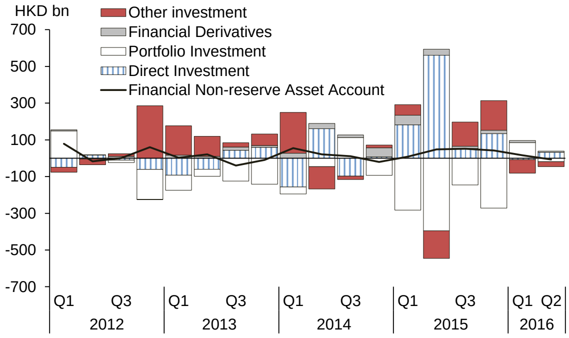
A. External Position

The overall BoP recorded a small deficit in Q2 as the current account surplus marginally shrunk with weak external demand.



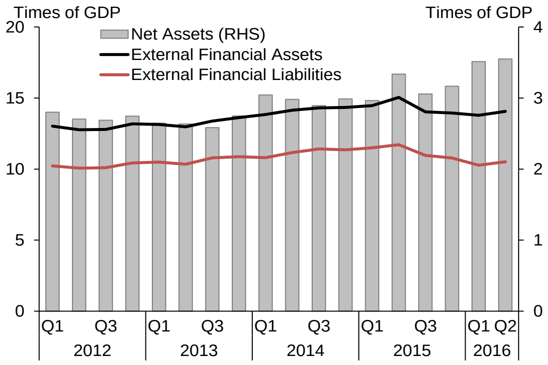
Source: CEIC

The deficit in the financial non-reserve asset account also dragged down the BoP, but the deficit was marginal by historical standards.



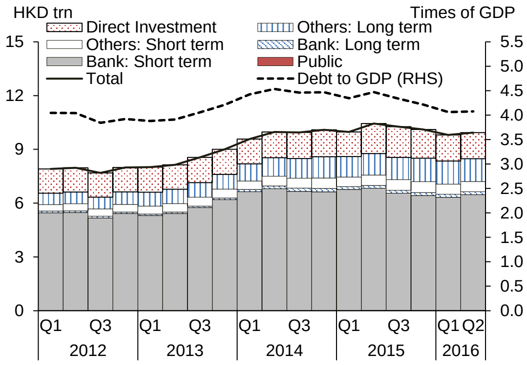
Source: CEIC

The net international investment position remained large at 3.6 times of GDP in Q2.



Source: CEIC

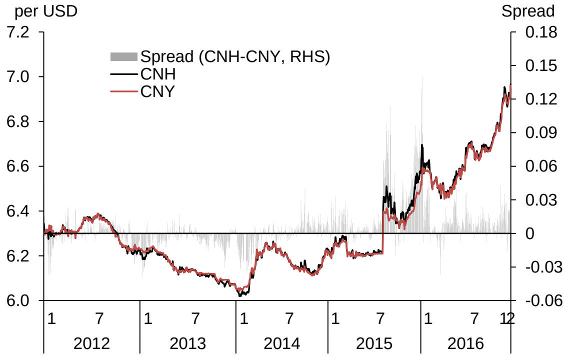
External debt is on a slight downward trend mainly due to moderate banks' short-term funding activities amid lackluster external loan demand.



Source: CEIC

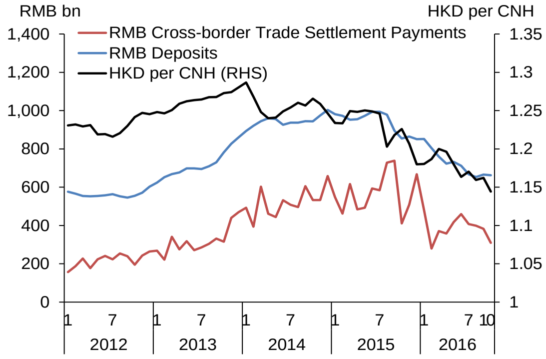
B. Offshore RMB Markets

The CNH discount, which had increased since August 2015, has shrunk, partly due to restricted speculative short positions of the CNH against CNY.



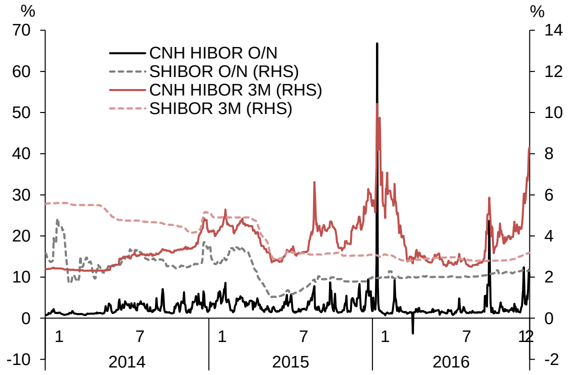
Note: CNH and CNY denote offshore RMB and onshore RMB respectively.
Source: Bloomberg

However, the offshore RMB business faces strong headwinds amid RMB depreciation.



Source: CEIC

In such a sluggish environment, the offshore RMB interbank market liquidity can be affected by the liquidity position adjustments of a few banks.



Source: Bloomberg