

LEGISLATIVE COUNCIL BRIEF

INTERNATIONAL MONETARY FUND 2022 ARTICLE IV CONSULTATION

INTRODUCTION

This note informs Members of the preliminary outcome of the International Monetary Fund (“IMF”)’s 2022 Article IV consultation with the Hong Kong Special Administrative Region.

2022 ARTICLE IV CONSULTATION

2. The 2022 Article IV consultation discussions were held from 1 to 15 December 2021. At the end of the consultation discussions, the IMF Article IV Mission (“Mission”) issued a concluding statement setting out its preliminary observations and views (“the Concluding Statement”, at **Annex**). The Mission is finalising a Staff Report for endorsement by the IMF Executive Board in February 2022.

3. The Concluding Statement presents a comprehensive and objective assessment of Hong Kong’s economic and financial position. The Mission expresses broad support for the Government’s various policies to safeguard financial stability and boost economic growth. It highlights the Government’s swift and bold policy response to shocks, including the pandemic, that contributed to strong economic recovery, identifies risks that could affect medium-term gross domestic product (“GDP”) growth, and provides recommendations on fiscal policy to address structural challenges. The Mission also notes that Hong Kong’s resilient financial system underpinned by robust regulatory and

supervisory frameworks, macroprudential policies which serve as important buffers, and the well-functioning Linked Exchange Rate System (“LERS”) would mitigate future shocks and challenges.

ECONOMIC OUTLOOK

4. The Mission notes that Hong Kong’s economy has not only mitigated the adverse shocks but also recovered strongly, mainly supported by the Government’s swift and bold policy responses including the fiscal stimuli equivalent to 12.25% and 3.5% of GDP in 2020 and 2021, respectively. It also notes that the Consumption Voucher Scheme (“CVS”) rolled out in the second half of 2021 has helped offset the effects from, inter alia, softening external demand in recent months. While the overall rebound has been strong, the Mission comments that the recovery remains uneven with continued stress on tourism and retail sectors, and private consumption is still below its pre-pandemic level. While employment in contact-intensive sectors such as retail services declined further in 2021, the overall unemployment rate has improved significantly from its peak level. On the basis of an expected scaling back of discretionary stimulus measures, a continued recovery in private demand and a gradual border re-opening, the Mission projects a real GDP growth of 6.4% and 3.0% in 2021 and 2022 respectively. The Mission also projects that the negative output gap, i.e. the gap between actual economic output and the economy’s full capacity, would narrow to approximately 1% of potential GDP, with further improvement in labour market conditions. In the medium term, the Mission expects scarring effects from the pandemic on the labour market and potential output.

5. The Mission notes that though the balance of risks is tilted to the downside in the short to medium term, there is upside potential to economic growth. For example, faster-than-expected border re-opening and global economic recovery, as well as the development of the Guangdong-Hong Kong-Macao Greater Bay Area (“GBA”) will contribute positively to Hong Kong’s economy while possible risks include any renewed local outbreaks led by new variants, sustained disruptions to global supply chains, correction in housing market, a disorderly tightening in the monetary policy of major advanced economies, further escalation of

China-US tensions, and a shift of market confidence in Hong Kong's status as a major international financial centre. The Mission also notes that the strong policy buffers and external position, a resilient financial system, and the well-functioning LERS would help mitigate any impact on financial stability and economic growth in Hong Kong.

THE MISSION'S POLICY RECOMMENDATIONS

6. As the recovery gains momentum but uncertainties linger and structural challenges remain, the Mission considers the Government should continue to pursue policies to support balanced and inclusive growth, safeguard financial stability, and capitalise opportunities for a greener economy. The Mission's observations and policy recommendations are summarised in paragraphs 7 to 13 below.

(a) Supporting Balanced and Inclusive Growth

7. As the recovery gains further momentum, the Mission recommends that financial policies should shift towards addressing solvency issues concerning corporates and individuals. It welcomes the authorities' plan to develop an exit strategy from the loan repayment deferral scheme which will expire in April 2022. Noting the robustness of Hong Kong's corporate insolvency framework, the Mission comments that the planned introduction of a statutory corporate rescue procedure is timely.

8. The Mission recommends that Hong Kong's fiscal policy return to a balanced budget while supporting an inclusive growth and addressing structural challenges. A gradual fiscal consolidation is recommended over the medium term to ensure a durable recovery while stabilising the decline in fiscal reserves. To foster balanced and inclusive growth, the Mission suggests that fiscal measures should target the hard-hit groups of low-income households, unemployed workers, and affected small and medium-sized enterprises, notably by leveraging the digitalisation of infrastructure. A few suggested measures are named, including distributing additional electronic consumption vouchers to low-income group, temporarily relaxing the eligibility criteria for the Comprehensive

Social Security Assistance Scheme and introducing a dedicated unemployment benefit system. To address structural challenges brought by an ageing population, high income inequality, and housing supply-demand imbalance, the Mission recommends increasing spending on social services for the affected demographic groups, focusing on education and job training in digital-related technologies, and increasing public housing supply. To meet those long-term fiscal needs, a comprehensive tax reform is suggested to broaden the tax base while maintaining fairness and international competitiveness.

9. To further enhance Hong Kong's competitiveness of the financial sector, bolster Hong Kong's status as a regional trade hub and boost economic growth potential in the long run, the Mission recommends deepening integration with regional and global economies, strengthening coordination among regulators in Hong Kong, Macao and the Mainland on the development of the GBA, and implementing digitalisation initiatives including the Smart City Blueprint and the "Fintech 2025" strategy.

(b) Safeguarding Financial Stability

10. The Mission recognises that the deepening of financial linkages with the Mainland creates both opportunities and challenges. The opportunities include the recent launch of the Wealth Management Connect Scheme in the GBA and the Southbound Bond Connect Scheme, as well as collaboration with the People's Bank of China on the Multiple Central Bank Digital Currency project. With respect to challenges associated with Hong Kong's financial ties with the Mainland, the Mission recommends enhancement of systemic risk monitoring including banks' exposures to Mainland borrowers, particularly those of the real estate sector with low credit ratings, liquidity positions of foreign bank branches, investment funds' liquidity, and compliance issues with respect to cross-border digital payments. The Mission notes that preserving the rule of law, improving the already strong regulatory framework and maintaining free flow of capital are key to safeguarding financial stability and strengthening competitiveness. The Mission also recognises that the LERS remains as an anchor for economic and financial stability.

11. The Mission supports the Government's three-pronged approach

to containing housing market risks and increasing housing affordability, which include macroprudential measures, demand-side management measures and increase in housing supply. The Mission comments that the current macroprudential measures for property market should be maintained to safeguard financial stability and the demand-side management measures have been effective in containing speculative activity and external demand. The Mission also welcomes the Government's stepped-up efforts to raise and expedite housing supply, including the multi-faceted approach to providing additional public housing units in the next ten years and the recently announced Northern Metropolis Development Strategy.

12. The Mission welcomes the authorities' ongoing efforts to strengthen the regulatory and supervisory framework, including improved data collection and monitoring of over-the-counter trades. It recommends further steps to enhance macroprudential oversight by adopting a more comprehensive and systematic approach to identifying and addressing systemic risk. On fintech, the Mission recommends strengthening of operational resilience and cyber security, close coordination among regulators, and continuous reviews of the regulatory perimeter of non-bank fintech firms.

(c) Seizing Opportunities for a Greener Economy

13. The Mission recognises that Hong Kong has made significant progress in addressing climate change in the past decade. It welcomes the recently announced plan to achieve carbon neutrality before 2050 with an intermediate target to halve the 2005 level of carbon emissions before 2035, and recommends that the Government consider introducing additional carbon pricing mechanisms to complement ongoing efforts. The Mission also welcomes the authorities' efforts in enhancing systemic risk analysis on climate-related issues, adopting mandatory financial disclosures by 2025, and promoting climate-focused scenarios analysis by financial institutions. Noting various ongoing efforts in enhancing the green and sustainable finance ecosystem, the Mission encourages the authorities to play a key role in mobilising private sector investment for green development, as well as in seizing the opportunities from enhanced regional and international collaboration.

THE GOVERNMENT'S ASSESSMENT

14. Overall speaking, we broadly agree with the Mission's observation that the economy has recovered strongly. The CVS has provided effective support to entrench the revival of the consumption-related sectors, particularly the retail and catering sectors. Attaining a broader based recovery needs to be supported by resumption of travel between Hong Kong and the rest of the world, especially the Mainland in a gradual and orderly manner. Regarding the potential scarring effects from the pandemic, the Government will continue to promote the development of innovation and technology, allocate substantial resources to education and training, and continue to endeavour to attract talents from all over the world, with a view to enhancing the competitiveness and productivity of our workforce.

15. We welcome the Mission's assessment that the development of the GBA would generate huge business opportunities and provide the best entry point for Hong Kong to integrate into the national development, thereby benefiting our medium- and long-term growth prospects. We also agree that our strong buffers, a resilient financial system, and the well-functioning of LERS would mitigate the downside risks identified by the Mission.

16. Our views on individual comments made by the Mission are as follows –

- (a) on fiscal policy, we welcome the Mission's comment on our swift and bold fiscal measures that have helped the strong recovery of the economy, supporting businesses and safeguarding jobs. The Government will continue to exercise fiscal prudence and incur expenditures as necessary when considering different measures to provide relief and necessary support to the public, and at the same time retain fiscal strength to cope with known and unknown situations and needs;
- (b) on tax reform, we will maintain our simple and low tax system to provide a facilitating environment for business

growth and workforce participation. To increase revenue, we have raised the rate of Stamp Duty on Stock Transfers from 0.1% to 0.13% with effect from 1 August 2021. As fighting the epidemic and reviving the economy are our current priorities, this is not the time to introduce new taxes. Nevertheless, we will carry out related research and make preparation to facilitate in-depth discussions at a suitable time and forge consensus before we introduce new taxes to increase revenue;

- (c) on Mainland-related opportunities and challenges, we welcome the Mission's assessment that our linkages to the Mainland creates opportunities and contributes to Hong Kong's economic growth. As regards the Mission's comment about the banking sector's credit exposure to the Mainland's real estate sector, in general banks' Mainland-related lending has all along been a supervisory focus of the Hong Kong Monetary Authority ("HKMA"). With respect to the Mainland property sector, the HKMA has stepped up monitoring of banks' exposures through rigorous data collection and analysis, close communications with banks, detailed review of banks' portfolios, and dedicated stress tests. Overall, the banking sector's exposures to highly leveraged Mainland developers remain manageable, and we observe no concentration of exposures among banks;
- (d) on property market, we welcome the Mission's support for the three-pronged approach to containing housing market risks. We agree that the current macroprudential stance should be maintained and should only be adjusted having regard to the evolving property market cycle. To increase land and housing supply, the Government has identified about 350 hectares of land to produce some 330 000 public housing units for the coming ten-year period from 2022-23 to 2031-32 that will meet the demand for about 301 000 public housing units;
- (e) on financial sector, we welcome the Mission's assessment

that banking supervision and regulation remain strong and the regulatory initiatives have kept pace with changes in the banking sector and technological advancements. We also share the Mission's observation that Hong Kong's financial sector has continued expanding robustly even during the pandemic, and welcome its reaffirmation of Hong Kong's position as a major international financial centre. To this end, we will continue to work closely with financial regulators to provide an enabling regulatory environment, formulate policy measures to facilitate an innovative Fintech ecosystem, nurture talent, and promote our strengths in the Mainland and overseas to attract more financial firms and talents to come to Hong Kong;

- (f) on green economy, we welcome the Mission's recognition that Hong Kong has made significant progress over the last decade to address climate change. We will continue to work towards carbon neutrality target before 2050. To promote the development of green and sustainable finance, we are working in concert with the financial regulators and the industry on a multi-pronged strategy. In addition to leveraging the Government Green Bond Programme and the Green and Sustainable Finance Grant Scheme to promote Hong Kong as the leading centre for green financing, we will also capitalise on the opportunities from the Mainland and strengthen regional and international collaboration on green development front, including carbon trading. To this end, we will support the Hong Kong Exchanges and Clearing Limited to promote cooperation with the Guangzhou Futures Exchange in relation to carbon market development. We also appreciate the Mission's recognition of our efforts to address climate-related risks, including mandatory climate-related financial disclosures that is aligned with the Task Force on Climate-related Financial Disclosures by 2025 and promoting climate-focused scenario analysis by financial institutions; and
- (g) on setting up a dedicated unemployment benefit system, we

note that the Mission has made reference to the practice of many economies which utilise their social insurance system for unemployment benefits. The first line of Hong Kong's unemployment benefit system relies on severance or long service payments, the level of which is on par with those paid by many other economies under a social insurance system. To enhance the system, our current priority is to abolish the practice of using the accrued benefits of employers' mandatory contributions under the Mandatory Provident Fund Scheme to "offset" such payments. Revamping our unemployment benefit system or the severance payment or long service payment system will complicate our work in abolishing the "offsetting" mechanism.

PUBLICITY

17. We will issue a press release, along with the publication of the Concluding Statement by the IMF, on 20 January 2022.

BACKGROUND

18. In accordance with Article IV of the IMF Articles of Agreement, members of the IMF and their territories are required to provide the IMF with information necessary for the IMF's surveillance of their exchange rate policies and their compliance with the general obligations regarding exchange arrangements. The general obligations include, inter alia, the endeavour to direct economic and financial policies towards the objective of fostering orderly growth, price stability as well as stable economic and financial conditions. The IMF may also request Article IV consultation with its members and their territories.

19. Since Hong Kong is not a member of the IMF, the consultation on Hong Kong forms part of the IMF's consultation with the People's Republic of China. The consultation and the presentation to the IMF Executive Board of the Staff Report on Hong Kong are undertaken separately from those on the Mainland, consistent with Hong Kong's

financial and monetary autonomy.

ENQUIRIES

20. For enquiries, please contact Mr Justin To, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services), at 2810 2067.

Financial Services and the Treasury Bureau
20 January 2022



**People's Republic of China—Hong Kong Special Administrative Region:
Staff Concluding Statement of the 2022 Article IV Consultation Discussions**

December 15, 2021

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or ‘mission’). Missions are undertaken as part of regular (usually annual) consultations under [Article IV](#) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

The Hong Kong SAR economy is recovering strongly as ample policy space has allowed swift and bold policy responses to the unprecedented crisis resulting from multiple shocks, including the pandemic. But the recovery remains uneven, with private consumption lagging, owing, in part, to a zero-COVID tolerance approach. The financial sector has remained resilient supported by significant buffers, strong institutional frameworks, and a well-functioning Linked Exchange Rate System (LERS). Securing a balanced recovery and maintaining the Hong Kong SAR's competitiveness as an international financial center requires a policy strategy aimed at promoting inclusive growth, safeguarding financial stability, and containing climate-related risks.

FROM STRONG RECOVERY TO SUSTAINABLE GROWTH

- 1. The economy has recovered strongly supported by swift and bold policy responses.** Hong Kong SAR has faced multiple domestic and external shocks since 2019, including social unrest, U.S.-China tensions, and the pandemic, which resulted in the economy contracting for two consecutive years. Strong and swift policy actions, notably a large fiscal stimulus amounting to about 12¼ and 3½ percent of GDP in 2020 and 2021, respectively, have helped mitigate the impact of the adverse shocks and enable a gradual recovery. Tentative signs of a handoff from public to private demand have emerged in 2021Q2-Q3, with a recovery in private consumption and investment offsetting the drag on growth from fiscal withdrawal and a softening of external demand.
- 2. The recovery remains uneven with continued stress on tourism and contact-intensive activities owing to a zero-COVID tolerance approach.** Private consumption is lagging other GDP components and remains below its pre-pandemic level. This, in turn, reflects the significant decline in household income and the uneven recovery in the labor market, as employment in some contact-intensive sectors (e.g., retail services) declined further in 2021

despite a sharp decline of the overall unemployment rate from a peak of 7.2 percent in the three-month period ending in February 2021 to 4.3 percent in October.

3. Real GDP is projected to grow by 6.4 and 3.0 percent in 2021 and 2022, respectively.

Against the backdrop of a continued recovery in private demand, the growth projection anticipates a moderate slowdown in fiscal consolidation in 2022 on the continued scaling back of the discretionary stimulus measures. Border re-opening is expected to be gradual throughout 2022, beginning with a limited opening to Mainland China. The negative output gap is expected to narrow to about 1 percent of potential GDP and CPI inflation is projected to gradually rise to about 2 percent in 2022 in line with improving labor market conditions. Over the medium term, the pandemic is expected to have scarring effects on potential output. This would arise largely from the uneven recovery in the labor market and its impact on labor participation, offset, in part, by increasing digitalization and the attendant impact this would have on the reallocation of factors of production and labor productivity. The medium-term growth rates of potential GDP is expected to slow to below 3 percent due to structural headwinds such as population aging.

4. The balance of risks is tilted to the downside, but ample policy buffers and the strong external position should help mitigate any adverse impact on financial stability and economic growth.

- *Downside.* Pandemic related uncertainty, including renewed local outbreaks led possibly by new variants, could lead to a slower resumption in the *flow of people*, further weakening the recovery in private consumption. A slower-than-expected global recovery, sustained disruptions to global supply chains, as well as de-globalization and decoupling could reduce the *flow of goods* and derail the recovery. A sharp rise in global risk premia, a disorderly tightening in the monetary policy of major advanced economies, large housing market corrections, escalating U.S.-China tensions, and a shift of market confidence in Hong Kong SAR's status as a major international financial center could affect the *flow of capital*.

- *Upside.* Faster-than-expected border re-opening could lead to a stronger recovery in private consumption. A faster-than-expected global recovery could contribute to stronger export growth than currently envisaged. The development of the Greater Bay Area (GBA) could further improve medium- and long-term growth prospects.

5. Climate change also poses challenges to growth and financial stability. If global efforts to reduce carbon emissions fall short of envisaged benchmarks, climate-related risk could intensify and have significant adverse effects on both financial institutions and corporates. Banks with large exposures to fossil energy, heavy industry, and transportation sectors are most vulnerable during the transition towards a low-carbon economy.

SUPPORTING BALANCED AND INCLUSIVE GROWTH

A. Adjusting Macroeconomic Policy to the Pace of the Recovery

6. As the recovery gains further momentum, financial policies should shift towards addressing solvency issues concerning corporates and individuals. The authorities' plan to engage with banks to develop an exit strategy from the loan repayment deferral scheme, which will expire at end-April 2022, is welcome. Leveraging on Hong Kong SAR's robust corporate insolvency framework, financial policies should facilitate the efficient restructuring of viable

firms while allowing nonviable firms to exit. In this context, the planned introduction of a statutory corporate rescue procedure in line with international best practice is timely. The cut in the countercyclical capital buffer (CCyB) during the pandemic was appropriate since it encouraged bank lending and supported the recovery. The HKMA should, however, stand ready to adjust the CCyB to the level that is consistent with updated assessments of systemic risk.

7. Fiscal policy should continue to support the recovery by returning to a balanced budget, albeit at a gradual pace and after recovery is firmly entrenched. The pace of fiscal consolidation in 2022 should remain gradual, with the cyclically adjusted primary balance tightening by about 1½ percent of potential GDP to help enable the handoff to private demand. A gradual consolidation over the medium term, at about ½ percent of GDP per year from around 2023 after durable recovery is entrenched, would help protect the recovery and stabilize the decline in fiscal reserves.

8. Fiscal policy should focus on more targeted support to foster balanced and inclusive growth, while its role as an automatic stabilizer could be strengthened over the medium term.

- *In the near term*, fiscal measures should be more targeted to support low-income households, unemployed workers, and affected SMEs, notably by leveraging the digitalization of infrastructure that would allow more effective identification and delivery of support to the most vulnerable. For example, additional electronic consumption vouchers could be distributed to low-income households that meet the assistance criteria. The eligibility criteria for the Comprehensive Social Security Assistance Scheme could be temporarily relaxed again to provide more help to the unemployed.

- *Over the medium term*, the introduction of a dedicated unemployment benefit system could be considered to expand automatic stabilizers and better protect the labor force against idiosyncratic and systemic shocks.

9. Fiscal policy should also address structural challenges of population aging, high income inequality, and insufficient public housing supply to promote inclusive growth.

- *Social welfare and healthcare.* As Hong Kong SAR's population is aging rapidly, spending pressure is expected to increase further to address gaps in social safety nets and medical services. There is room to strengthen the provision of medical services and financial assistance for the elderly population, notably among low-income households.

- *Education and training.* Upgrading human capital through education and job training, with a focus on digital-related technologies, would mitigate the scarring effects of the pandemic and facilitate the sectoral reallocation of labor in the transition to a digitalized economy.

- *Public housing.* Stepping up expenditure to increase public housing and related infrastructure investment would be critical in addressing the large housing supply-demand imbalance, improving housing affordability, and reducing poverty and inequality.

10. To address long-term fiscal needs, build buffers, and secure greater equity, a comprehensive tax reform over the medium term remains imperative. Given the projected increase in spending pressures to address rapid population aging and still maintain fiscal sustainability, the government should consider a comprehensive tax reform to broaden the tax

base while maintaining fairness and international competitiveness. International benchmarking suggests that there is room to introduce a VAT, raise excise taxes, and increase the progressivity of the personal income tax by raising the tax rates on top brackets. Considerations could also be given to introducing taxes on capital gains and dividends.

B. Strengthening Productivity and Competitiveness

11. Further integration with regional and global economies will strengthen Hong Kong SAR's status as a regional trade hub and boost growth potential in the long run. Hong Kong SAR is considering participation in the Regional Comprehensive Economic Partnership (RCEP), whose current members account for more than 70 percent of Hong Kong SAR's total trade. In the development of the GBA, the coordination among regulators in Mainland China and Hong Kong and Macao SARs could be strengthened by taking into account the differences in legal, regulatory, and institutional frameworks.

12. Accelerated digitalization could enhance the competitiveness of financial services and promote the transformation toward a post-pandemic "new normal." The digitalization initiatives, including the Smart City Blueprint and "Fintech 2025", should be implemented with a focus on facilitating the sectoral reallocation of resources towards digitalized services and promoting financial inclusion, especially for low-income groups, the elderly, and SMEs.

SAFEGUARDING FINANCIAL STABILITY

13. The financial system remains resilient supported by significant policy buffers, a strong external position, and strong institutional frameworks. Hong Kong SAR's financial system has continued expanding robustly even during the pandemic while maintaining its role as a major international financial center.

A. Opportunities and Challenges from Rising Ties with Mainland China

14. Financial linkages with Mainland China have deepened, creating both opportunities and challenges for Hong Kong SAR as a key financial gateway for Mainland China. This includes the recent launch of the cross-boundary Wealth Management Connect Scheme in the GBA and the Southbound Bond Connect Scheme. The HKMA has also been collaborating with the People's Bank of China, among others, for potential use of a wholesale CBDC for cross-border payments (*Multiple CBDC Bridge project*) and has tested the cross-border retail use of the e-CNY in Hong Kong SAR. The e-CNY could potentially reduce the costs and increase the speed of cross-border transactions for residents or corporates, and further strengthen the financial integration between the two economies, but potential risks such as compliance with regulations in both jurisdictions should be carefully studied before a large-scale adoption.

15. The authorities should continue to strengthen systemic risk analysis of Mainland China-related credit risks. The nonperforming loan (NPL) ratio from Mainland-related lending remains low at 0.8 percent as of June 2021, even below Hong Kong SAR banks' overall NPL ratio of 0.9 percent. However, against the backdrop of recent financial stress in several Mainland's property developers, the credit exposure of Hong Kong SAR banks to Mainland China's real estate sector should be closely monitored and analyzed as recommended by the FSAP. The authorities should also continue to ensure that the internal credit risk models used by Hong Kong SAR banks to determine the capital charges for exposures to Mainland Chinese

borrowers, particularly those in the real estate sector with low credit ratings, are sufficiently forward-looking. Continued close monitoring of banks' significant exposures to non-bank Mainland Chinese entities and a periodic stress test of banks' large exposures—on top of the regular stress testing—would also help.

B. Strengthening Resilience to Global Risk Sentiment

16. The free flow of capital should be maintained to safeguard financial stability of both Hong Kong SAR and regional and global economies. The authorities should continue to preserve the rule of law and strengthen the high-quality regulatory framework to preserve the solid foundation for Hong Kong SAR's financial stability and competitiveness and to maintain the free flow of capital. At the same time, the authorities should also closely monitor financial markets and the banking sector for potential disruptions and be ready to take actions to contain systemic risk, if necessary, with clear and careful communication.

17. Some liquidity risks of banks and investment funds deserve closer monitoring. The banking sector is resilient to liquidity stress test as noted by the FSAP, and further steps can be taken to integrate all bank liquidity stress tests into a single framework to enhance monitoring of liquidity position of more vulnerable segments such as those foreign bank branches which rely on unsecured interbank funding. The monitoring and stress testing of investment funds' liquidity could also be integrated into the supervisory framework.

18. The LERS remains the appropriate arrangement as an anchor for economic and financial stability. The credibility of the currency board arrangement has been ensured by a transparent set of rules governing the arrangement, ample fiscal and FX buffers, strong financial regulation and supervision, the flexible economy, and a prudent fiscal framework.

C. Containing Housing Market Risks

19. The three-pronged approach to increasing housing affordability and containing housing market risks remains valid, but more efforts are needed to raise housing supply.

- *Increasing housing supply is critical to resolve the structural supply-demand imbalance.* Housing production has increased on average since 2015 but has still fallen short of target by about 30 percent on average. Staff welcomes the identification of the land to provide 330,000 public housing units within the next ten years and urges the authorities to bring the actual production back to the target without further delays. To increase housing supply, a comprehensive approach is urgently needed, including increasing land supply for housing production (e.g., land resumption, reclamation, and rezoning), while expediting and streamlining the process for land identification and production. The recently announced Northern Metropolis development strategy could help boost housing supply over the longer-term period.

- *The macroprudential stance for property markets should be maintained to safeguard financial stability.* Given resilient house prices and mortgage growth, the existing residential property market-related macroprudential policies should be kept unchanged for now, and any changes should be data-dependent with due attention to the emerging risk of regulatory leakages. The Council of Financial Regulators should take a lead in strengthening the regular surveillance and data collection on lending by non-bank lenders (e.g., property developers and non-bank

financial institutions), and the authorities should regularly reassess the need to expand the regulatory perimeter to mitigate the leakages in macroprudential policies.

- *Stamp duties have been effective in containing speculative activity and external demand.* However, staff recommends phasing out the New Residential Stamp Duty, a residency-based capital flow management measure and a macroprudential measure (CFM/MPM) levied at a higher rate on non-residents than on first-time resident home buyers, once systemic risks from the non-resident inflow dissipate.

D. Further Enhancing Regulatory and Supervisory Frameworks

20. The ongoing efforts to further strengthen the regulatory and supervisory frameworks are welcome. Banking supervision and regulation remain strong, and the regulatory initiatives have kept pace with changes in the banking sector and technological advancements. Staff welcomes the authorities' early implementation of FSAP recommendations, including efforts to strengthen monitoring of over-the-counter trades. The authorities have improved data collection through the Granular Data Reporting, and further steps should be taken to enhance macroprudential oversight, including by adopting a more comprehensive and systematic approach to identify and address systemic risk.

21. A consistent and cross-sectoral supervisory and regulatory framework is critical to effectively address industry-wide fintech-related issues. The operational resilience and cyber security of the financial sector should be strengthened in tandem with the development in fintech. Close coordination among regulators is also essential to achieve a more holistic activity-based approach consistent across sectors, especially in the areas of cyber and IT-related risks, RegTech adoption, and use of artificial intelligence. Continued review of the regulatory perimeter of non-bank fintech firms is also warranted, and the trading of virtual assets should also be closely monitored to identify and mitigate risks associated with virtual assets, including those from fraud and money laundering/financing of terrorism.

SEIZING OPPORTUNITIES FOR A GREENER ECONOMY

22. Hong Kong SAR has made a significant progress over the last decade to address climate change. The recently announced updated action plan to achieve carbon neutrality before 2050, with an ambitious intermediate target of reducing carbon emissions by 50 percent from the 2005 level before 2035, is welcome. To complement ongoing efforts, the government could consider introducing additional carbon pricing mechanisms to incentivize energy saving and green transportation while providing supports for low-income households to alleviate their burden.

23. Climate-related risks should be carefully monitored and assessed by strengthening systemic risk analysis. It is important to ensure that climate-related risks are adequately embedded in financial institutions' risk management and the authorities' systemic risk analysis. To this end, staff welcomes the authorities' efforts to address these risks, including enhancing their systemic risk analysis on climate-related issues, adopting mandatory climate-related financial disclosures aligned with the Task Force on Climate-related Financial Disclosures by 2025 and promoting climate-focused scenario analysis by financial institutions.

24. Hong Kong SAR should play a key role in global efforts to mobilize private sector investment for green development by enhancing the green and sustainable finance ecosystem. The ongoing efforts, including adopting forthcoming internationally accepted standards, subsidizing the eligible green and sustainable bond issuers and borrowers, and scaling up the government green bond issuance, could help develop Hong Kong SAR into a green and sustainable finance center. Capitalizing on the opportunities from Mainland China and strengthening regional and international collaboration would also help maintain Hong Kong SAR's status as a major international financial center.

In closing, the mission would like to thank the Hong Kong SAR authorities for their open and productive discussions and organizational support throughout the virtual visit.