China, P.R.: Hong Kong

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS Nov. 30, 2015

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Hong Kong's economy is feeling the brunt of the Mainland slowdown but also the end of its homegrown decade long property bubble. However, most observers regard both the government and the banks as strong enough to meet these challenges without facing major problems.

Summary and conclusions

Moderate slowdown. In 2015, growth is likely to weaken further to only 2,3% responding to negative impulses from external trade, the government budget and the cooling of the property market. These are temporary trends, however, and will soon yield to rising productivity lifting the growth rate closer to its long term potential around 3% a year.

Strong external and internal balances: In 2015, the current account surplus will remain solid at 2% of GDP, but is projected to rise to 3% of GDP in 2016 more in line with historical averages. That will help the monetary authorities build reserves further from its present level of 6 months of import cover. The budget will likewise over-perform to show a surplus of the same magnitude to raise government reserves to 36% of GDP providing continued assurance of the sovereigns' capacity to defend both itself and the nation's financial system against shocks.

Risks are looming but unlikely to prove overwhelming: The risks in a medium term scenario are mostly related to external factors, in particular developments in China. While not the main scenario of many observers, a hard landing in that country would have the potential to seriously affect the economy of Hong Kong and its banking sector due to extensive trade and financial inter-links. Growth in Hong Kong could be dented to the tune of a few percentage points. However, barring any worse case scenario combined with adverse political developments in the Mainland, such a shock should not necessarily be much worse than the crisis with external origins which Hong Kong has experience and survived in the past.

Other but less significant risks include disruptive domestic political events or a more rapid than expected US tightening of monetary policies with ramifications for highly domestic borrowers among households and corporates. We still believe that healthy financial and economic balances and above all a record of confidence building with international investors are likely to mitigate the impact of any of the above mentioned risk scenarios.

Unchanged ratings: Over the recent 12 months period all sovereign ratings have remained stable. For the time being we find this applying to country risk as well.

Recent economic developments

Growth undershoots expectations: In the first half of the current year, the economy expanded at a rate of 2,5%, year-on-year (yoy) about the same as in the year before. This growth -- clearly below expectations – was led by investments and private consumption while the government sector and net exports exerted drags. These developments are likely to intensify in the second half of the year as judged by the continued weakness of the purchasing managers' index (PMI) on falling output and orders. Declining retails sales add to the bleaker picture related in part to stagnating inflows of tourists from the Mainland. The latter should remain buoyed by a still strong labour market with unemployment at a 3,3% and growing purchasing powers for households as CPI inflation subsides to 2,5% yoy. As a result growth should reach around 2,3% for the current year, almost 0,5pp lower than the average of the four preceding years.

External balances remain strong: Despite softer external demand in particular but not exclusively from the Mainland, the trade balance ended in a greater surplus as lower oil prices reduced the import bill. That also helped offset diminishing revenues from slowing tourist arrivals from the Mainland, which now account for four out of five visitors, in part due to capacity problems in Hong Kong and discontent among locals over "visitor invasion". All counted, the current account in 2015 is still likely to stage a surplus of around 2% of GDP, slightly higher than last year. The enormous size of external trade – exports + imports stand at more than 3 times nominal GDP – is much related to transit trade with limited impact on the domestic economy.

Capital flows have continued to benefit from growing links with the Mainland including through the Qualified Domestic Intuitional Investor scheme and the Shanghai-Hong Kong Stock Connect. They have contributed to lifting gross mainland exposure to $854bn as of last March. Last year, the net international investment position (NIIP) also reached an exceptionally strong level of 283%/GDP. That is including foreign exchange reserves of $334bn as of last September equivalent to 6 months import coverage but about twice as much when stripping out transit trade. However, these funds are dwarfed by gross external debt at more than one trillion US dollars of which about a half is on short terms. They reflect Hong Kong's role as an international finance centre with large assets and matching liabilities and supported by a track record of strong macro policies to bolster investor confidence. In addition, the Hong Kong Monetary Authority (HKMA) – de facto central bank – has an extensive swap-arrangement with the Peoples Bank of China (PBoC) to support liquidity in the offshore RMB market.

Fiscal position as strong as ever: The fiscal year ending March 2015 (FY2015) showed a budget surplus of 3,6%/GDP as usual a couple of percentage points better than first projected. For FY2016, the surplus is budgeted at 1,6% of GFDP but indications already signals it may end even stronger. The accumulation of significant surpluses since the early 2000s has raised government reserves to 36%/GDP more than seven times larger than government debt at 5%/GDP which has been issued primarily to support monetary policy operations of the HKMA. These reserves are kept with the HKMA which in return has placed them in foreign exchange a potential restraint on the central bank's freedom to utilize all of its foreign reserves. In addition to maintaining prudent fiscal policies the government is also led by the objective to keep total government expenditure within 20%/GDP.

Foreign exchange and monetary policies: With the HK dollar's undisturbed peg to the US dollar since 1983, domestic interest rates follow the US rates closely giving HKMA little freedom to guide domestic credit conditions with conventional monetary levers. In recent years, this has boosted credit demand more than desirable as interest rates sank in line with rates in the US, a country with a weaker economy since the global financial crisis in 2008-09.

In return, the HKMA has acted by adjusting prudential standards including lowering banks' loan to value ratios to 55% and capping households' debt service to income ratio at 35%. This has now reduced growth of mortgage lending to 9% annualized, still ahead of nominal GDP growth but a significant climb down from the hefty days few years back when credit growth leapfrogged at high double digit growth rates. This has begun to cool the property market after years of overheating.

Banks remain healthy and well regulated: With assets and liabilities about 8 times greater than GDP, the banking system may look overstretched, but observers emphasize steady and strong profitability including high capitalization as well as a solid supervisory regime under central bank oversight. Household debt has reached 66%/GDP, up from 50% 8 years ago, still comparable to peers though. In contrast, total private sector debt stands at more than 200%/GDP of which corporate lending make up a good two thirds.

Financial sector foreign exposure dominated by China: By the end of 2013, claims of the financial sector on China had reached 160% of GDP, or 17% of total assets of which 120%/GDP were claims on banks. This may seem like an unduly high concentration risk but there are mitigating factors including the high share accounted for by foreign bank branches at 43% with ultimate credit risk likely to be borne by head offices in an emergency. Also, more than half of the Mainland exposure is collateralized although that comes with a qualification that bankruptcy procedures are largely untested in China. It may also be noted that in recent years many HK banks have found easy funding in RMB, largely as short term deposits from Mainland companies and individuals. That could pose a risk should the flows dry up including for regulatory reasons in the Mainland. This risk, however, has now been much reduced as the Renminbi are included in the SDR basket, a longstanding goal of the Beijing government. This will tie the hands of the PBoC in terms of following norms accepted by international capital markets.

Political developments

Since the massive anti-government demonstrations in downtown Hong Kong ebbed in late 2014, calm has prevailed in domestic politics. However, the situation is still fluid and it is premature to conclude that tension has gone away. At recent local elections the pro-Beijing parties held on to 70% of the seats, but the pan-democratic front experienced a shift from the traditional Democratic Party to the more radical New Democratic Party. Also, the respect for the ruling polity may not have much improved. A recent anti-corruption case – not instigated by Beijing – reflects poorer results from neutral parties such as Transparency International whose surveys have shown Hong Kong's rank dropping on the Corruption Perception index from 12th to 17th out of some 150 countries. Many observers believe political calm will prevail till next general elections in 2017 of the Hong Kong CEO. The external rating agencies do not warn of major political threats to their present sovereign risk outlooks..

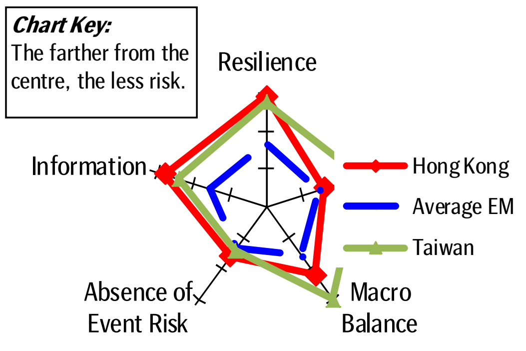
Outlook

The near terms outlook for Hong Kong looks reasonably good. After a disappointing growth rate of only 2,3% in 2015, activity is expected to quicken to almost 3% growth in 2016 and remain at that level or higher for the rest of the decade barring any major disturbances of external or internal origin. All macro variables are likely to follow in the tracks of Hong Kong's recent past with solid budget and current account surpluses. From a pure macro perspective including a proven record of economic adjustability and strong underlying competitiveness over several decades, Hong Kong ranks among the best performers in an international comparison hardly much behind triple A-rated Singapore.

In a medium term horizon, by contrast, creditworthiness of both the sovereign and even more so of the country is to some extent affected by external risk in particular related to China. A steep downturn in that country – a hard landing -- would likely have a significant impact also on Hong Kong due to its large exposure to the Mainland in terms of trade -- 57% of exports -- and financial links. (Conf Box 1) In contrast, a hard landing in Japan would likely have a smaller effect as trade accounts for only 4% even though financial links could be more significant. A steeper than expected hiking of interest rates in the US would affect over-borrowed Hong Kong households and domestic companies through interest parity but unlikely enough to threaten the stability of the banking system. These risks are much offset by decades of proven resilience against shocks, including the Asian crisis in 1997 and the GFC in 2008-9. That is as long as political calm and security prevails both domestically and in the region.

Hong Kong: Risk Profile

Key Figures	2015
Population (millions)	7.3
GDP/capita ($1000)	42.7
Real GDP (% chg)	2.3
Inflation (%)	2.5
Curr.Acc. Balance (% of GDP)	2.0
Reserves/imports (months)	7.0
Budget balance (% of GDP)	3.2
Government debt (% of GDP)	0.1

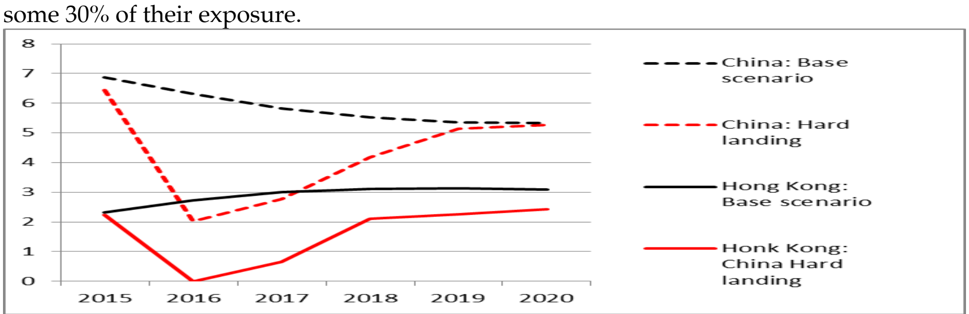


External Ratings:
Fitch: AA+ / Stable
Moody's: Aa1/ Stable
S&P: AAA / Stable

Peers:
Chile
Japan
Taiwan

Graph: The pentagon shows the profile of Hong Kong as typically "slim", i.e., strong on resilience and information, but only average on event risk, albeit stronger than Taiwan.

Box 1. A hard landing in China has major ramifications for Hong Kong: A hard landing in China starting in 2016 as developers arrest further growth in output slows the Mainland economy to an average of 3% annual expansion in 2016-2018 (3pp below the baseline) after which trend rises to slightly more than 5% a year. For Hong Kong this means an almost equally strong deceleration of growth by about 2-3 pp in 2016-17 bringing the country to the verge of recession before growth resumes to 2,4% at the end of the decade. The channel of this effect is primarily deterioration of Hong Kong's visible trade and service balances and to some extent weaker credit extension from domestic banks scarred in part by rapid accumulation of bad debt in Mainland banks representing some 30% of their exposure.



Scenarios run on Oxford Economics global model

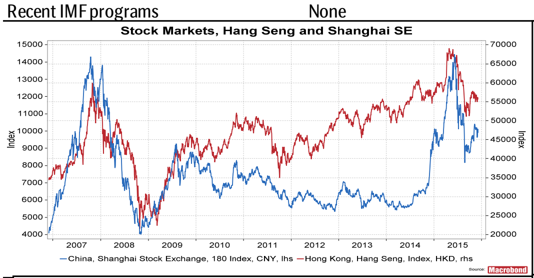
Hong Kong: Economic Indicators

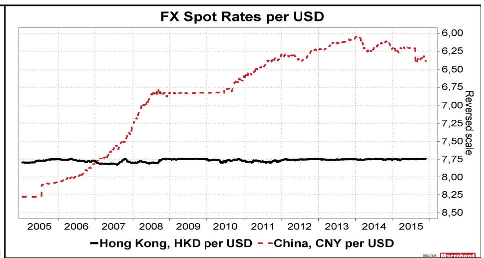
Macroeconomic	2012	2013	2014	2015	2016	2017	2018
GDP real (% chg)	1.7	3.1	2.5	2.3	2.7	3.0	3.1
GDP (bn US$)	263	276	291	311	328	347	367
GDP/capita (US$)	36 936	38 439	40 200	42 691	44 562	46 832	49 258
Investments/GDP (%)	25	24	23	22	21	21	20
Trade/GDP (%)	364	377	367	327	310	312	319
Money & Prices							
CPI inflation (%)	4.7	4.0	3.5	2.5	2.1	2.2	2.2
Money, M2 (% chg)	10.6	11.6	12.2	7.2	5.2	6.5	6.2
Interest rates (%)	0.4	0.4	0.4	0.4	0.5	1.2	2.0
Stock prices (% chg)	-4.4	10.4	2.7	4.5	-5.0	8.7	5.9
Exch. Rate (US$)	7.8	7.8	7.8	7.8	7.8	7.8	7.8
Government Finances							
Budget balance/GDP (%)	1.6	1.6	1.8	3.2	2.2	1.5	1.5
Govt debt/GDP (%)	0.5	0.5	0.3	0.1	0.1	0.1	0.1
Balance of Payments (US$ bn)							
Current account	4.1	4.2	5.4	6.2	13.4	13.6	14.3
(% of GDP)	1.6	1.5	1.9	2.0	4.1	3.9	3.9
Export of goods	468	506	519	500	499	531	573
Imports of goods	487	534	549	518	518	553	598
Other current acct flows	23	32	36	24	33	36	39
Net FDI	-13.2	-6.5	-39.4	94.7	67.1	66.6	67.0
Debt service requirement	723	723	723	723	723	723	723
Net other capital flows	-714	-677	-673	-800	-800	-786	-785
Chg in intl reserves		44	16	24	3	18	19
External Debt & Liquidity (US$ bn)							
Reserves	219	263	278	302	305	323	342
Gross external debt (% of GDP)	261	287	333	327	332	365	372
Gross External Debt	685	792	967	1017	1086	1267	1368
o/w short term debt	546	545	542	537	546	535	550

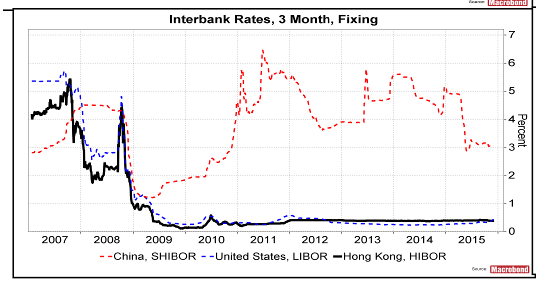
*Source: OEF (Oxford Economic Forecasting) and SEB estimates. *IMF forecast*

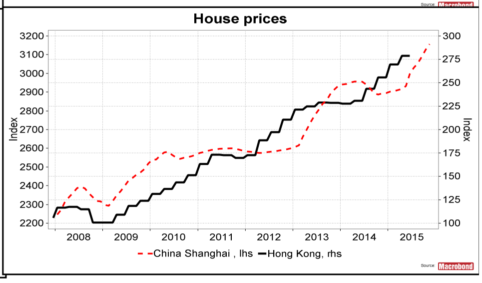
Rating history					
Fitch (eoy)	AA-	AA-	AA	AA	AA+
S&P (eoy)	AA	AA	AA	AA+	AAA

Type of government:	Quasi democratic election system
Next elections	Executive and legislative elections in 2017
Other:	
Latest PC deal	None
Recent IMF programs	None









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