

Hong Kong

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The economy is recovering from two years of recession. Longer-term scars from the downturn should be limited. External balances have strengthened further. Meanwhile, mainland China has tightened its political grip on Hong Kong.

Country Risk Analysis

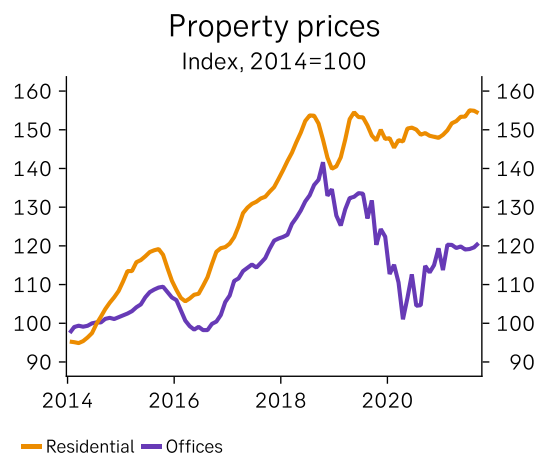
Recent economic developments

Stronger than expected recovery in first half of 2021. Following two years of recessions, with last year's being the deepest on record (-6.1%), the economy has made a stronger than expected recovery. In 2021, the comeback has been fueled by both domestic and external demand, but investment activity in particular has showed strong growth. In Q3 real GDP grew 5.4% year-on-year. This still leaves the level of GDP below pre-pandemic levels. Going hand in hand with the recovery, inflation, largely absent in 2020, has gradually picked-up and recently registered 1.4%.

External finances remain a key strength. The downturn has done little to alter the country's strong external balances. Import compression contributed to a rise in the current account surplus in 2020. The surplus has remained high in 2021 too, helped by strong exports to China, which takes more than half of all exports (although much is re-exported). The surpluses have supported a rise in FX reserves. At roughly USD 494 bn they are equivalent to about six times the currency in circulation. This boosts the credibility of the country's currency board arrangement. Gross external debt is high, mainly attributed to the banking sector. However, the banking sector's ample foreign assets and a high level of central bank reserves makes the country one of the world's largest *net* external creditors at the tune of more than 300% of GDP.

Banking sector largely unscathed through downturn. The downturn has had a modest impact on Hong Kong's large banking sector (total assets about 9.5xGDP). The IMF recently concluded that the sector remains well capitalized and profitable. They also remarked that supervision and regulation remains strong. At the same time, profitability has come down and the share of non-performing loans has edged up from very low levels. Key risks relate to stretched real estate prices and large exposures to mainland China.

Property prices rising in 2021. Real estate prices continue to defy fears of a plunge. They were broadly stable in 2020 and have been rising moderately in 2021, in tandem with the economic recovery. With household incomes relatively muted, this has led to some continued weakening in housing affordability. At the same time, strong macro prudential regulations have capped household leverage and debt-servicing. This limits the risks for the banking sector but does little to dampen widespread social discontent with housing affordability.



Source: Hong Kong Rating & Valuation Department, Macrobond

Rating agencies staying pat. Following the sovereign rating downgrades in early 2020, the major credit rating agencies have left their ratings unchanged, largely reflecting the still high government fiscal strength.

Economic policies

Temporary weakening in very strong public finances. The government has a long tradition of prudent fiscal policy, including running budget surpluses. However, its response to last year's downturn generated the largest general government budget deficit ever on record, just above 9% of GDP. Thanks to the prudent fiscal policies large fiscal reserves had been built over a long period of time before the pandemic. They are now being drawn upon. Despite a decrease in 2020, these reserves amounted to about 33% of GDP at year-end (according to Moody's).

The use of fiscal reserves limited the rise in government debt. Gross debt to GDP reached about 1% of GDP last year and is expected at roughly 2% in 2021. Average maturity is long and debt servicing costs are low. The banking sector's large aggregate balance sheet implies an important contingent liability for the government.

Monetary and exchange rate policy. Hong Kong's longstanding peg to the US dollar at 7.75-7.85 HKD/USD, which has survived several financial crisis since its inception in 1983, has prevailed the past year too without any notable market pressure.

Political and security situation

Political representation gradually being narrowed. Chief Executive Carrie Lam leads the government up until 2022. Political control of Hong Kong from the mainland has tightened further. In early 2021, the government enacted an electoral reform law which aims at keeping people believed to be "unpatriotic" from political positions. The law was criticised by most foreign observers which saw it as a step towards dismantling the electoral system and hence further hollowing-out democracy. The legislation follows on the sweeping National Security law that was enacted in 2020 and perceived by many as effective in curtailing protests and limiting the freedom of speech. The mainland's firming grip over politics implies a decline in country's autonomy over domestic affairs. This being said, the political developments have so far had little visible impact on Hong Kong's strong standing as a commercial and

financial centre. For example, the number of companies registered in Hong Kong's official companies registry has remained broadly stable. Another indicator of Hong Kong's standing as a financial centre is the volume of IPO's on the stock exchange which, despite flagging in Q3 2021, reached record highs in the first nine months of 2021.

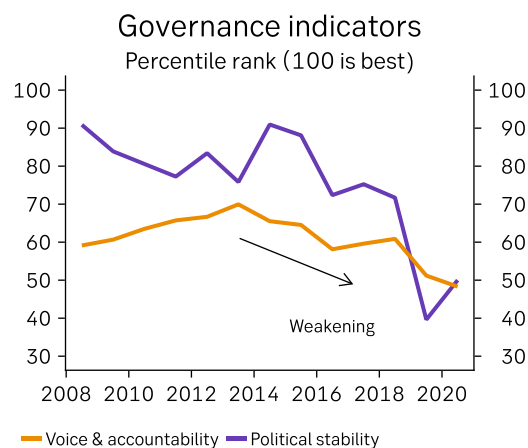
Structural issues

Negative trend in quality of

governance. The quality of institutions is generally perceived as high which contributes to consistent economic policy making. At the same time, some sovereign credit rating agencies have argued that the institutions' limited ability to respond to pressing social needs in the past couple of years is a weakness. Moreover, most observers have concluded that Hong Kong's institutions are converging with those of the mainland. This may explain a weakening in some of the World Bank's governance indicators, in particular political stability.

Freedom House assesses Hong Kong's political rights and civil liberties as "partly free" as opposed to China's "not free". On corruption perceptions, Transparency International ranks Hong Kong on a strong 11th place in the world. China is ranked 78.

Per capita incomes is a relative strength. Hong Kong's level of GDP per capita is higher than most country risk peers. This is a key country risk strength.



Outlook

Growth to slow following strong end of 2021. Factors such as the pandemic's development and supply disruptions in many key economies make the near-term outlook uncertain. Our house forecasters Oxford Economics expect household spending to underpin growth for the rest of the year, barring any new Covid outbreak. Spending should be fueled by improvements in the labour market together with the government's so called Consumption Voucher Scheme. This is expected to lead to a 6.5% GDP expansion this year. For 2022, growth will be less than half that pace, partly as an effect of cooling Chinese demand.

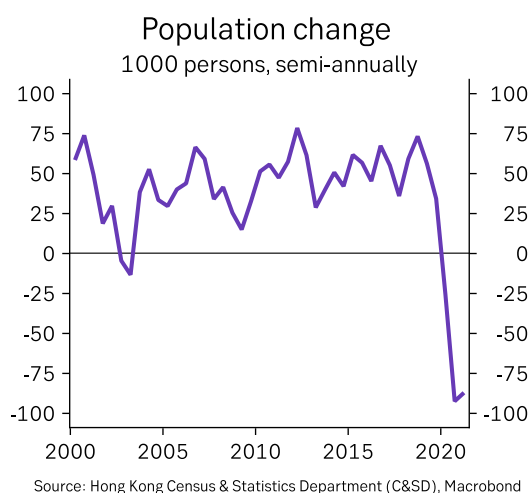
The government assumes sustained, albeit modest, budget deficits through FY25. Most forecasters expect fiscal reserves to decrease significantly in the next few years. However, even a reduction to half of the current levels would leave reserves covering 8-9 months of government spending.

Long-term outlook largely shaped by China. Longer-term scars from the downturn appear to be limited. After the initial bounce-back following the pandemic, economic growth is likely to settle at about 2%. Slowing growth in China will weigh on re-exports and on trade related services. Although tourism could also decline, the

growing middle-class in China should work in the opposite direction. Other well-known caps to longer-term growth include a shrinking working age population and the limited supply of land. A key issue guiding our view on country risk going forward will be what a possible further integration into mainland China will look like. Given Hong Kong's importance for mainland businesses, we assume that the Chinese authorities will neither interfere in the free flow of capital to and from the territory nor limit its right to set its economic policies. Therefore, our main scenario is that Hong Kong will broadly maintain its position as a commercial and financial hub in the region. In addition, we assume that the US will not impose new, severe restrictions on the country beyond the Hong Kong Autonomy Act.

Downside risks largely related to China. The most important risks to our main scenario relates to these assumptions. The risk that the mainland decides to introduce limits to Hong Kong's right to set its own policies or that new US sanctions will be introduced, raising the costs for businesses operating in Hong Kong, would reduce the attractiveness of Hong Kong as a financial and trade hub. This would make the economy less competitive and hence weigh on growth. Other external risks relate to a more marked than expected slowdown in China and the overall development of US-China relations. A further escalation of the trade conflict between the two could dampen global trade flows and dent foreign capital flows to the region. This would put Hong Kong under pressure given its high dependence on the external economy.

Domestic risks coming from property prices and social tensions. Property prices have long been considered over-valued by most standards. Hence, a risk to our main scenario remains a sharp and sudden correction in prices. Although banks may be affected by squeezed households, the main risk is the potential impact on household spending and thus economic growth. Another risk relates to the social tensions and grievances that sparked the 2019 protests. They still have not been remedied. Dissatisfaction may cause a brain-drain unless discontented emigrants are replaced by equally skilled mainland labour. Some have likened the exodus seen since 2019 by the developments in the run-up to the British hand-over of Hong-Kong in 1997.



Hong Kong: Key Economic Indicators

	2017	2018	2019	2020	2021	2022	2023	2024	2025
Macroeconomic									
GDP (% chg)	3,8	2,9	-1,6	-6,1	6,5	2,2	2,8	2,2	2,4
GDP (USD bn)	341	362	363	347	371	389	408	425	443
GDP/capita (USD)	46647	49012	48769	46193	49087	51135	53272	55120	57097
Investments/GDP	22%	22%	18%	17%	18%	17%	18%	19%	19%
Trade/GDP	324%	323%	303%	317%	363%	361%	363%	364%	364%
Money & Prices									
CPI inflation (%)	1,7	2,5	2,9	-0,9	2,2	2,7	2,4	2,2	2,1
Money supply, M2 (% chg)	10,0	4,3	2,8	5,8	4,9	5,6	4,6	4,3	4,2
Interest rates, short-term	0,9	1,75	2,12	1,06	0,19	0,38	0,99	1,64	2,04
Oil price (USD, Brent)	54,3	71,1	64,4	41,8	71,0	72,5	63,6	60,1	61,0
Government Finances									
Budget balance/GDP	1,5%	1,3%	-0,6%	-9,2%	-3,7%	-1,9%	-1,4%	-1,0%	-0,2%
Govt debt/GDP	0%	0%	0%	0%	2%	3%	3%	5%	5%
Interest rate costs/revenues	0,0%	0,0%	0,0%	0,0%	0,0%	0,1%	0,1%	0,1%	0,1%
Balance of Payments (USD bn)									
Current account	15,6	13,5	21,2	22,7	31,3	22,2	22,6	22,2	23,7
as % of GDP	4,6	3,7	5,8	6,5	8,5	5,7	5,5	5,2	5,3
Exports of goods	540,5	568,2	543,1	547,4	671,5	694,8	730,5	762,9	794,8
Imports of goods	563,5	600,5	558,5	552,8	677,0	711,1	750,5	784,6	816,9
FDI, net	24,0	22,0	20,5	17,0	32,3	24,7	25,7	25,9	26,1
as % of GDP	7,0	6,1	5,7	4,9	8,7	6,3	6,3	6,1	5,9
External Debt & Liquidity (USD bn)									
Gross debt	1576,6	1695,9	1667,3	1783,4	1971,5	2109,1	2199,5	2294,6	2393,2
o/w short term debt	1056,3	1136,3	1117,1	1194,9	1320,9	1413,1	1473,7	1537,4	1603,5
as % of GDP	462	469	459	514	531	542	539	540	540
Reserves (eoy)	431	424	441	492	497	508	540	574	608
months of imports	37	34	41	46	40	38	37	38	39
Exchange rate vs USD (eoy)	7,81	7,83	7,79	7,75	7,79	7,79	7,79	7,79	7,79

Source: Oxford Economics

Rating history (eoy)

Fitch	AA+	AA+	AA	AA-
Moody's	Aa2	Aa2	Aa2	Aa3

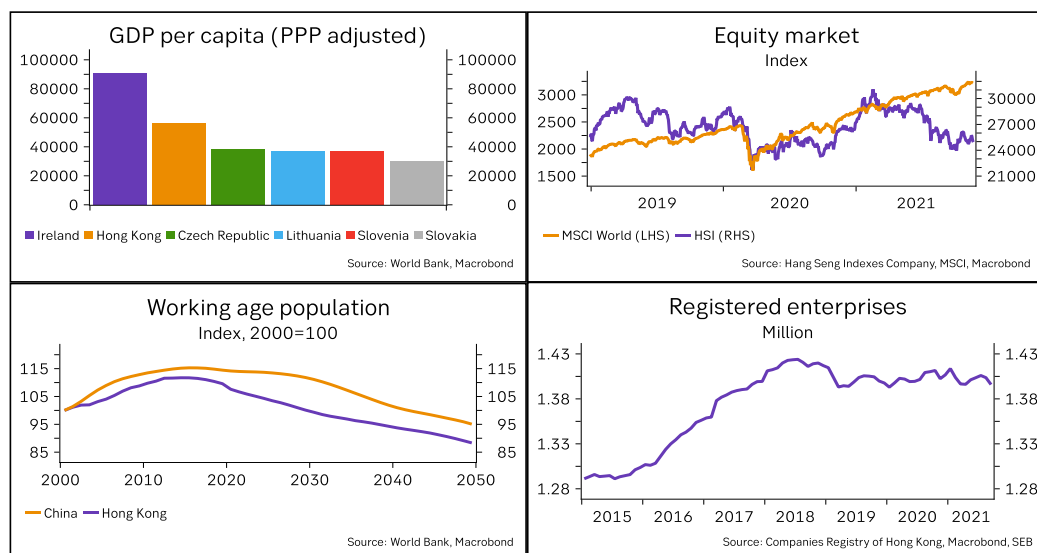
Type of government: Quasi democratic election system

Next elections: Executive elections 2022; Legislative in Dec, 2021

Other:

Latest PC deal: None

Latest IMF arrangements: None



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