EM Alpha

The market implications of the HK FY 24-25 Budget

29 February 2024

GEM FI & FX Strategy
Emerging Markets Global

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HK - Hong Kong

FY – Fiscal Year

IRS – interest rate swap

For a full list of our recommended trades, see: "Global Emerging Markets Weekly: What if the Fed doesn't cut? 23 February 2024"

SAR – Special Administrative Region

HKGB – Hong Kong government bond

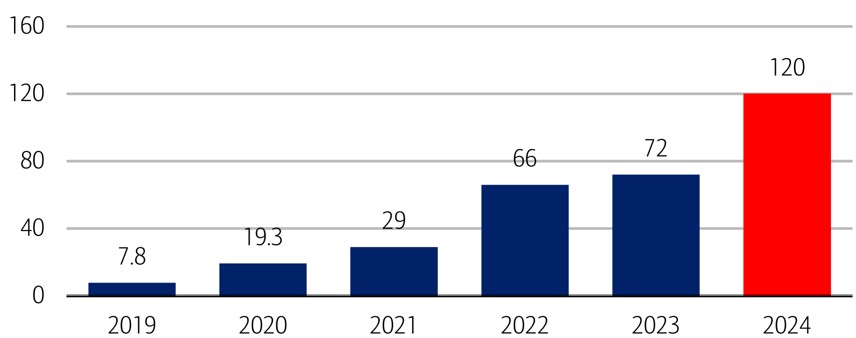
FY 24-25 budget emphasizes infrastructure spending funded by bond issuances

The details to the Hong Kong government budget for FY 2024-2025 shows the HK government remains committed to a strong increase in infrastructure spending despite government revenue is cyclically weak. Total estimated commitments of the Capital Works Reserve Fund (CWRF) rose and are now at HK$ 650bn (from HK$ 633bn in the last budget). At a time when land sales are weak, this future commitment will be funded by annual bond issuances. For the coming fiscal year, the HK government will net raise HK$ 120bn from the bond market to support infrastructure spending. Recurrent expenditures will be supported by using accumulated savings with a net transfer of HK$ 100bn from the Land Fund to the General Revenue Account. This scenario is quite consistent with the base case we laid out in FY24-25 Budget Preview: Between a rock and a hard place.(see note)

Staying structurally bearish on long end HK-US spreads

The Hong Kong government budget for FY 2024-2025 reveal plans to revive the property market by all removing curbs to buying. This can help spur HKD loan growth should the mortgage market rebound from these supportive government measures. Secondly, FY 24-25 can see the debut of infrastructure bonds which may be issued in HKD. Both these factors can help back-end HK-US IRS spreads normalize and go back closer to its historical average of 30bps. The current spread is -2bps. **We stay paid 10y HK-US IRS** (current: -2bps, entry: -2bps, target 40bps, stop: -22bps, carry: -2.4bps/ quarter). Risks to the trade is the continuation of weak HKD loan growth and further asset-swap activities by Hong Kong banks.

Exhibit 1: Proceeds from issuance of Hong Kong government bonds (HK$ Bn)
Net issuance of HKGBs which impacts fiscal reserves is set to rapidly increase in FY 24-25



Source: HK Treasury

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The market implications of the HK FY 24-25 Budget

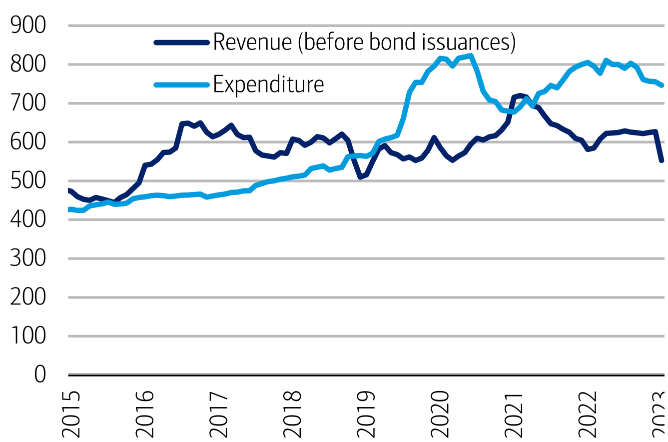
We have several key takeaways from the Hong Kong government budget for FY 2024-2025, unveiled on February 28, 2024 (see detailed full note on the budget here: Hong Kong Watch: 2024-25 Budget: Property policy relaxation beats expectation 28 February 2024):

1) **The Hong Kong SAR government is struggling to increase revenue.** The budget revealed one of the major measures to increase revenue is an increase in the salary tax rate (from 15% to 16%) for very high-income earners on the marginal income above HK$ 5mn. Given the small number of workers this will impact, the expected revenue raised is limited, estimated to be less than HK$ 1bn. On land sales for FY 24-25, the HK government expects to collect HK$ 35bn, a fraction of the HK$ 143bn raised back in FY 22-23. All said, the Hong Kong government is unable to meaningfully increase revenue to fund its rising expenditures (**Exhibit 2**).

2) **Expenditures will continue to rise, led by infrastructure spending.** As our HK economist reported, the growth in infrastructure spending will accelerate in the next four fiscal year, with the expected future commitments in infrastructure spending to be HK$ 650bn, up from HK$ 633bn in the last fiscal year (**Exhibit 3**). Historically, Hong Kong's infrastructure was financed by the strong land premium raised from land sales. Should the Hong Kong government achieve its land sale target of HK$ 35bn in the coming fiscal year, this is still well short of HK$ 130bn the Capital Works Reserve Fund is expecting to spend.

Exhibit 2: Hong Kong government's revenue versus expenditure (HK$ Bn, 12-month sum)

We expect the expenditures of the Hong Kong government to continue to exceed revenue for the coming fiscal year



Source: Bloomberg, CEIC

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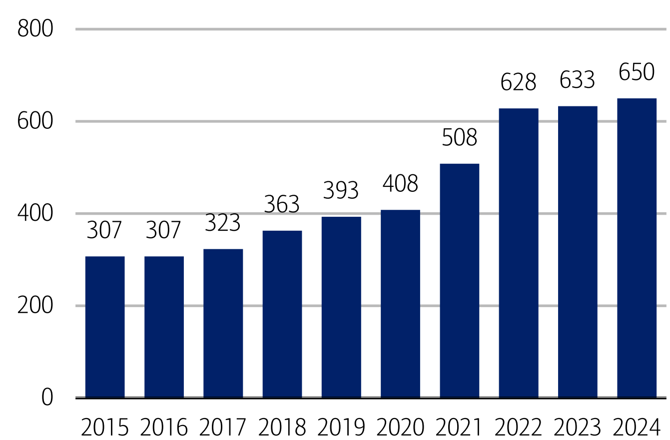
Exhibit 3: Estimated outstanding commitment of the CWRF (HK$ Bn)

The Hong Kong government commits to spending HK$ 650bn in infrastructure in the coming years



Source: HK Treasury

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3) **The recurrent needs of the General Revenue Account are being filled by the Land Fund.** The FY 24-25 estimates show that the General Revenue Account (GRA) will have expenditures exceed revenue by HK$ 110bn. Without transfer from other funds, this would push the GRA down to HK$30bn by the end of the next fiscal year, or less than one month of expenditures (In 2023, monthly expenditures of the Hong Kong government were HK$ 62bn). To avoid running the cash levels to a very low level, Hong Kong's recurrent expenditures will be covered by a net transfer of HK$ 100bn from the Land Fund, Hong Kong's long-term savings. (**Exhibit 4**) The net transfer from the Land Fund to cover for the shortfall in the GRA is a new development and shows: 1) the lack land sales which to fund the Capital Works Reserve Fund; and 2) the existing

commitments of the CWRF and its inability to support the GRA.

Exhibit 4: Net transfer between the government funds of HK (HK$ Mn)
In FY 24-25, recurrent spending will be funded by the Land Fund

Net transfer between funds (HK$ Mln)	2017	2018	2019	2020	2021	2022	2023	2024
General Revenue Account	(23,864)	(23,863)	57,400	47,926	58,523	23,636	95,229	99,815
Capital Works Reserve Fund			(80,000)	(55,000)	(84,000)	(35,000)	(100,000)	
Capital Investment Fund	9,000			6,000	20,135			
Civil Service Pension Reserve Fund	3,800	2,300	1,530		1,840	3,021		
Disaster Relief Fund	64	50	70	74	59	68	21	185
Innovation and Technology Fund	9,000		20,000		2,000	5,175	4,750	
Land Fund								(100,000)
Loan Fund	2,000	2,000	1,000	1,000	1,443	2,000		
Lotteries Fund						1,100		

Source: HK Treasury

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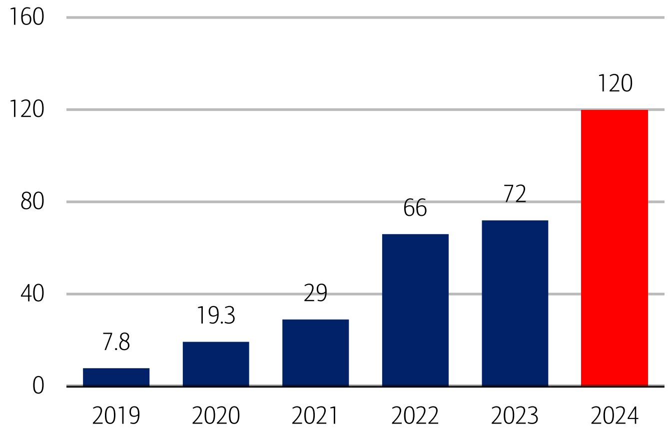
4) **Upcoming infrastructure is being financed by bond issuances.** Historically, Hong Kong's infrastructure is financed by land sales. However, as this is no longer a viable strategy in the near term, the HK government is turning to the bond market to fill the financing gap. In the FY 24-25 Budget, the HK government revealed it will issue a historic amount of Green and Infrastructure Bonds, at HK$ 120bn (**Exhibit 5**). This is a rapid acceleration of bond issuances which impacts the fiscal reserves (as issuance under the retail and institutional program does not impact the level of fiscal reserves).

   In the budget, the Finance Secretary mentioned that the HK government "**plan to issue bonds of about $95 billion to $135 billion per annum** in the next five years to drive the development of the Northern Metropolis and other infrastructure projects" and "**the ratio of Government debt to GDP will be in the range of about 9 to 13 per cent** from 2024-25 to 2028-29".

5) **The announcement of the removal of all property market curb is positive for mortgage growth.** At first glance, this measure suggests the HK government is trying to support property prices, not unlike the policies currently enacted in mainland China. All else equals, these policies should increase demand for HK properties at a time when demand is depressed by weak growth and high interest rate payment while supply of unsold housing is at its highest level since 2005.

Exhibit 5: Proceeds from issuance of Hong Kong government bonds (HK$ Bn)

Net issuance of HKGBs which impacts fiscal reserves is set to rapidly increase in FY 24-25



Source: HK Treausry

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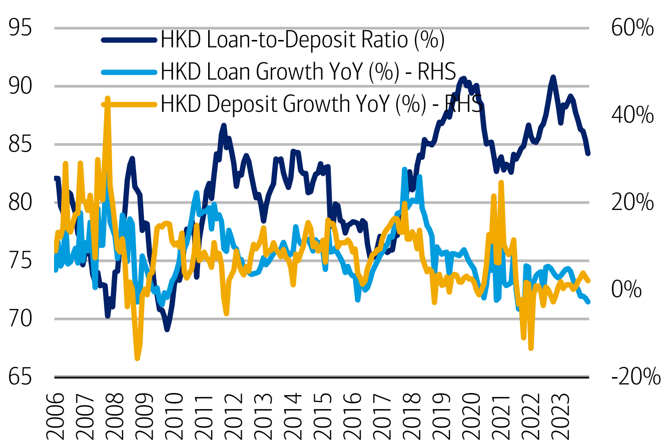
The key market impacts from the FY 24-25 HK Budget are listed below:

1) **The removal of the property market curbs should boost HKD loan growth.** Current loan growth in HKD remains weak relative to HKD deposit growth resulting in the HKD loan-to-deposit ratio to decline (**Exhibit 6**). The loan-to-deposit ratio is a proxy for what is happening in the overall asset-and-liability mix of Hong Kong banks between HKD and in foreign currencies (FX). A declining HKD loan-to-deposit ratio means that there is too much HKD funding chasing too few HKD assets. At the trough, in October 2023, the annual growth of HKD deposits exceeded annual growth of HKD assets by HK$ 317bn, implying extra HKD funding that seeking a home (**Exhibit 7**). That excess HKD funding typically went to being invested in FX bond, especially when US Treasuries at the 10-year pushed to 5% around that period.

Exhibit 6: HKD Loan and Deposit growth (%)

The weakness in HKD loan growth is resulting the loan-to-deposit rate to decline



Source: Bloomberg

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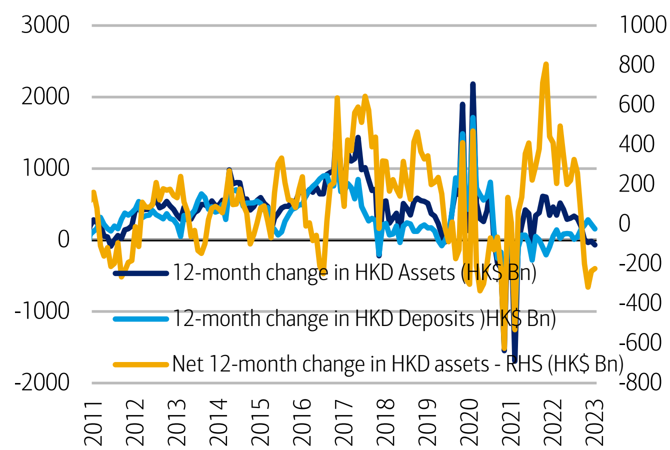
Exhibit 7: 12-month change in HKD asset versus deposit growth (%)

In the recent past, net funding in HKD exceed asset growth by HK$ 317bn



Source: CEIC

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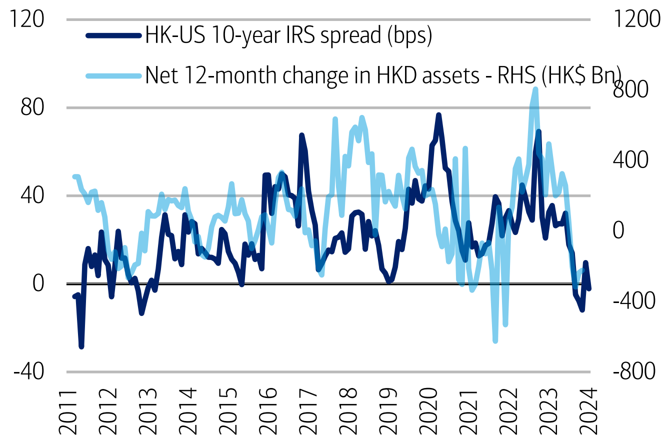
2) **Excess HKD funding depressed long-end HIBOR-SOFR spreads.** The excess HKD funding is invested foreign currency bonds which are then swapped back to create a synthetic HKD fixed-duration asset. On net, this result in Hong Kong banks to receive HIBOR, especially on the long-end. This net receiving activity on HIBOR swap pushed 10y HK-US IRS spreads to a low level, especially compared to the average of the past decade. **Exhibit 8** shows, since 2021, 10-year HK-US IRS spreads have been strongly motivated by the growth in net HKD asset on the balance sheet of Hong Kong banks (where negative growth would result in asset-swap and lower HK-US spreads).

Exhibit 8: HK-US 10-year spreads and net changes in HKD assets

Since 2021, 10-year US-HK spreads have been motivated by the change in the net HKD position of HK banks



Source: CEIC

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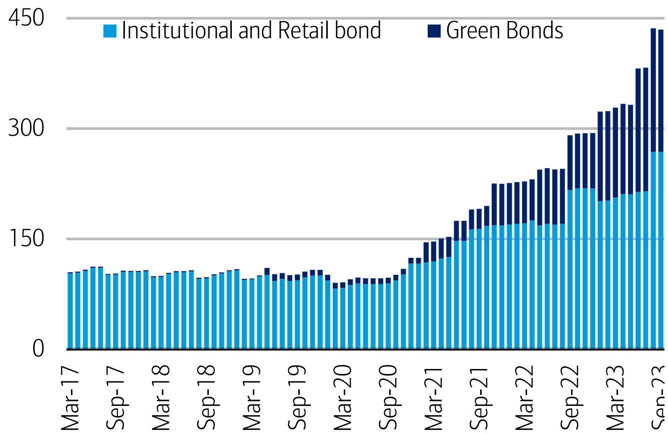
3) **Rising HKD bond issuances can help normalize back-end HK-US spreads.** In addition to rising HKD loan growth, the increase in other HKD assets, such as Hong Kong government bonds, can also help normalize back-end HK-US spreads. Historically, the Hong Kong governments runs the retail and institutional bond program which are issued in HKD (**Exhibit 9**). The issuance of institutional and retail bonds is not considered "true" debt as the funds raised is reinvested with the HKMA into FX assets. Despite not being true debt, this will still impact total HKD assets held by HK banks as it does represent an increase in local duration supply.

4) **The fastest and most relevant category of HKGB is the growth of Green Bonds.** In the latest budget, the final estimate for Green Bond issuance in FY 23-24 is for HK$ 72.5bn. As **Exhibit 10** shows, only a small share of Green Bonds of total outstanding is issued in HKD (at 12%). Almost half of Green Bonds are issued in USD, followed by EUR and CNH. Issuances in foreign currency bond won't directly impact HK-US spreads but can impact cross-currency spreads when the foreign currency bond is swapped to become a synthetic HKD bond.

5) **Infrastructure bonds may be issued in HKD.** However, the details to the Green Bond issuance schedule for the upcoming FY 24-25 is not yet finalized. In the budget, the Finance Secretary mentioned that HK$ 120bn in bond proceeds will be raised "to drive green/sustainable and infrastructure projects".

   Infrastructure Bonds have been mentioned in the FY 23-24 budget but have yet to be issued. FY 24-25 may see the first issuances of Hong Kong's infrastructure bonds. Judging from the language in which Infrastructure Bonds were introduced in the FY 23-24 Budget, we cannot rule out these new bonds can be issued in HKD, which would then go on to impact HK-US long-end spreads.

Exhibit 9: Outstanding supply of Hong Kong government bond (HK$ Bn)
In the past three years, various types of HKGB have been rising



Source: CEIC

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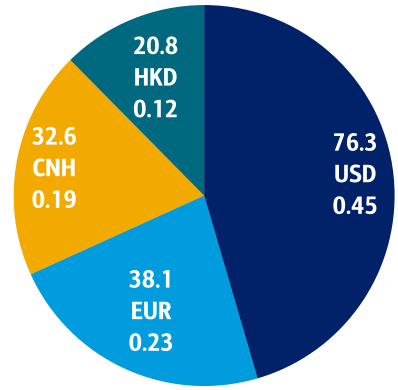
Exhibit 10: Outstanding Green Bonds by currency compositions and HK$ Bn (As of Aug 2023)
The largest share of Green Bonds are issued in USD



Source: HK Treasury

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Staying paid 10-year HK-US IRS spread: With prospects of HKD loan growth, led by mortgage rebound and the debut of infrastructure bonds, we think that back-end HK-US spreads can normalize from the current depressed levels. We stay paid 10y HK-US IRS (current: -2bps, entry: -2bps, target 40bps, stop: -22bps, carry: -2.4bps/ quarter). Risks to the trade is the continuation of weak HKD loan growth and further asset-swap activities by Hong Kong banks.

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