Moody's Investors Service Print

Rating Action:

# Moody's downgrades Hong Kong's rating to Aa3; changes outlook to stable

20 Jan 2020

Singapore, January 20, 2020 -- Moody's Investors Service has today downgraded the long-term issuer and senior unsecured ratings of the Government of Hong Kong to Aa3 from Aa2 and changed the outlook to stable from negative.

The downgrade principally reflects Moody's view that Hong Kong's Institutions and Governance Strength is lower than previously estimated. The absence of tangible plans to address either the political or economic and social concerns of the Hong Kong population that have come to the fore in the past nine months may reflect weaker inherent institutional capacity than Moody's had previously assessed. It may also point to more significant constraints on the autonomy of the Special Administrative Region's (SAR) institutions than previously thought.

The stable outlook at Aa3 reflects superior fiscal strength and consistent macroeconomic stability, which Moody's expects to persist through a period of heightened uncertainty about political and social developments associated with weak or negative GDP growth. Combined with the assessment that, albeit somewhat less strong, Hong Kong's institutions and governance remain markedly stronger than China's (A1 stable), these credit characteristics account for a one-notch sovereign rating gap between Hong Kong and China.

Moody's has also downgraded the senior unsecured foreign currency ratings of the Trust Certificates issued by Hong Kong Sukuk 2015 Limited, a special purpose vehicle established by the Government of Hong Kong, to Aa3 from Aa2. The payment obligations associated with these certificates are direct obligations of the government and rank pari passu with other senior unsecured debt of the government.

Hong Kong's long-term foreign-currency bond ceiling and the local currency bond and deposits ceilings remain unchanged at Aaa, while the long-term foreign currency deposits ceiling has been lowered to Aa3 from Aa2. Hong Kong's short-term foreign currency bond and bank deposits ceilings remain unchanged at P-1.

RATINGS RATIONALE

RATIONALE FOR THE DOWNGRADE TO Aa3

The absence of an effective response by Hong Kong's executive and legislative branches of government to the concerns that have contributed to the ongoing protests, and the inertia which has increasingly characterised the legislative and executive branches, indicates weaker Institutions and Governance Strength than Moody's previously assessed.

The underlying drivers of the protests are certainly deep-seated and intractable. Nevertheless, the response by Hong Kong's government to both political demands by parts of the population and broader concerns about living standards in the SAR, housing costs and equality of economic opportunities has been notably slow, tentative and inconclusive. On the economic and social front, while several fiscal stimulus packages have been announced since last August, Moody's does not expect that the measures planned so far will effectively improve housing affordability or start addressing demands for a more equal distribution of income and wealth. There has also been lack of clarity on what conclusions the government draws and what actions it will take in response to the District Council elections on 24 November 2019, which saw a record turnout result in an overwhelming majority for pro-democracy candidates.

The absence of effective response and lack of clarity on how the government is planning to address either the political or social and economic concerns may partly reflect weaker inherent institutional capacity than Moody's had previously assessed. It may also point to more significant constraints on the autonomy of Hong Kong's institutions than previously thought notwithstanding the "One country, Two systems" policy which has underpinned autonomy for the last two decades, ultimately reflecting the SAR's role as part of China and the responsibility of the executive to the mainland authorities.

Pressures on Hong Kong's institutions undermine its credit profile directly. In addition, actual or perceived changes in the autonomy of Hong Kong's institutions raise the risk that actions by foreign governments negatively impact its competitiveness and economic strength and hinder the effectiveness of policymaking still further. The most notable recent development in this regard has been the passage of the Hong Kong Human Rights and Democracy Act of 2019 by the US Congress, according to which the US Department of State and other agencies will from now on conduct an annual review to determine whether changes in the SAR's political status justify changing the nature of US trade policy with Hong Kong.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook at Aa3 reflects Moody's assessment that a one-notch gap between Hong Kong's and China's rating will likely persist for the foreseeable future. In particular, Hong Kong's rating is supported by "aaa" fiscal strength that Moody's expects to be resilient to a period of low or negative growth, and a very high likelihood that macroeconomic stability will be preserved. Moreover, while Moody's assessment of the strength of Hong Kong's institutions and governance is now somewhat weaker than previously, it remains markedly stronger than China's at "baa1".

Hong Kong's minimal government debt burden and large fiscal reserves continue to support "aaa" fiscal strength. While Moody's expects government debt to rise modestly due to fiscal policy easing in a context of a sharp economic slowdown, it will remain very low. Fiscal reserves of HKD1.2 trillion (around 40% of GDP) in fiscal 2019/20 (the year ending March 2020) represent a material buffer to address long-term structural issues, including a fast ageing population, or absorb the current and future periods of slow or negative growth.

Moreover, ample foreign exchange reserves contribute to macroeconomic stability for a small, open economy and large financial centre and support the credibility and viability of the currency peg. In Hong Kong's past, and during the current recession and period of political, social and economic uncertainty, the peg's credibility has remained strong. This track record supports Moody's view that the Hong Kong Monetary Authority (HKMA), the central bank, will maintain macro-economic stability.

Over time, the closer institutional and economic linkages between Hong Kong and China become, the more closely the two ratings will converge.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Environmental considerations are not currently material to Hong Kong's credit profile. As a small island economy, Hong Kong is exposed to rising sea levels, while the territory's location exposes it to tropical storms, which are likely to become more frequent and damaging with climate change. However, Hong Kong is well-positioned to adopt climate adaptation measures given the institutional, technical and financial resources at its disposal.

Social considerations are material to Hong Kong's credit profile and have played a part in this rating action. For example, income and wealth inequality and rapid and continued increases in housing costs have been important elements of social pressures in Hong Kong for a significant period of time but, as yet, Moody's sees limited effectiveness in policy responses to these issues. Hong Kong also faces demographic pressures from an ageing population, the costs of which are likely to be largely borne by households given a relatively narrow revenue base for the government, with a negative impact on growth potential and, indirectly, fiscal strength. Openness to foreign labour somewhat mitigates the SAR's exposure to ageing.

Governance considerations are also an important factor in Hong Kong's credit profile and a key driver of this rating action, captured in Moody's "aa3" assessment of Hong Kong's institutions and governance strength. Prudent macroeconomic and fiscal policies have resulted in the accumulation of large fiscal reserves. However, the political protests and broader concerns about living standards have revealed some weaknesses in Hong Kong's legislative and executive institutions that prevent policymakers from effectively mobilizing these financial buffers to adapt changing conditions.

WHAT COULD CHANGE THE RATING UP

Moody's would likely upgrade Hong Kong's rating if the ongoing political and social tensions were to be resolved in a way which provided assurance that Hong Kong's economic and institutions and governance strength was stronger than currently assessed, and the associated medium- to long-term risks to the SAR's status as a key financial and economic hub for the region were reduced.

WHAT COULD CHANGE THE RATING DOWN

Moody's would likely downgrade Hong Kong's rating if it were to conclude that Hong Kong's economic strength and/or the quality of its institutions are weaker than currently assessed. In particular, still closer institutional integration between Hong Kong and China would likely constrain the autonomy of Hong Kong's legislative, judiciary and/or executive still further, contributing to a downgrade.

An erosion in China's credit profile would also be credit negative for Hong Kong.

GDP per capita (PPP basis, US$): $64,199 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 3.0% (2018 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2.6% (2018 Actual)

Gen. Gov. Financial Balance/GDP: 2.4% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 4.3% (2018 Actual) (also known as External Balance)

External debt/GDP: 466.6% (2018 Actual)

Level of economic development: aa3 level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 13 January 2020, a rating committee was called to discuss the rating of the Government of Hong Kong. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength has materially decreased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For ratings issued on a program, series, category/class of debt or security this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series, category/class of debt, security or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this credit rating action, and whose ratings may change as a result of this credit rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Martin Petch
VP - Senior Credit Officer
Sovereign Risk Group
Moody's Investors Service Singapore Pte. Ltd.
50 Raffles Place #23-06
Singapore Land Tower
Singapore 48623
Singapore
JOURNALISTS: 852 3758 1350
Client Service: 852 3551 3077
Marie Diron
MD - Sovereign Risk
Sovereign Risk Group
JOURNALISTS: 852 3758 1350
Client Service: 852 3551 3077
Releasing Office:
Moody's Investors Service Singapore Pte. Ltd.
50 Raffles Place #23-06
Singapore Land Tower
Singapore 48623
Singapore
JOURNALISTS: 852 3758 1350
Client Service: 852 3551 3077