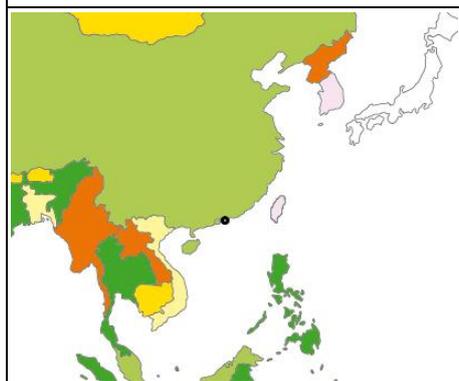


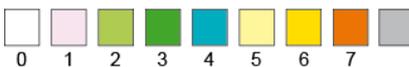
Hong Kong



COUNTRY RISK CATEGORY

1/7

The country risk categories range from 0 to 7. The lower the number the better the credit rating the country has.



EKN'S OUTSTANDING GUARANTEES TO THE COUNTRY

SHORT-TERM TRANSACTIONS: SEK 0.0 MILLION

MEDIUM AND LONG-TERM TRANSACTIONS: SEK 859 MILLION

DATE

24 OCTOBER 2014

Increased influence from mainland

Hong Kong's economy is strong. The region's development has benefitted from strong institutions, a favourable business climate and increasing economic integration with the mainland. However, this integration creates greater exposure to China and its economic imbalances. With a very strong macroeconomic foundation, as well as public finances, banking system, external debt and international reserves, Hong Kong is considered well-equipped to meet economic challenges such as lower growth in China or a potential price correction in the property market. In the run-up to the 2017 elections of Hong Kong's leader, Beijing's hardening line concerning its right to dictate the ground rules for the elections has gone into a collision course with an increasingly active democracy movement in Hong Kong. The increasing tensions are creating uncertainty concerning the results and have a negative impact in terms of risks. The most likely result is however that the situation will be managed in a way that does not harm Hong Kong's position in the long term.

THE COUNTRY'S STRENGTHS AND WEAKNESSES

Strengths

- Open and flexible economy with good regulatory and business environment
- Strategic position as a centre of trade and finance in Asia, especially as a hub for China's increasing internationalisation
- Long history of strong public finances and external balance surpluses, which has led to the accumulation of extensive international reserves and budget reserves

Weaknesses

- Substantial exposure to China in trade and finance with increased dependence on Chinese growth.
- Increased pressure on political influence from China with rising social tensions as a consequence
- A small economy with high exposure to the international community results in periodically volatile growth
- Overheating tendencies in the property sector

Risk assessment

Hong Kong has been ranked in country risk category 1 since 2007 when it was upgraded. EKN's classification is in line with the classification made jointly within the OECD.

EKN has no general restrictions. Each transaction is assessed on its own merits. This applies regardless of whether the transaction has a short credit period (up to one year) or a long credit period.

WHAT MIGHT CAUSE A CHANGE IN THE COUNTRY POLICY?

The policy may be made less restrictive in the event of

- An upgrade of the classification of China, e.g. as a result of long-term reforms leading to a reduction in economic imbalances in China.
- Peaceful and stable development in Hong Kong that solidifies Hong Kong's special position in China according to the principle of "one country, two systems".

The policy may be made more restrictive in the event of

- Negative developments in China, e.g. a deeper economic decline or financial crisis with substantial negative effects on Hong Kong.
- An escalation of political pressure from Beijing leading to a limitation of Hong Kong's special position and the undermining of the country's position as an international financial centre.

EKN'S EXPOSURE AND EXPERIENCE

Limited provision of guarantees

The provision of guarantees has been very limited for a long time. EKN has issued guarantees for over SEK 1 billion over the past ten years. EKN's current exposure totals SEK 1 billion, with guarantees accounting for SEK 859 million and the remainder made up of offers. The majority consist of new telecom transactions. No claims were reported for the period.

COUNTRY ANALYST



EKN's country analyst for Hong Kong:
Johan Fredriksson
Email: johan.fredriksson@ekn.se

DISCLAIMER

The country analysis is based on a range of sources and reflects information that is relevant to EKN at the time of publication. The responsibility for how the information is used or interpreted rests solely with the user, and EKN cannot be held responsible for any loss or damage.

Political tensions and economic integration

Hong Kong has a special autonomous status in China. According to the "one country, two systems" formula, it is guaranteed that the political, economic and legal systems will remain separate until 2047. This is largely respected by both parties, but their views on Beijing's influence make the major political dividing line in Hong Kong. Political focus is on 2017 and the amendments to the basic law and the election process that must take place to fulfil Beijing's promise from 1997 that the region's chief executive would be elected at that time in a general election. It is clear that Beijing is not prepared to allow the electoral system in Hong Kong to develop without their influence. Beijing's line on the issue has hardened over the past year. The measures taken include the issuance of a directive on how Hong Kong's new electoral process is to be shaped. The directive respects the principle of general elections, but counterbalances it with restrictions in the electoral system. In practice, this gives Beijing the ability to weed out candidates from among those allowed to run in the elections. The next step in the legislative process would be for the leadership of Hong Kong to convert the directive into a bill to be brought for a vote before the legislative council, probably in 2015. If the bill is blocked, it could result in the current, although less democratic, order being sustained.

Beijing's line puts the regional leadership, which is loyal to Beijing, on a collision course with the increasingly active democracy movement. These developments also feed into a social discontent which is partially rooted in rising housing prices and growing income gaps. Both of these phenomena are partially attributable to growing capital inflows from the mainland. It is disconcerting that the positions have hardened in both camps. The most recent student demonstrations have begun to focus on disrupting economic activities in Hong Kong via civil disobedience. Beijing is not likely to budge from its basic position, but direct involvement will be avoided to the greatest extent possible. The local government's strategy seems to be to wait out the demonstrators. The protests will probably continue in some form, but is likely to diminish in extent, since sections of the population prefer a less confrontational line. The dilemma the political leaders are facing is how to find a way out that neither undermines the authority of China's highest leadership nor leads to violent developments that ruin Hong Kong's reputation as a financial centre and China's window to the outside world. The increased political tensions have a negative effect in terms of risks. The most likely result is however that the situation will be managed in a way that does not harm Hong Kong's position in the long term.

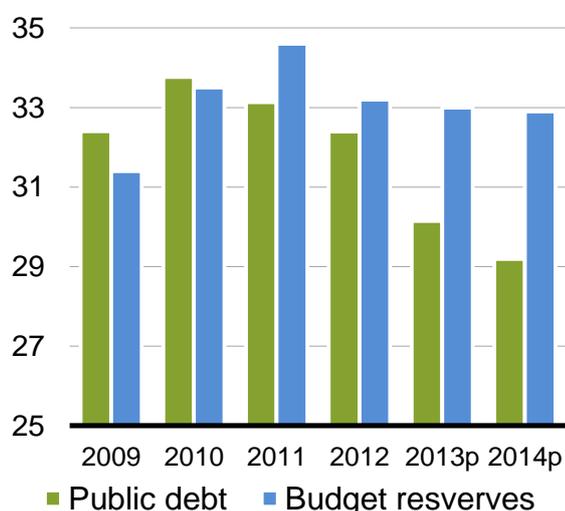
Hong Kong has a service-based economy with a strong position as a logistics hub for trade with China and as an international financial centre. As a small, open economy with a large financial sector, Hong Kong is exposed to external disruptions. Hong Kong has historically experienced volatile growth. China is by far its largest trade partner, increased Chinese tourism is benefitting the economy and a growing proportion of the banking system's assets are related to China (34 per cent Q1 2014 vs. 11 per cent 2009). Hong Kong is also a leading centre for the growing trade in Chinese currency outside of mainland China. Hong Kong's economic integration with China is therefore continuing to be strengthened. The fact that Hong Kong's economic development is becoming even more intertwined with China's is also increasing the region's exposure to the Chinese economy with its weaker institutions and economic imbalances.

Sizable buffers provide resilience

The GDP growth of both China and Hong Kong seems to be heading toward stabilising at a lower level (7 per cent and 3 per cent, respectively) in the future. However, sustained imbalances in China pose a risk of financial spill-over effects and a broader economic slowdown.

The property market is a cause of concern. The prices have been driven up sharply for several years by a limited supply, negative real interest rates and substantial liquidity inflows. With a fixed exchange rate, the central bank has no interest rate weapon to wield. The authorities are instead trying to use different measures to slow down the rise in prices, such as a stricter regulatory framework and investments to increase the supply of housing. Several sources have warned of a price correction in the coming years, which, considering the significance of this sector for the economy, could impact the financial markets, growth and public revenues.

BUDGET RESERVES EXCEED FALLING PUBLIC DEBT (% OF GDP)



Hong Kong has previously demonstrated its ability to manage crises and its economic conditions for being able to manage a crisis are strong. The banking system is well-capitalised, well-regulated and mostly foreign-owned (over 90 per cent). The public finances are strong. The gross public debt is at a low level of 33 per cent of GDP, and with budget surpluses since 2004, large reserves have been accumulated which exceed the national debt. The country's external position is strong as well. The current account balance is running a structural surplus, albeit falling, and the

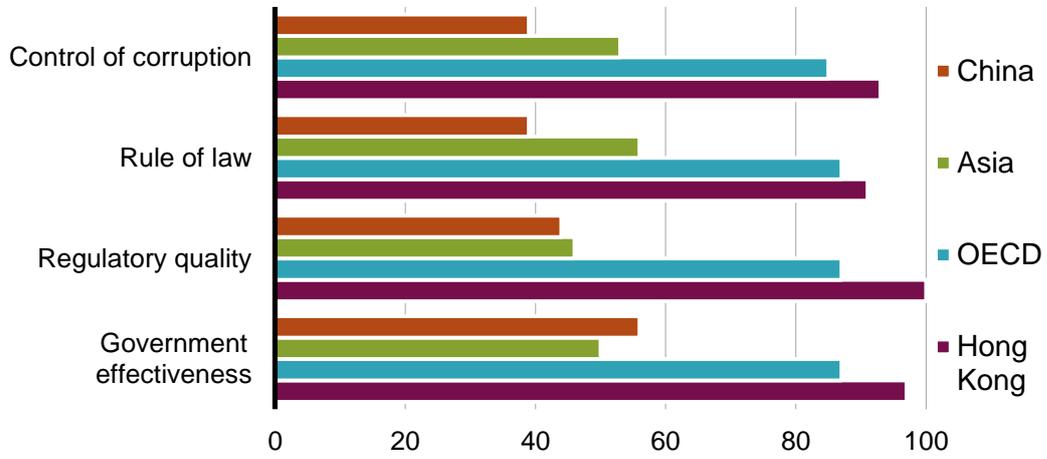
international reserves cover two years of imports. The seemingly high external debt (420 per cent of GDP) is a result of the financial sector's importance, and internal corporate loans also make up a significant portion (15 per cent). The banking sector has considerable assets in foreign currencies. If public sector assets are included, external assets exceed liabilities by leaps and bounds. Hong Kong is a large net lender internationally. Overall, Hong Kong is considered well-equipped to meet potential economic disruptions.

BUSINESS ENVIRONMENT

Hong Kong's overall business and regulatory environment is considered very good. It differs from China's considerably. Public institutions and the legal system maintain a high standard of quality and integrity. The courts are independent and act in line with legal certainty. Hong Kong comes in the elite levels in global indices for the business climate, regulation quality, corruption and rule of law. The same goes for the IFC's Resolving insolvency index where the expected rate of recovery in Hong Kong (approximately 80 per cent) is higher than the OECD average. Financial transparency meets high standards internationally for the majority of companies. Hong Kong's accounting standard (HKFRS) for large companies is essentially identical to the IFRS, while SMEs apply a simplified model of the IFRS. Given Hong Kong's

extensive integration with China, credit analyses should take such links into account in individual transactions.

WORLD CLASS BUSINESS ENVIRONMENT (ON A SCALE OF 0 TO 100)



Source: *Governance Indicators 2012, World Bank*