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MISSION CONCLUDING STATEMENT

People's Republic of China—Macao Special Administrative Region: Staff Concluding Statement of the 2022 Article IV Mission

January 23, 2022

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV \(/external/pubs/ft/aa/aa04.htm\)](/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC:

Macao SAR's recovery is expected to continue in 2022, but it will take time before the economy returns to its pre-crisis level. Although the strong fiscal support and the financial strength of Macao SAR's casino groups cushioned employment and consumption, the sharp decline in activity exposed Macao SAR's vulnerabilities to external forces affecting the inflow of tourists. Short-term risks to the outlook include a re-intensification of the COVID-19 pandemic and increase in Macao SAR's financial sector stress. The heavy impact of the pandemic on Macao SAR's growth highlights the need to diversify the economy beyond the gaming industry. The high exposure to climate-related shocks poses long-term concerns.

- *Fiscal:* Premature withdrawal of policy support should be avoided. Fiscal measures should be better targeted to vulnerable groups and job creation to enhance the recovery and inclusion. Additional spending on healthcare, education, and climate-resilient public infrastructure will boost near-term demand while facilitating economic diversification and mitigating climate risks over the medium term. A medium-term fiscal strategy would help support

the diversification and climate resiliency efforts, while ensuring fiscal sustainability and intergenerational equity over the longer term.

- *Financial* : Strengthening the risk monitoring of household debt and enhancing the insolvency and debt resolution and restructuring frameworks would alleviate vulnerabilities in the financial system and support the recovery. Close supervisory cooperation with the Mainland would help minimize possible negative spillovers from the ongoing stress in the Mainland's property sector.
- *Structural* : Achieving the government's economic diversification goals will require concerted efforts in skill building and talent attraction, closing physical and digital infrastructure gaps, enhancing the efficiency of public institutions, and streamlining business regulations.
- *Climate change* : Scaling up public investments in critical infrastructure and coastal management as well as better understanding and management of financial risks due to climate change would help mitigate climate-related risks.

I. Macroeconomic Situation: Elevated Uncertainty Ahead

The pandemic took a large toll on Macao SAR's economy

Macao SAR has been hit hard by the COVID-19 crisis, but the strong policy response has helped contain the spread of the virus and soften its economic impact. Strict containment and border control measures helped preserve people's health and safety. Deploying its large fiscal reserves, the government was able to stabilize employment and consumption.

However, the crisis brought Macao SAR's overreliance on the gaming sector into sharp relief. The gaming sector—the key growth driver in the past two decades—almost came to a stop as tourist flows dried up. Despite the strong fiscal support and the financial strength of casino groups cushioning employment and consumption, aggregate GDP shrank by 54 percent in 2020, mostly on the collapse of services exports. This highlights the vulnerability of Macao SAR's economy to external forces affecting the inflow of tourists, such as travel restrictions related to the pandemic.

The economy is estimated to have expanded by 17 percent in 2021 helped by the partial recovery of the gaming sector. The establishment of a travel corridor lifted quarantine requirements for qualified visitors between Macao SAR and the Mainland and breathed life into the gaming sector. However, reoccurring outbreaks weighed on gaming services in the second half of the year.

The financial sector weathered the pandemic well, but pockets of vulnerability are emerging. The banking system remains well capitalized with solid levels of liquidity and profitability. Capital adequacy is in double digits, and the nonperforming loan ratio remains low, in part due to policy support and low exposure to the gaming sector. Household debt to banks, half of which are mortgages, accounts for more than half of banks' domestic credit exposing banks to shock to household income. The external side of banks' balance sheet has a large exposure to Mainland China, while a significant share of foreign liabilities has less than one year maturity, creating funding vulnerabilities.

Staff's preliminary assessment is that Macao SAR's overall external position remains substantially stronger than warranted by medium-term fundamentals and desirable policies. The current account surplus in 2021 is estimated at less than half of the level observed in 2019 due to the still relatively low tourism receipts but increased relative to 2020. The assessment takes into account Macao SAR's specific circumstances while reflecting the persistent saving-investment gap, driven, in part, by high precautionary savings and subdued investments.

Macao SAR's recovery is expected to continue going forward. GDP is projected to grow by 15 percent in 2022 driven by the gradual return of foreign tourists and the recovery of domestic demand. Boosted by increasing investment linked to the issuance of new gaming concessions and further integration with the Guangdong-Hong Kong-Macao Greater Bay Area (GBA), growth is expected to accelerate to 23 percent in 2023 before gradually converging to its long-term potential of around 3.5 percent over the medium term. However, given the depth of the economic losses during the pandemic, the level of GDP is expected to surpass its pre-crisis level only in 2025. In the absence of rapid progress towards economic diversification, the current account balance is set to return to pre-pandemic levels as tourists return to Macao SAR.

The balance of risks is tilted to the downside in the short term . While better-than-expected control of the pandemic and faster-than-envisaged integration with the GBA could contribute to stronger growth than currently envisaged, most

risks are for lower growth.

- *Resurgent pandemic*: A resurgence of COVID-19 and associated mobility restrictions could stall Macao SAR's recovery in the near term and prompt persistent behavioral changes (e.g., a permanent shift toward online gaming), undermining the medium-term viability of the gaming sector.
- *Tighter regulation of the gaming industry*: The amended proposal to reform Macao SAR's gaming law was welcomed by gaming operators and has addressed a number of investor concerns, but some uncertainty remains. The recent ban on the gaming services' marketing in the Mainland poses risks to the outlook of the VIP segment of the market.
- *Spillovers from Mainland China*: Potential large-scale defaults in Mainland China's real estate sector and a sudden growth slowdown in Mainland China could prompt negative spillovers to Macao SAR's economy and financial system.
- *Financial risks*. The pandemic took a large toll on household income reducing their debt-servicing capacity, which could potentially impact banks and threaten financial stability. Tighter global financial conditions could pressure non-financial firms, with knock-on effects on the banking system.
- *Climate change*: Intensification of climate-related risks, owing to insufficient efforts to reduce carbon emissions globally, could adversely affect both financial institutions and corporates.

II. Policies: Building a Stronger Economy

Policy support remains critical in the near term

The strength of the recovery hinges on a safe reopening of the economy to tourists. Building on the government's vaccination efforts, further boosting vaccination rates will be critical in this regard. Moreover, establishing additional travel corridors between Macao SAR and other economies with high inoculation and low infection rates could accelerate the recovery of the gaming sector.

Fiscal support remains essential. The fiscal tightening envisaged in the 2022 budget is premature, given the still-large output gap and significant downside risks. Given fiscal space remains ample for now, a neutral fiscal stance in 2022 would be better tailored to support economic activity in the non-gaming sector and mitigate any long-term impact of the pandemic on the economy's potential.

At the same time, fiscal policy should be recalibrated to promote growth. Targeting cash transfers to the most vulnerable households, which have a high propensity to consume, can be more effective in supporting the recovery and inclusion. Incentivizing job creation will support the recovery and facilitate resource reallocation. In this regard, the government's job placement and matching efforts, particularly for youth, are encouraging. Additional spending on healthcare and education and scaling up macro-critical public investments in climate resiliency will boost demand in the near term while facilitating economic diversification and adaptation to climate change in the medium term. To ensure the efficiency of Covid-19-related public spending, it is important to follow the same strict guidelines for fiscal transparency and accountability as for all other government spending.

Proactive policies are needed to safeguard financial stability.

- *Private sector indebtedness*: Strengthening the monitoring of enterprises and households to better anticipate the potential increase of insolvencies due to the pandemic will be important. Encouraging banks to conservatively provision will help withstand a potential asset quality deterioration. Enhancing the insolvency and debt resolution and restructuring frameworks, including through special out-of-court solutions, would avoid overloading the court system and support growth.
- *Spillovers from Mainland China*: The regulatory and supervisory framework should be enhanced to manage risks from the significant exposure to Mainland China. Monitoring of credit risk of borrowers from Mainland China should be further strengthened. In addition, forward-looking risk assessments and close supervisory cooperation with the Mainland would help minimize the potential for regulatory arbitrage. Moreover, the liquidity position of banks with large short-term foreign liabilities should be carefully monitored.

- *Macprudential policy:* The objective of curbing risks from residential property price growth could be achieved by linking the differentiation in LTV limits directly to banks' risk assessment of loans and borrowers, instead of the current residency-based differentiation.

The peg to the Hong Kong dollar continues to serve Macao SAR well. The peg has provided a credible nominal anchor for economic and financial stability. The strength of the exchange rate regime is underpinned by the implementation of countercyclical fiscal policy, flexible labor markets, a healthy banking sector, and adequate reserve coverage. Maintenance of these policies will ensure the continued success of the exchange rate regime.

Finding new growth engines through economic diversification

The government has developed a diversification strategy that, if implemented well, can substantially reduce the economy's vulnerability to shocks. The recently released Master Plan of the Development of the Guangdong-Macao Intensive Cooperation Zone aims to develop four nascent industries and facilitate Macao SAR's integration into the GBA. The progress made by the government in promoting the development of modern financial services is welcome. Advancing the government's diversification agenda will require addressing structural bottlenecks, such as the limited supply of relevant skills and the high cost of occupational mobility.

Bridging the gap in the skill composition to support the diversification and development of modern financial services will require a multipronged approach.

- *Skill building:* Investing in outcome-orientated occupational and on-the-job training as well as strengthening science-business linkages will facilitate the acquisition of skills and help narrow skill gaps. Administrative requirements for hiring non-resident skilled workers could be streamlined to help compete for foreign talent.
- *Regional Integration:* The increased integration with the GBA provides an opportunity to access a larger pool of skilled labor and offshore some economic activities, capitalizing on the Mainland's comparative advantage in manufacturing.
- *Physical and ICT Infrastructure:* Closing the infrastructure gap vis-a-vis OECD countries, including for digital infrastructure, will allow Macao SAR to access skilled labor from remote locations. Here, steps by the Monetary Authority of Macao (AMCM) to deploy new financial infrastructure to promote development of modern financial services are welcome. Efforts aimed at boosting the supply of public housing and reforming regulatory frameworks to increase housing supply by the private sector should continue.
- *Effective public institutions and business environment:* Increasing regulatory predictability, raising the independence of the judiciary, and strengthening the protection of property rights as well as streamlining labor and business regulations will increase Macao SAR's attractiveness to foreign investors and facilitate resource reallocation toward expanding sectors.
- *Financial supervision:* It is important to balance the government's efforts in promoting financial sector development with the need to preserve financial stability and integrity. While the authorities made progress in reforming the legal environment, the regulatory and supervisory framework should be further strengthened to manage potential risks from the expanding financial sector. Expansion of the financial services sector will also require measures to identify and mitigate ML/TF risks.
- *Enhanced cooperation:* The government has many initiatives to promote its diversification agenda. However, these efforts are spread across different government agencies. Enhancing cooperation between these agencies would improve the effectiveness of the government's diversification efforts.

Actions to strengthen the AML/CFT framework are welcome and should be sustained. The government has made good progress in addressing technical compliance deficiencies. However, the AML/CFT framework applicable to the offshore sector and the investigation and prosecution of laundering of foreign proceeds of crime, particularly through the gaming sector, need to be strengthened further.

Mitigating Climate Risks Through Adaptation

Macao SAR is highly exposed to climate-related risks. While not a major carbon emitter, Macao SAR is significantly affected

by climate change. Macao SAR faces high risks of cyclones and medium risk of coastal floods and water scarcity. Some critical infrastructures are at risk of being below the annual flood level within ten years, which could be far more costly compared with the cost of climate-adaptation measures.

To mitigate climate-related risks, Macao SAR needs to align public policies with climate objectives. Macao SAR could benefit from building early warning systems to monitor and evaluate its exposure to climate change risks. The existing land-use planning strategy could be updated to adequately address sea-level rise and storm surges. Measures are needed to strengthen coastal protection and mitigate coastal erosion. Scaling up public investments in critical infrastructure, water security, and coastal management would be important. In addition, better understanding and management of financial risks due to climate change would help shield the financial system from climate-related risks. In this regard, the authorities' intention to improve insurance coverage for climate-related disasters is a step in the right direction.

Buttressing diversification efforts and climate resilience through fiscal policy

A well-articulated medium-term fiscal strategy would help support the diversification and climate resiliency efforts. Increasing spending on education, healthcare, and climate-resilient public infrastructure throughout the medium term will support the recovery now, while addressing bottlenecks for diversification and increasing the economy's resilience to climate change going forward. Diversification would also help reduce external imbalances in the medium term.

The trade-offs from multiple demands on fiscal policy are better addressed in a credible medium/long-term fiscal framework (MLTFF) than the current annual budget process. A MLTFF can preserve fiscal space for necessary fiscal measures by integrating all fiscal decisions into a well-specified framework with clear short- and medium-term priorities, steps to ensure efficiency of spending and tax policies, and clear guidelines and plans to ensure fiscal sustainability and intergenerational equity over the longer term.

The mission would like to thank the authorities for the excellent discussion and organizational support throughout the virtual visit.

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