The Impacts of the Social Unrest and the COVID-19 Epidemic on the Hong Kong Economy, and the Way Forward

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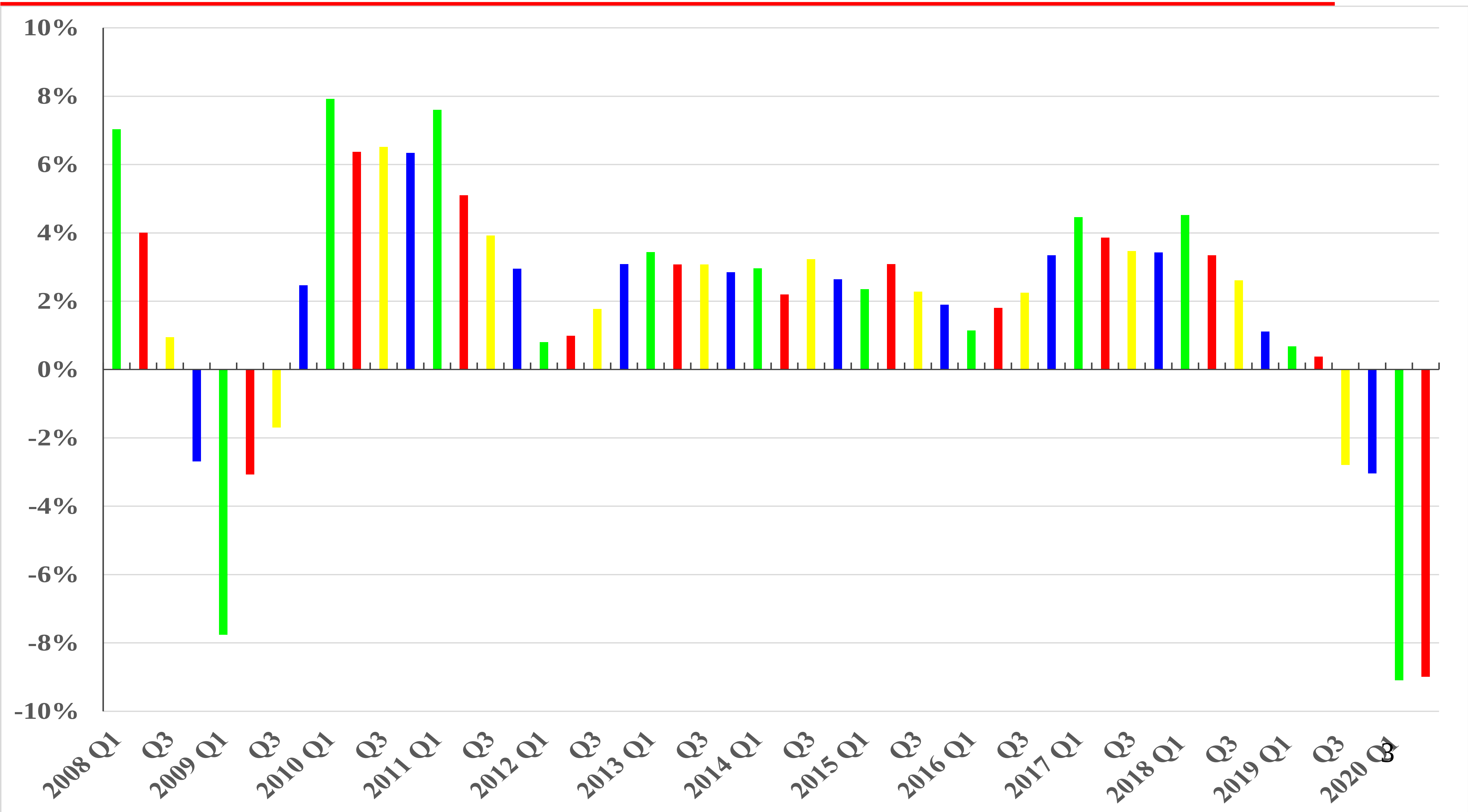
*All opinions expressed herein are the author's own and do not necessarily reflect the views of any of the organisations with which the author is affiliated.

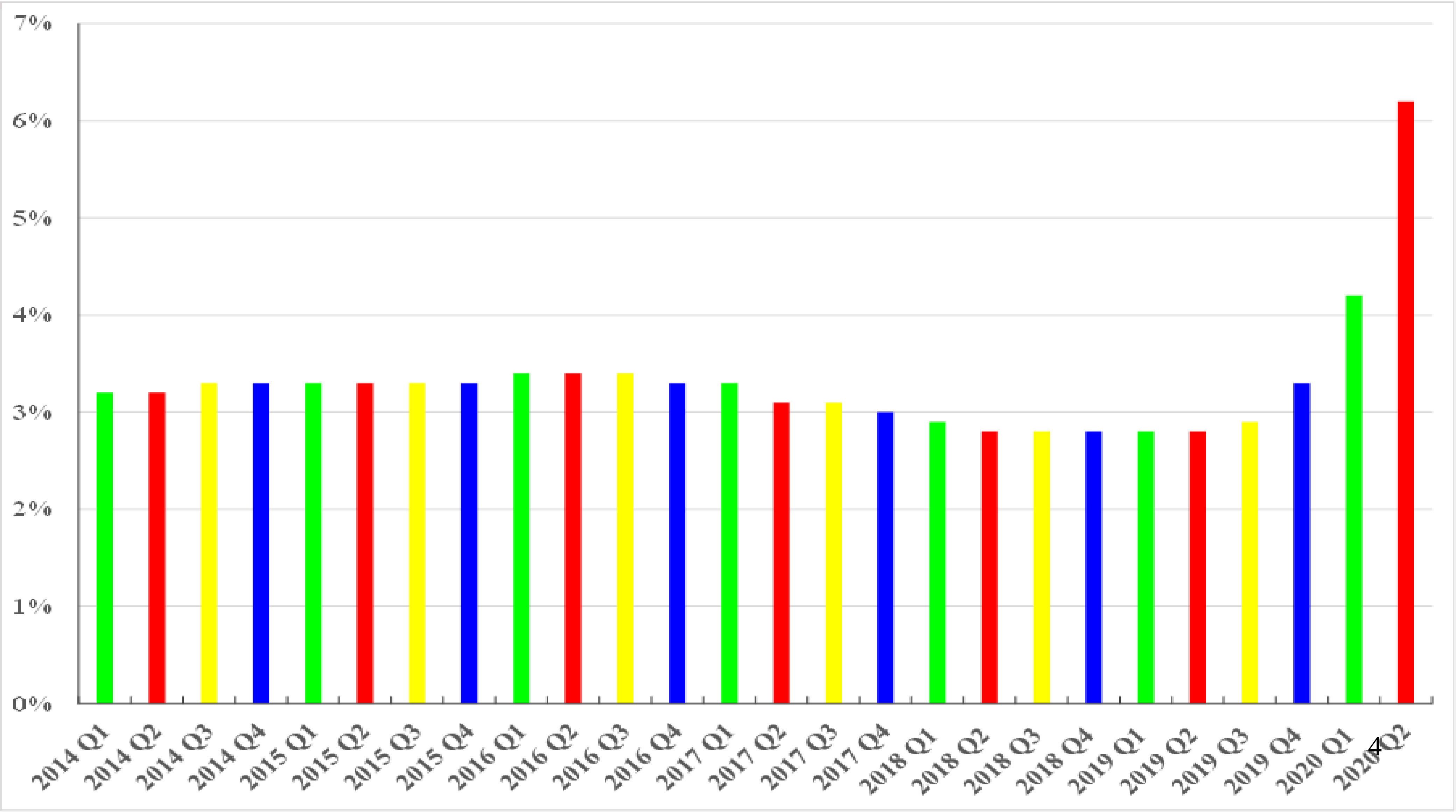
Introduction

- Both the social unrest, which started in the second quarter of 2019, and the COVID-19 epidemic, which started in the first quarter of 2020, had large negative impacts on the economy of Hong Kong. The year-over-year rate of growth of the real GDP of Hong Kong fell from 0.4% in 2019Q2, to successively -2.8%, -3.0%, -9.1% and -9.0% in the following 4 quarters. Under more normal circumstances, the Hong Kong economy would have probably grown more than 3% per annum.
- The HKSAR Government's latest economic outlook projects real GDP to contract by between 6% and 8% in 2020 as a whole. I believe it would be closer to 8% than 6%.
- Hong Kong has already had three rounds of anti-epidemic cash relief, which helped to prevent a total collapse of consumption. However, such cash payouts are basically one-off, diminishing in effectiveness, and unsustainable.

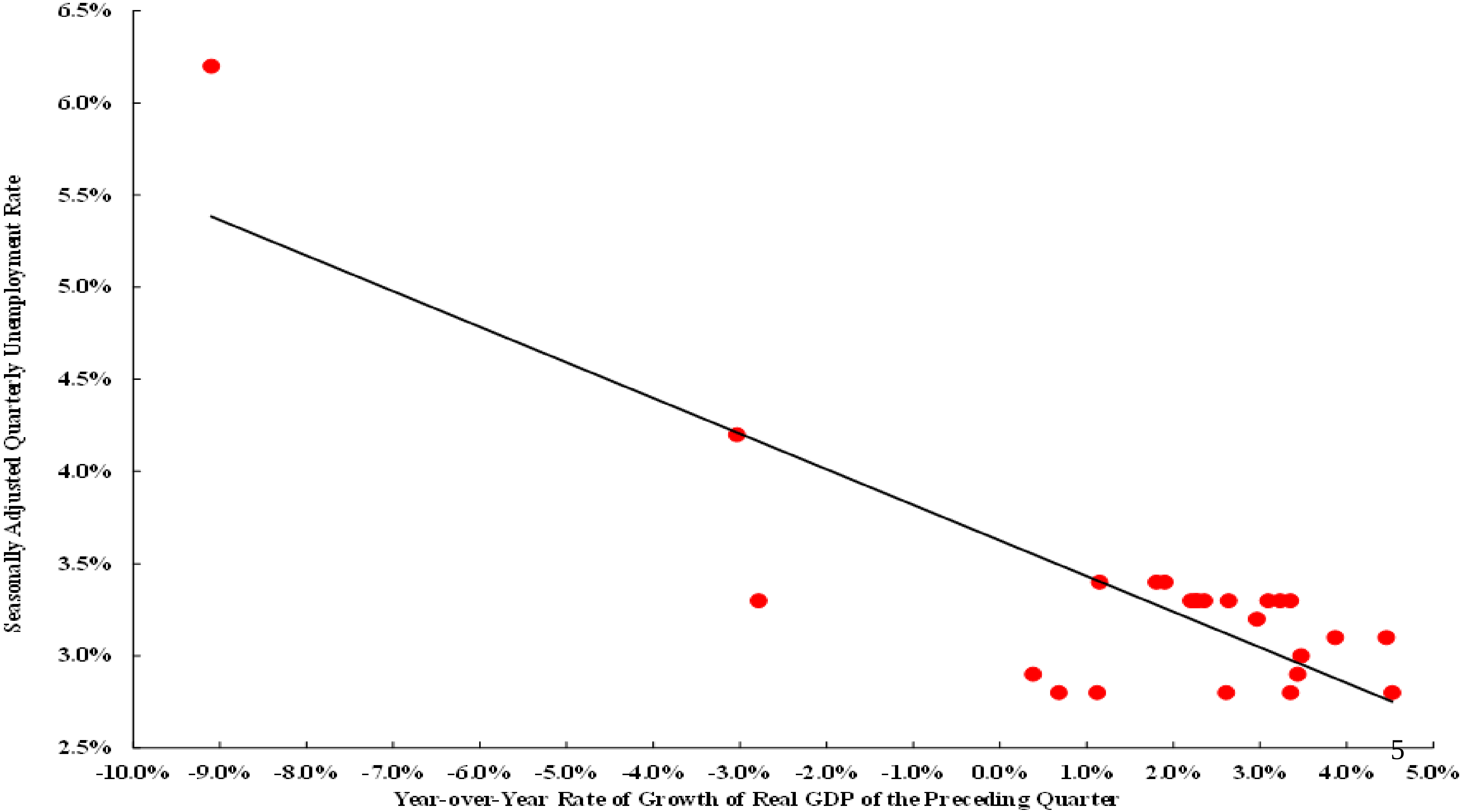
The Y-o-Y Quarterly Rates of Growth of the Real GDP (2018 prices) of Hong Kong, %



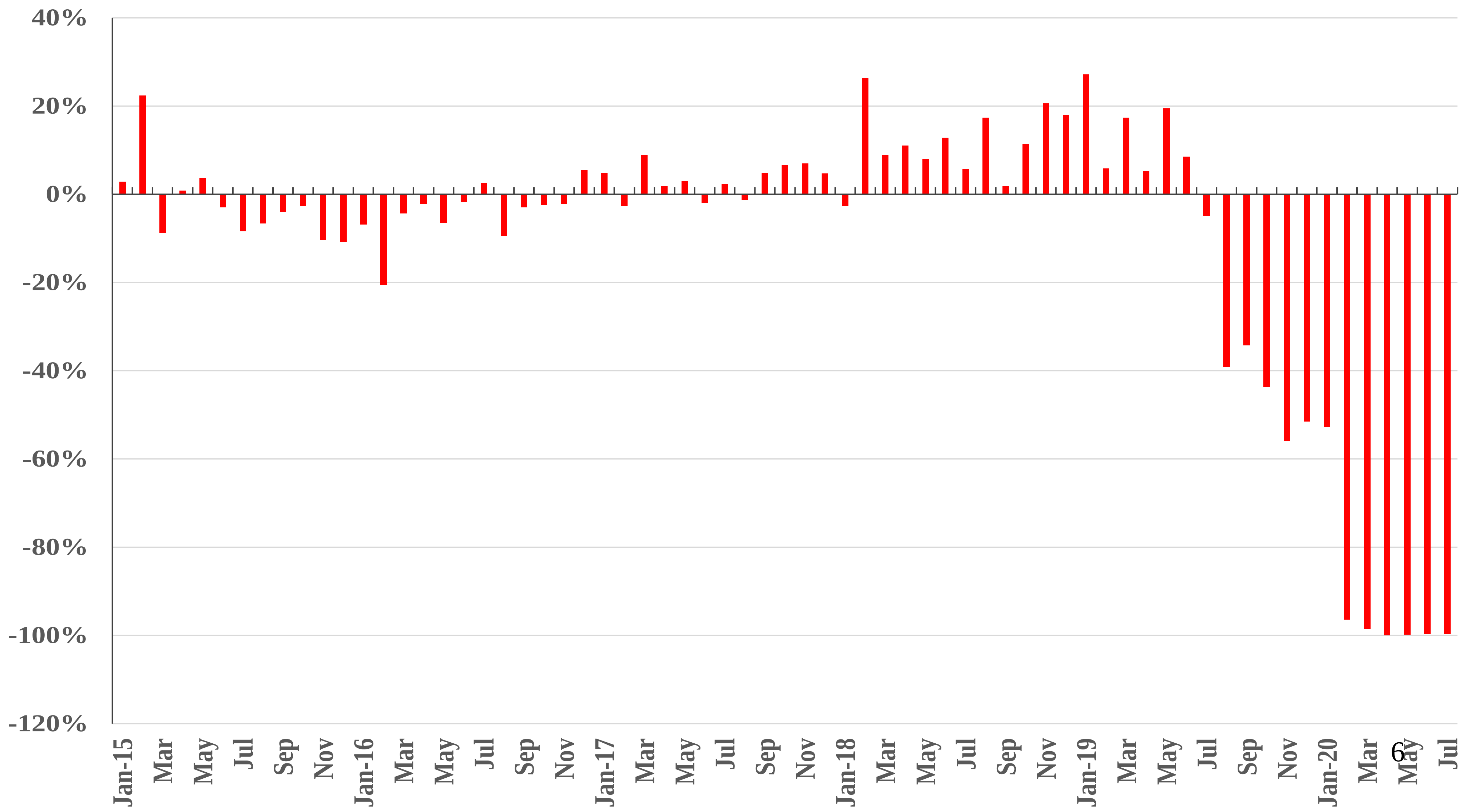
The Seasonally Adjusted Quarterly Rates of Unemployment in Hong Kong (percent)



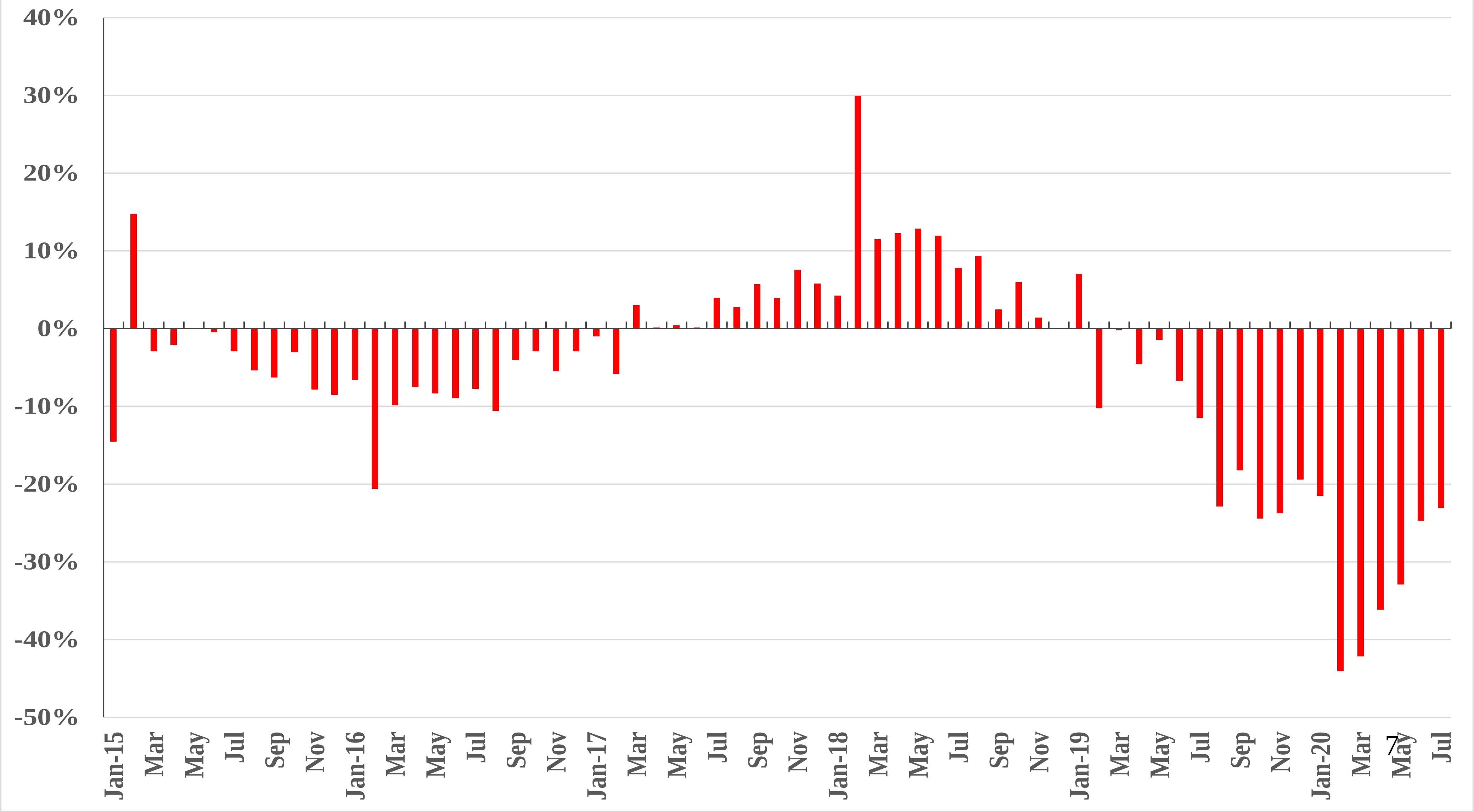
A Scatter Diagram: the Rate of Unemployment vs the Lagged Rate of Growth of Real GDP



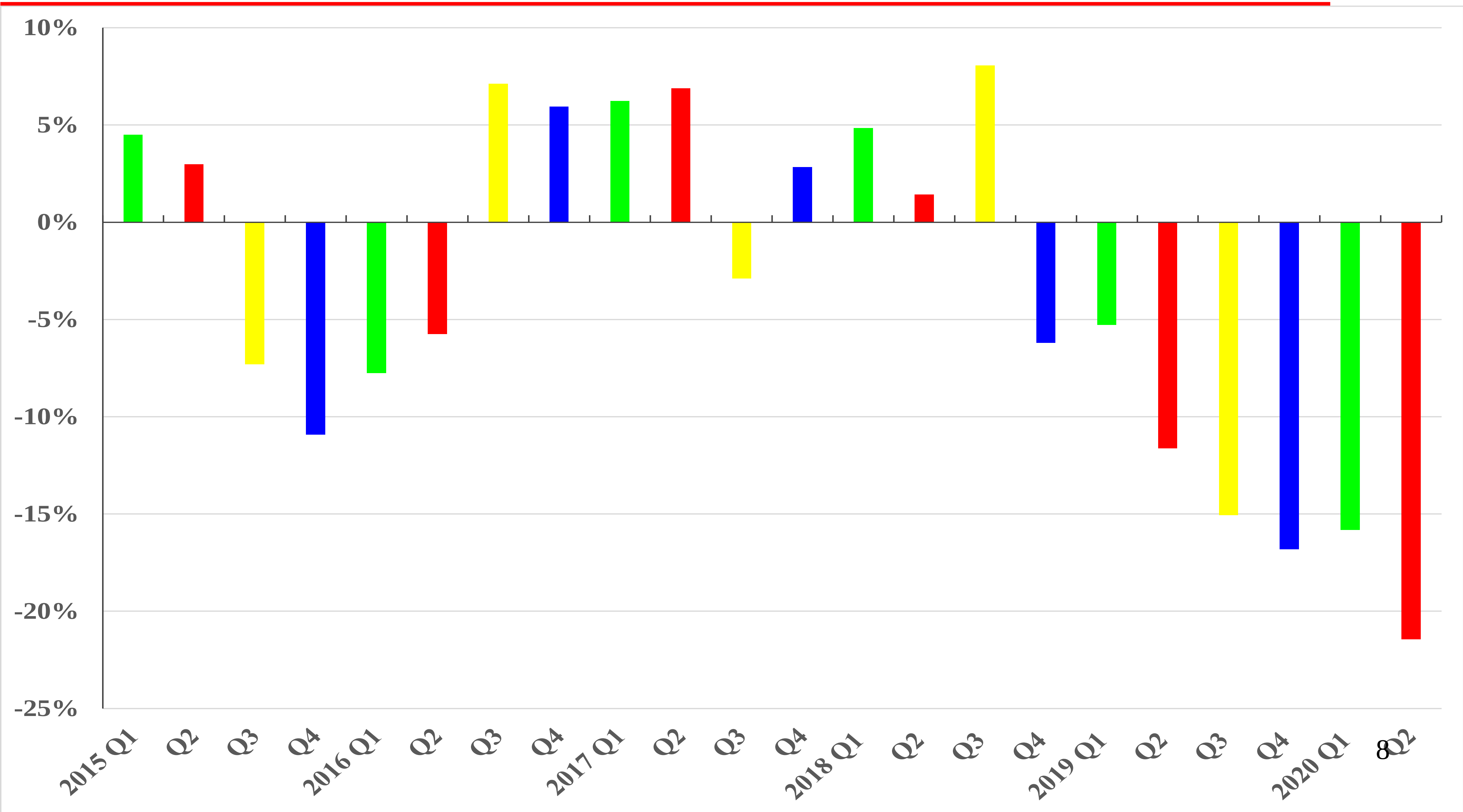
The Year-over-Year Monthly Rates of Growth of Total Visitor Arrivals in Hong Kong, %



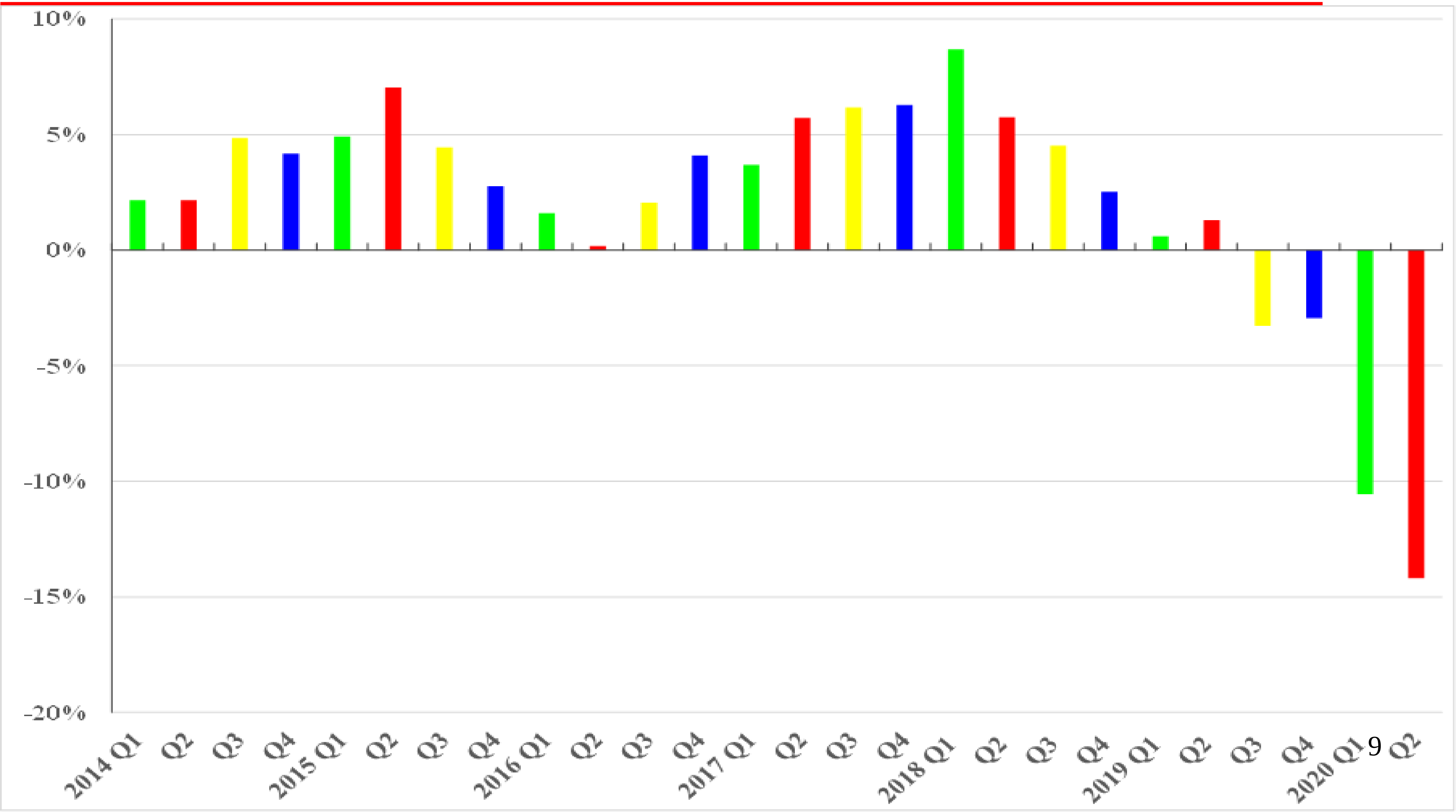
The Year-over-Year Monthly Rates of Growth of Retail Sales in Hong Kong (percent)



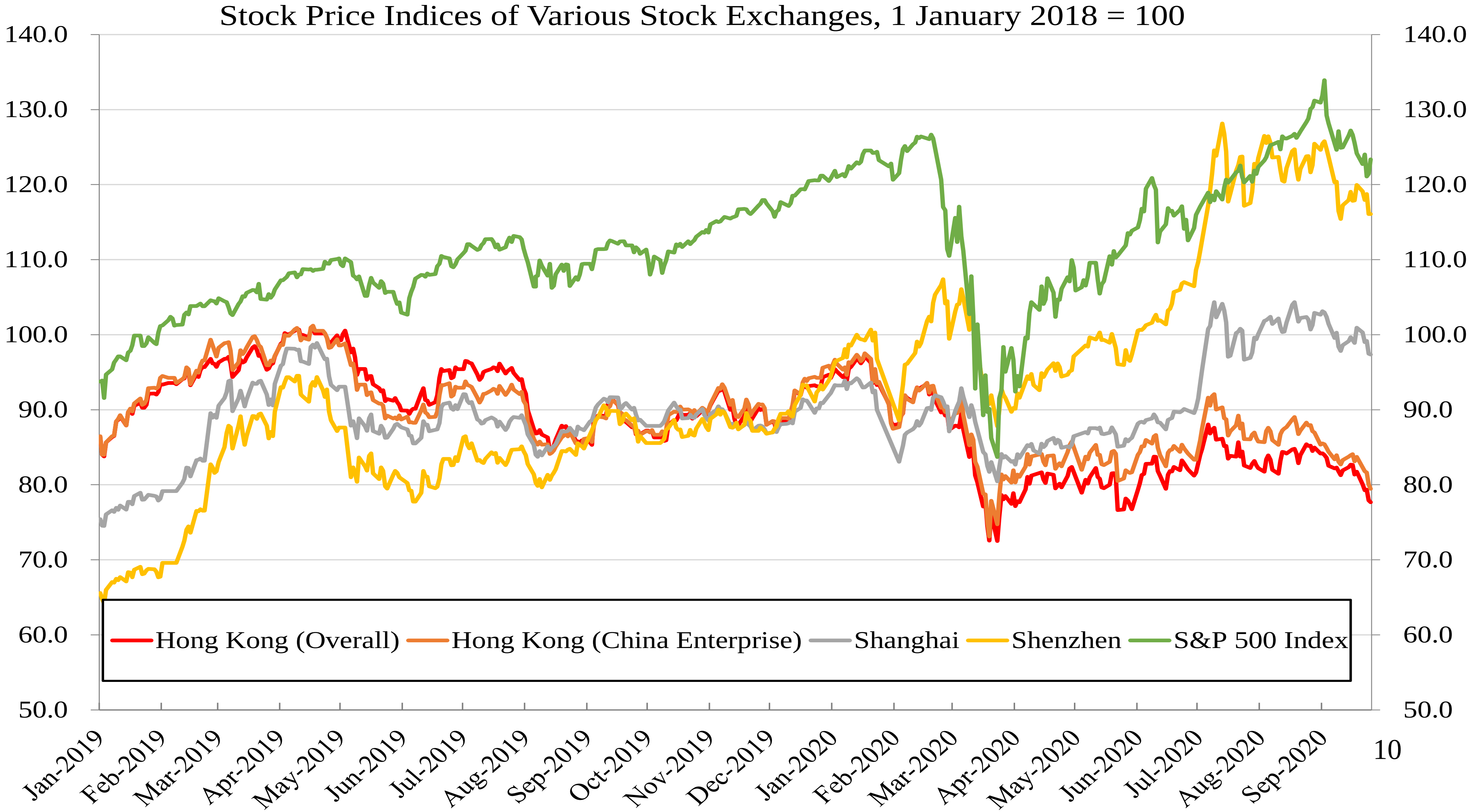
The Y-o-Y Quarterly Rates of Growth of Real Gross Fixed Investment in Hong Kong , %



The Year-over-Year Quarterly Rates of Growth of Household Consumption in Hong Kong, %



The Chinese, Hong Kong and U.S. Stock Market Indexes, 2019M1 to Date



The Economic Impacts of the Social Unrest and the COVID-19 Epidemic

- The impacts of the social unrest and the COVID-19 epidemic on the real GDP of Hong Kong are estimated by comparing the actual year-over-year quarterly rates of growth from 2019Q2 to 2020Q2 with the corresponding hypothetical quarterly rates of growth, estimated from historical data, attributing any differences to the impacts of the social unrest and the COVID-19 epidemic respectively.
- It is possible to separate out the impacts because the social unrest mostly affected the last three quarters of 2019 and the COVID-19 epidemic only affected 2020. However, the social unrest may return to have an impact in 2020Q4, although it appears unlikely because of the enactment of the National Security Law for Hong Kong on 1 July 2020.

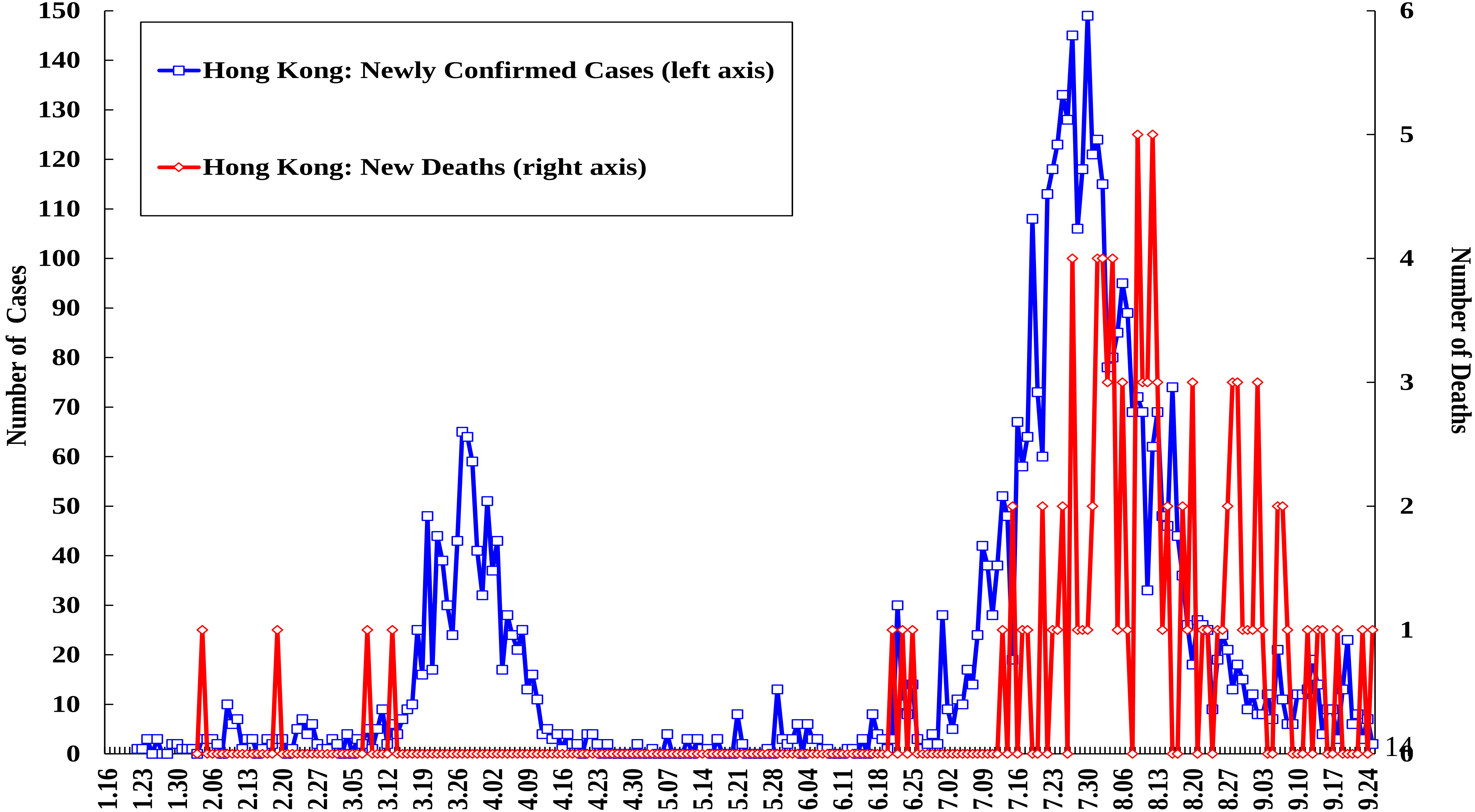
The Economic Impacts of the Social Unrest and the COVID-19 Epidemic

- The social unrest discouraged visitors, interrupted public transportation, and prevented shops, bars and restaurants, entertainment and personal service providers such as cinemas, barber shops and beauty parlours from operating normally.
- The COVID-19 epidemic also mandated periods of work-at-home, quarantines, social distancing, and banning of large gatherings, which also resulted in a significant reduction of economic activities, especially retail shopping and tourism.
- Moreover, they both contributed to the formation of negative expectations about the future prospects of the Hong Kong economy, which in turn reduced the motivation for both private investment and consumption in Hong Kong.

The Economic Impacts of the Social Unrest

- Based on historical data, we derive the following hypothetical year-over-year real rates of growth: Q1, 4.20%; Q2, 3.46%; Q3, 3.14%; and Q4, 2.68%, with an annualised rate of growth of 3.37%.
- The actual quarterly rates of growth from 2019 Q2 to 2020 Q2 were 0.38%, -2.79%, -3.04%, -9.10% and -9.00% respectively. The loss of GDP due to the social unrest from 2019Q2 to 2019Q4 may be estimated, by comparing the actual rates of growth with the hypothetical rates of growth, to be 2019Q2, 3.08%; Q3, 5.93%; and Q4, 5.72%; or an annualised rate of **3.68%**.

The Daily Newly Confirmed COVID-19 Cases and Deaths, Hong Kong



The Economic Impacts of the COVID-19 Epidemic

- The first confirmed COVID-19 case in Hong Kong was reported on 22 January 2020 and the first death occurred on 4 February 2020. Hong Kong actually did extremely well at the beginning: the number of daily newly confirmed cases fell to zero on 15 February and the number of new deaths remained very low.
- However, beginning in early March, the COVID-19 epidemic flared up again because of the influx of a large number of returning residents from Europe and North America. with the number of daily newly confirmed cases rising rapidly. Fortunately, this second wave subsided in approximately a month and did not result in any deaths.
- Then beginning in late June, there was a third, much larger, wave, that seemed to have started in the community. At its peak, the number of daily newly confirmed cases almost reached 150. This number has since fallen to the single digits.

The Economic Impacts of the COVID-19 Epidemic

- As of 25 September 2020, the cumulative numbers of confirmed COVID-19 cases and deaths in Hong Kong reached 5,058 and 105 respectively.
- In terms of controlling the spread of the epidemic, Hong Kong has been doing much better than Singapore, a city with a smaller population than Hong Kong, which has cumulatively 57,665 confirmed cases, but only 27 deaths. However, Beijing, a city with a population of over 21 million, has cumulatively only 936 confirmed cases and 9 deaths.
- The ultimate total damage to the Hong Kong economy depends on how much longer the COVID-19 epidemic will linger in Hong Kong and whether there will be a fourth wave.

The Economic Impacts of the COVID-19 Epidemic

- The loss of GDP due to the COVID-19 epidemic may be similarly estimated to be 2020Q1, 13.30%; and Q2, 12.46%; or an annualised rate of 6.44% as of the end of 2020 Q2.
- We expect that the real GDP is likely to contract by another 9.0% in Q3 and recover slightly to contract by 5.0% in Q4, taking into account the effects of the relief measures of the government.
- The loss of GDP due to the COVID-19 epidemic for 2020Q3 and Q4 may be estimated to be 12.14% and 7.68% respectively. For 2020 as a whole, the total loss due to COVID-19 may be estimated as 11.40%.

The Costs of the Social Unrest and the COVID-19 Epidemic to Hong Kong

Loss due to Social Unrest	Loss due to COVID-19	
2019 Q2-Q4	2020 Q1-Q2	2020 Q1-Q4 (projected)
(percent of GDP)		
3.7%	6.4%	11.4%

The Need for Additional Economic Stimuli

- The economic recovery will be slow. Both retail sales and tourists, from the Mainland and elsewhere, will only return slowly. Gross fixed investment, the creator of new GDP and employment, as well as household consumption, will remain low and subdued even after the epidemic, because of depletion of resources and unfavourable expectations of the future.
- Hong Kong, because of its "Linked Exchange Rate System (LERS)" or more colloquially "the U.S. Dollar Peg", has no independent monetary policy. The rate of interest in Hong Kong essentially has to follow the rate of interest in the U.S. set by the U.S. Federal Reserve Board.
- At a time like this, the government must take concrete fiscal measures to stimulate the economy and to try to change expectations. It can do so by undertaking public investment on a significant enough scale both to create GDP and employment and also as a signal to change expectations of the private sector so as to accelerate the recovery. Ultimately, economies are driven by expectations.

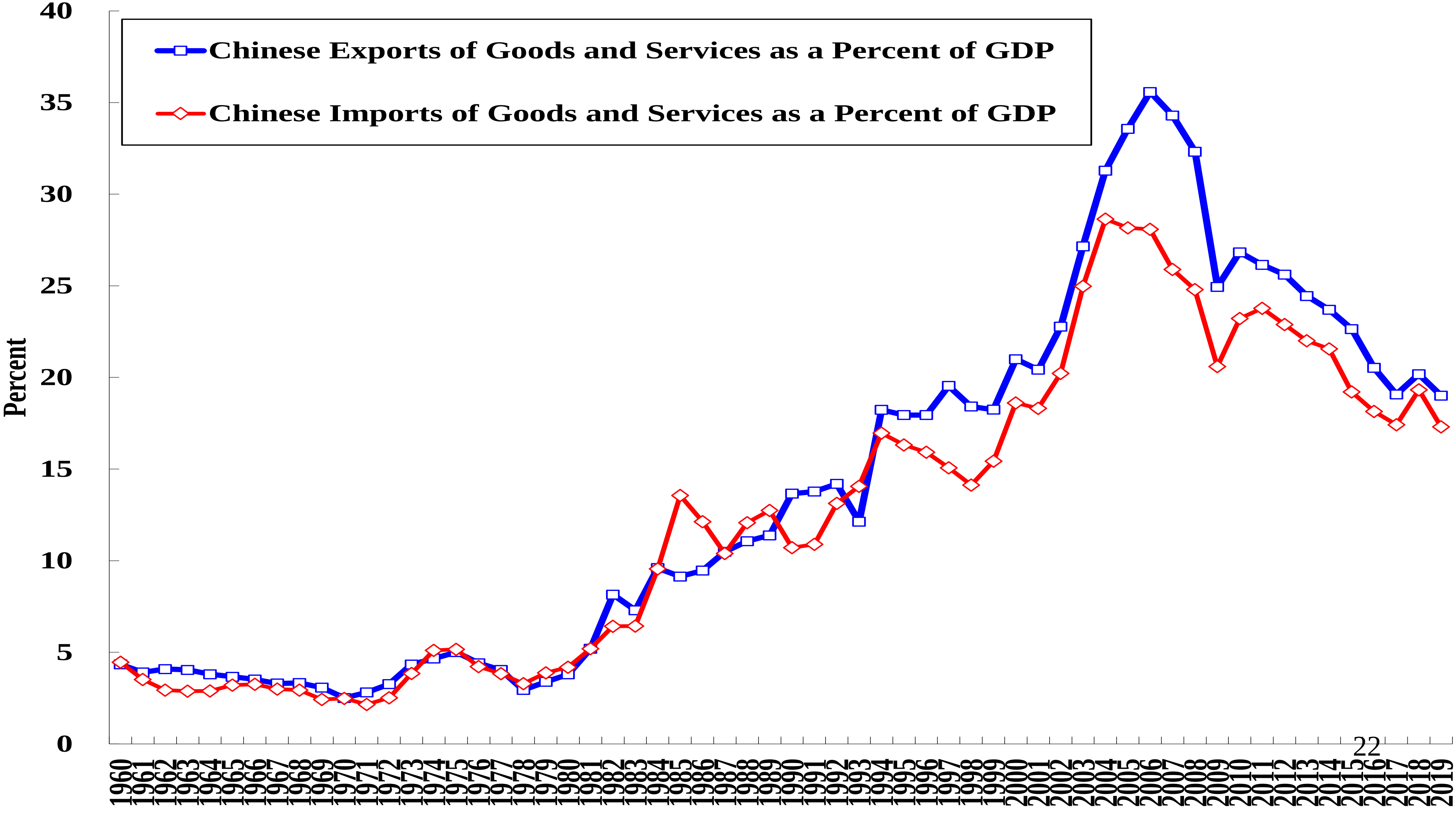
The Underlying Trends in the Chinese and Hong Kong Economies

- Going forward, we should also understand how the world has changed, perhaps permanently. We have to face a new normal.
- The International Monetary Fund (IMF), the World Bank and the OECD have all forecast a contraction in global GDP in 2020, ranging between 4.9% and 6%. They have also forecast a recovery in 2021 ranging between 4.2% and 5.4%. However, we should be prepared that the sentiments of nationalism, protectionism, and isolationism will continue to be strong in many countries. Tourism, both inbound and outbound, is unlikely to return to pre-COVID-19 levels any time soon.
- The Mainland, which has emerged from the COVID-19 epidemic, also contracted 6.8% in 2020Q1, year-over-year, but returned to a positive growth of 3.2% in 2020Q2. Alone among all major economies, China will register a positive growth in 2020. My own projection is a rate of growth of 3.4% for 2020 as a whole and 8.0% for 2021.

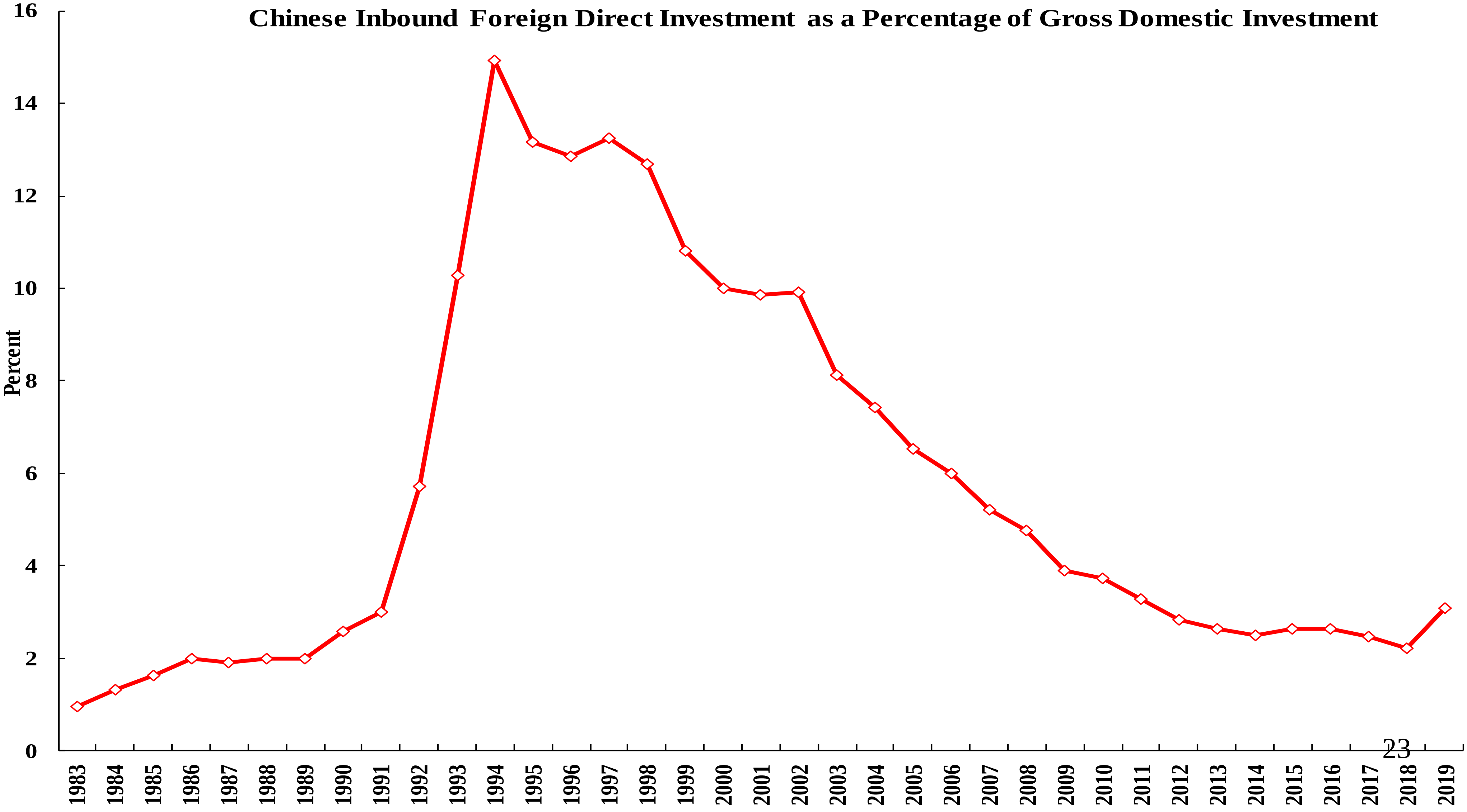
The Underlying Trends in the Chinese and Hong Kong Economies

- However, the Mainland economy itself has been undergoing a transformation from being export-driven to domestic-demand-driven, and from being the world's factory to the world's market. Its domestic circulation (國內循環) will become the primary focus, supported by as well as supporting the international circulation (國際循環) .
- In 2019, the ratio of Chinese exports of goods and services to Chinese GDP was 18.6%, and that of goods only was 16.9%, about half of their respective peak values of 35.6% and 32.1% in 2006.
- With the U.S. sanctions, the role of Hong Kong as a bridge, conduit and gateway for international trade and investment with the Mainland has been further reduced, in addition to the rise of Mainland cities and ports that are competitive with Hong Kong.
- However, Hong Kong has as its hinterland the Mainland economy, which has been and will continue to grow at a much higher rate than the U.S. and the rest of the world and is expected to become the largest economy in the world around 2030.

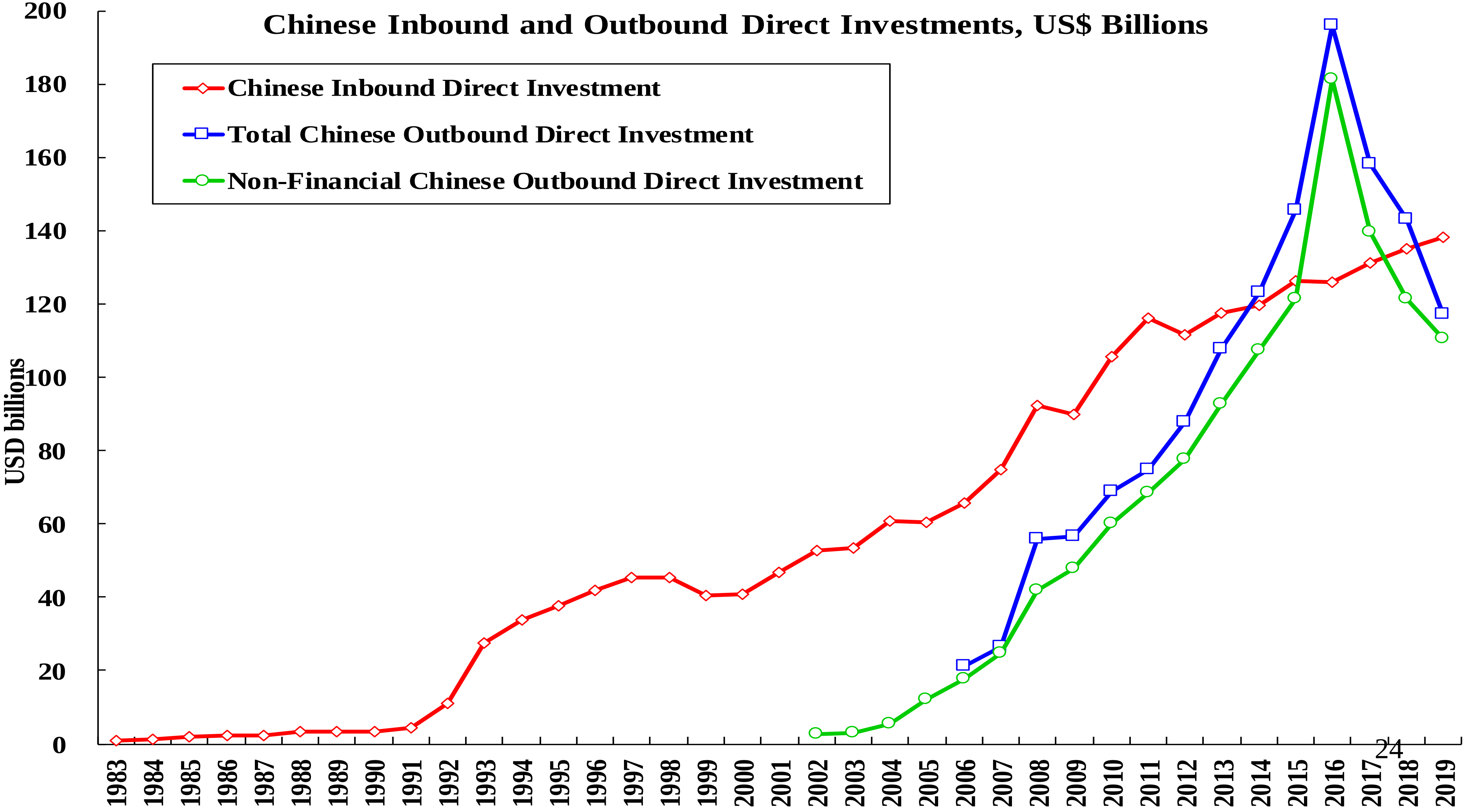
Chinese Exports and Imports of Goods and Services as a Percentage of Chinese GDP



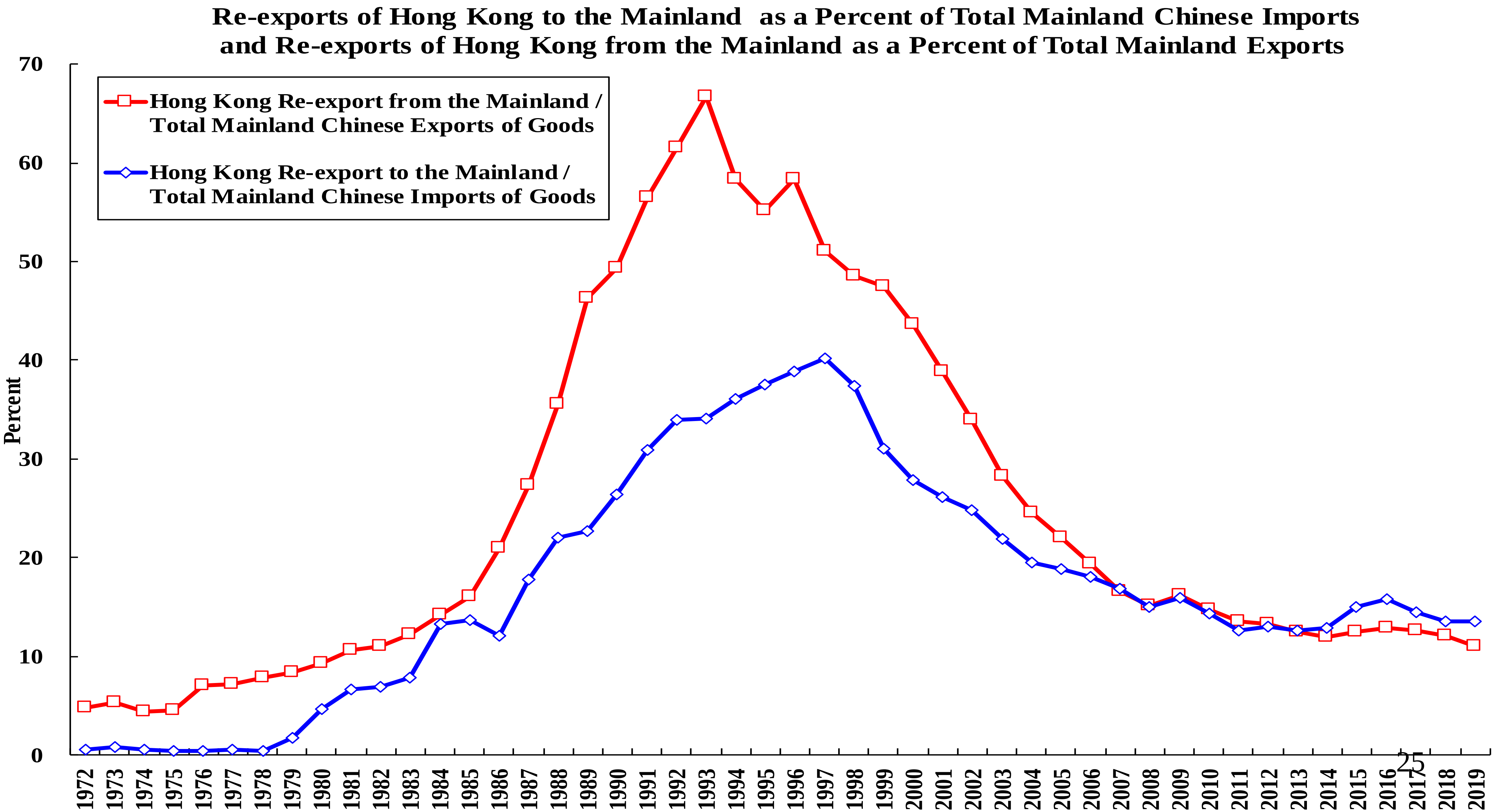
Chinese Inbound Foreign Direct Investment as Percent of Chinese Gross Domestic Investment



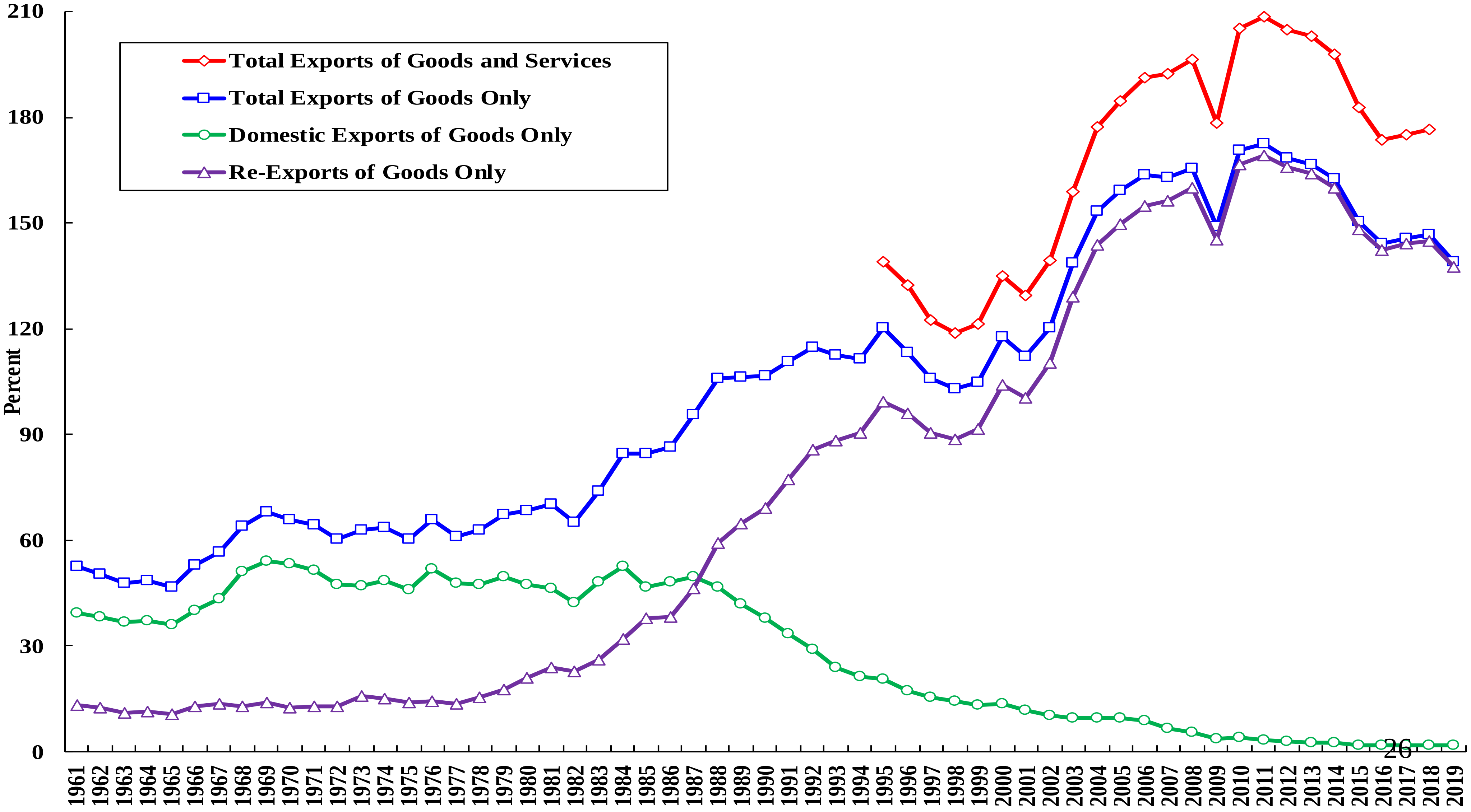
Total Chinese Inbound and Outbound Direct Investments, US$ billions



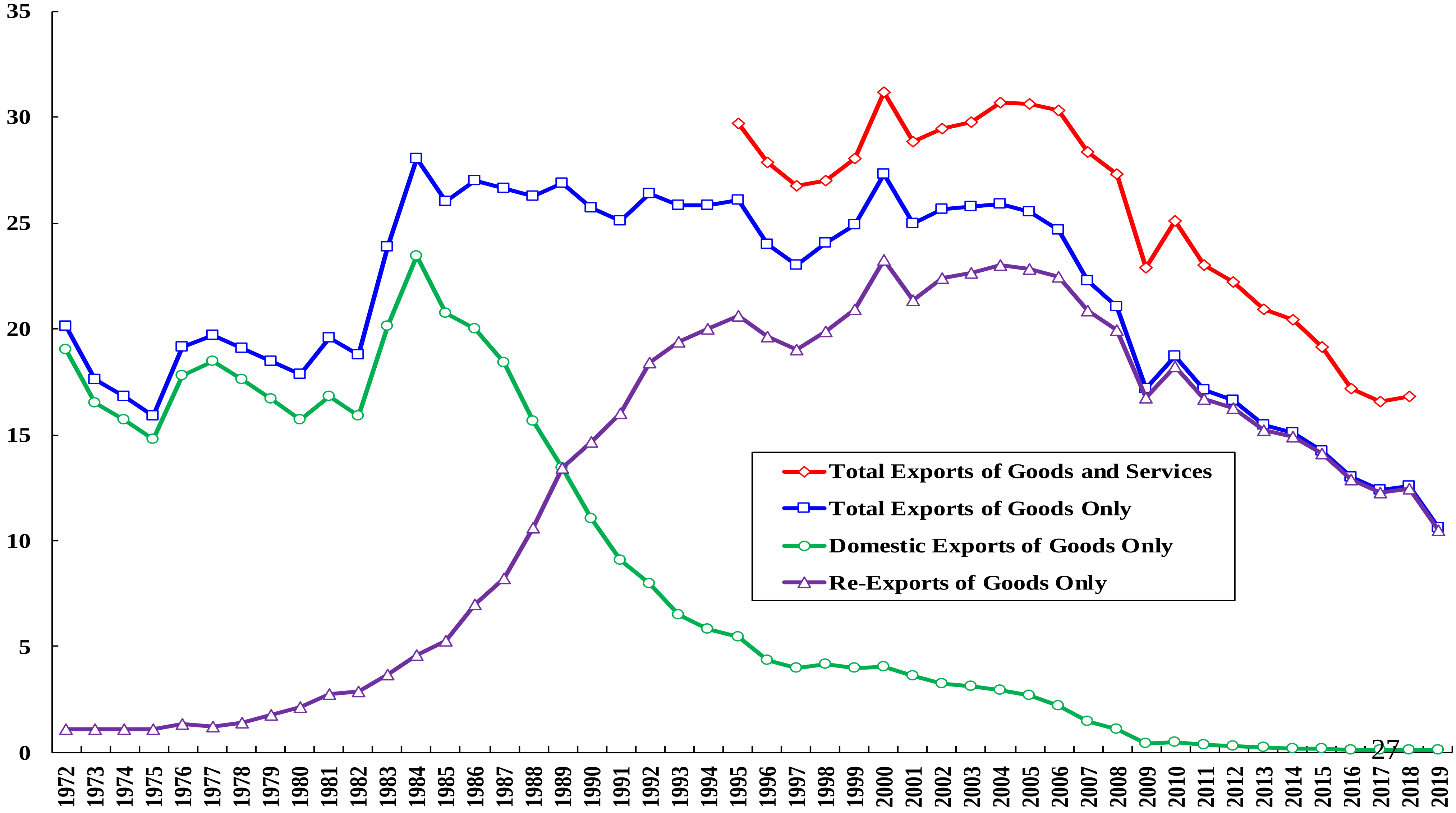
HK Re-Exports to and from the Mainland as a Percent of Mainland Imports and Exports



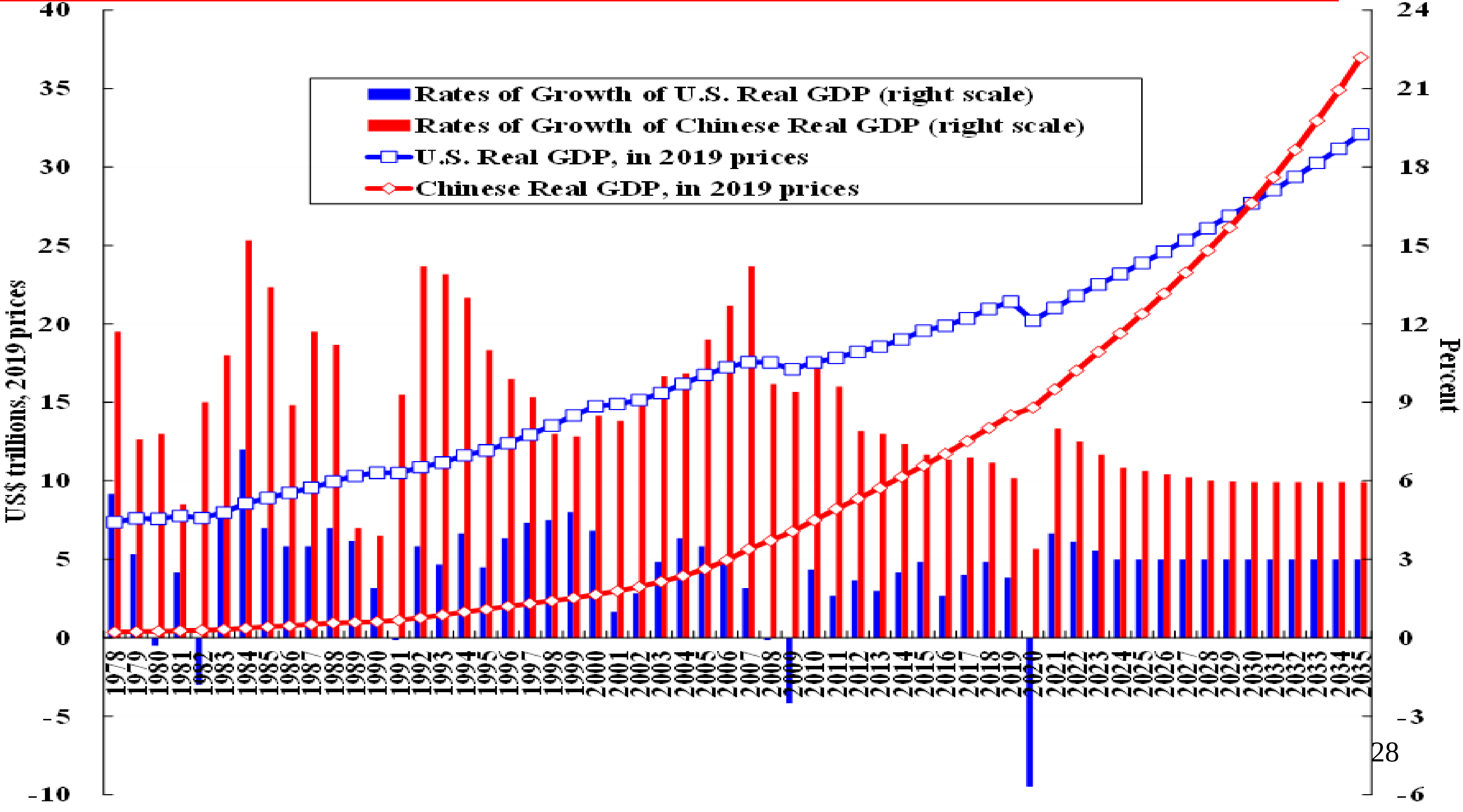
Exports to the World as Percent of GDP: Hong Kong



Exports to the U.S. as Percent of GDP: Hong Kong



Actual and Projected Real GDPs (2019 US$) and Their Rates of Growth: China and the U.S.



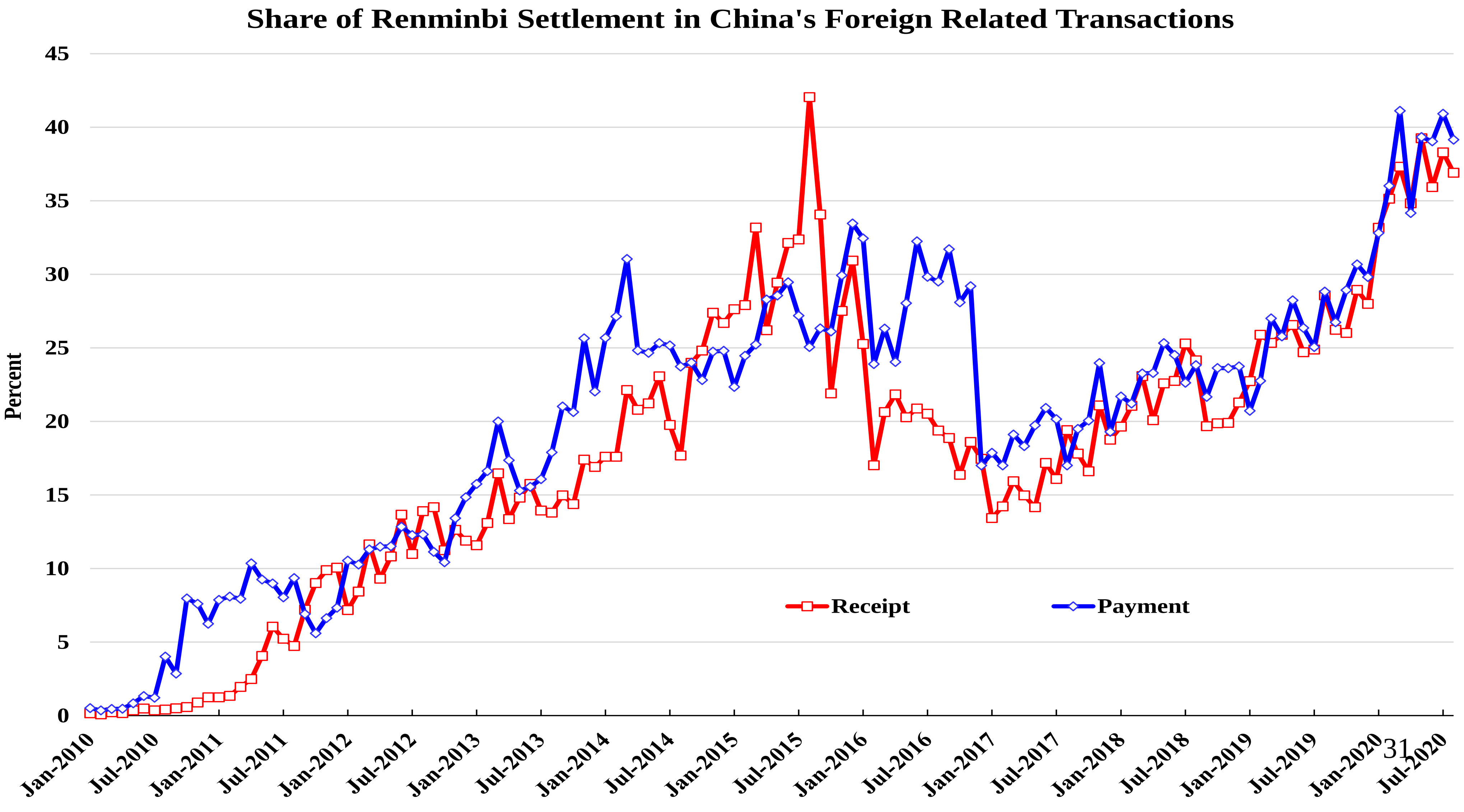
The Impacts of the China-U.S. Strategic Competition: Capital Markets

- Currently several hundred Chinese enterprises are listed on U.S. stock exchanges as their primary or secondary listings.
- However, the use of the New York stock exchanges by Chinese enterprises to raise capital has declined significantly over time. Back in **2014**, the distribution of Chinese Initial Public Offering (IPO) funding broke down to approximately **43% U.S., 29% Hong Kong and 28% A-shares** in Shanghai. In **2019**, the distribution of Chinese IPO funding broke down to **7% U.S., 12% Hong Kong and 81% China**.
- The total market capitalisation of publicly listed Chinese enterprises was distributed **8.7% U.S., 20.9% Hong Kong and 70.4% China in 2019**.
- The "Holding Foreign Companies Accountable Act", passed by the U.S. Senate, is intended to potentially de-list Chinese enterprises listed in the U.S.
- This may prove to be beneficial to the Hong Kong Stock Exchange as well as these Chinese enterprises (their P/E's are likely to be higher in Hong Kong and China). Netease and JD.com have already returned to Hong Kong for secondary listings, followed by YumChina.

The Impacts of the China-U.S. Strategic Competition: Clearing and Settlement

- Before 2010, almost all Chinese international transactions were settled in U.S. Dollars. However, there is now some uncertainty whether Chinese enterprises can continue to use the **Society for Worldwide Interbank Financial Telecommunication (SWIFT)** system to clear and settle international transactions in U.S. Dollars.
- Then China began to try to settle part of its international trade transactions in Renminbi in 2010. The share of settlement in Renminbi began to rise and grew steadily until it reached a peak of 32.5% in mid-2015. Then, because of an abrupt devaluation of the Renminbi, it declined to 15.6% in 2017M2. Then it began to recover, and was at 38.0% in 2020M8. There is still a great deal of room for the Renminbi to expand its use in the settlement of Chinese international trade.
- In the medium to long run, China will encourage its trading-partner countries to settle in their own respective currencies rather than in U.S. Dollars, reducing transaction costs and exchange risks all around.
- Hong Kong can benefit by being the leading offshore Renminbi centre.

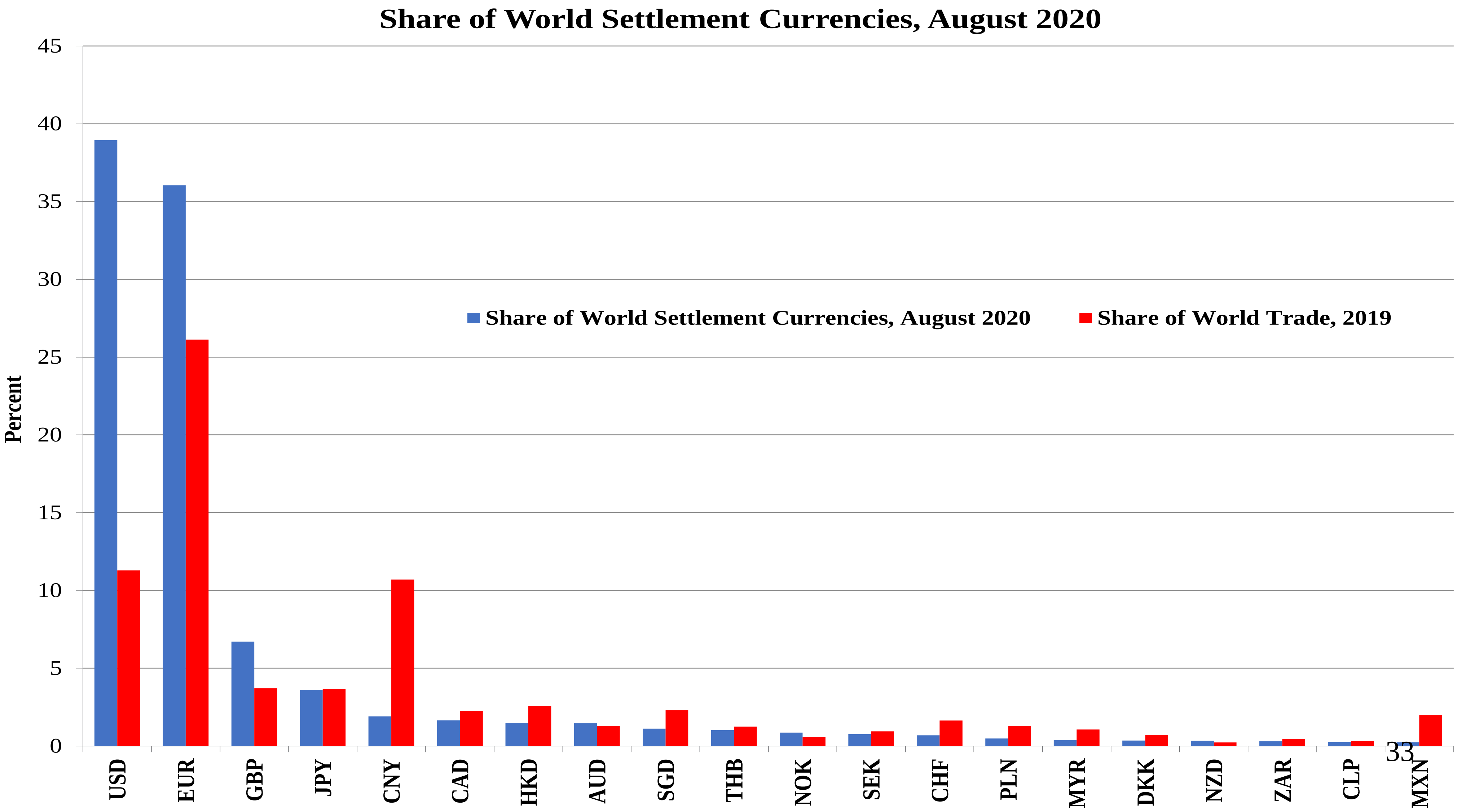
Share of Renminbi Settlement in China's Foreign Related Transactions



The Impacts of the China-U.S. Strategic Competition: Clearing and Settlement

- The U.S. Dollar is the most important medium of international exchange. It accounts for 40% of world settlement of all international transactions through the SWIFT system even though the U.S. accounts for only 11.3% of all international trade (including both goods and services) transactions. For most countries, international trade transactions constitute the bulk of their international transactions, but this is not true of major international investors such as the U.S. and Japan.
- In contrast, even though China accounts for 10.7% of all international trade, almost as much as the U.S., only 1.76% of all international transactions is settled in Renminbi through the SWIFT system.
- By comparison, Japan accounts for 3.7% of all international trade and its currency, the Japanese Yen, is used in the settlement of 3.7% of all international transactions.
- There is obviously a great deal of room for the use of the Renminbi to grow in the settlement of international transactions, especially international trade transactions.

Share of World Settlement Currencies, August 2020



The Way Forward

- Basic assumptions: The social unrest will not recur and the COVID-19 epidemic is under control.
- If either or both are ongoing, many small and medium enterprises will either declare bankruptcy or shut down; the private sector will not make new investments; and households will have every incentive to conserve their savings. The net result is a even more serious recession with rising unemployment.
- In the near term, the focus of public investment should be on projects that can be readily launched using local labour and material and with minimal import content requirements.

The Way Forward—Near Term: Possible Areas for Public Investment

- Retrofitting of all public buildings to make them energy-efficient—for example, installation of solar panels, replacement of antiquated air conditioning systems, use of double-glazed windows, etc. One can even make all public buildings epidemic-safe, with automated doors, sensor- and voice-operated lifts, body-temperature-sensitive surveillance cameras at building entrances, etc., at the same time. Such retrofitting can pay for itself through savings of energy, maintenance and other operating costs over time.
- Building more hospitals with up-to-date surgical and intensive-care facilities and isolation wards; building more elderly care homes; and training more nurses. Hong Kong should be prepared for future epidemics which are certain to come.
- Stepping up maintenance and major repairs of public rental housing units, bringing them to a standard that is acceptable in the event of sale.

The Way Forward—Near Term: Possible Areas for Public Investment

- Repair and restoration of the antiquated underground sewage system to avoid frequent flooding and to prevent it from becoming a source of bacteria and viruses.
- Promotion of the use of the internet, which has now become indispensable for most people because of the COVID-19 epidemic, for example, for online schooling and for work-at-home. The Government should endeavour to provide free or at least affordable Wi-Fi service at all the public housing estates. The private internet providers do not lose any business as the public housing tenants cannot afford the subscriptions anyway.
- Digitalisation of all old government documents such as birth, death, marriage and divorce records and property deeds, so that they will be readily accessible if ever needed. This will also greatly reduce future transactions time and cost for both the government and the citizens. Duplicate copies can be easily maintained.

The Way Forward—Near Term: Where Can the Money Come From?

- Hong Kong still has large accumulated surpluses approximately equal to HK$800 billion or almost 30% of its GDP and can easily afford to run budget deficits for at least several years if necessary. Moreover, it has almost zero public debt, compared to the public debt to GDP ratios of Japan (over 250%) and the U.S. (over 100%). Hong Kong has plenty of unused borrowing capacity and its credit rating should be better than either Japan or the U.S. This is also the right time to borrow or to invest as the long-term rate of interest is at an unprecedentedly low level.
- First of all, the retrofitting of government buildings to be more energy-efficient is ideally suited to be financed with "green" bonds. As the retrofitting costs can be recouped over time through future energy savings, no subsidy is required. The government can issue long-term, say thirty-year, fixed-rate bonds to finance such a project. It will have much lower electric utility bills in the future. It can use the savings to repay the principal and the interest of the bond financing.
- Second, the additional hospitals are also a long-term investment, and should come out from the capital budget of the government.

The Way Forward—Near Term: Where Can the Money Come From?

- Third, the costs of repairing and restoring the government's rental housing units can also be financed through long-term bonds. These repair and restoration costs should be amortised over the remaining life of the rental housing unit and added to the monthly rental rates. If and when the unit is privatised, the unamortised balance can and should be added to the sale price of the unit. The additional rental revenues and the proceeds from the sales should go to servicing and retiring the bonds.
- Fourth, the sewage system can also be financed through the issuance of bonds since it will last for another few decades. The costs can be recovered from an increase in building permit fees or in rates since the property owners are the principal beneficiaries.
- Fifth, provision of internet access to public housing estates brings great benefits to the public tenants and their families and should be borne by the government as a regular expenditure. Once built, the operating costs should be minimal.
- Finally, digitalisation of old government documents is also a one-off capital expenditure that should be borne by the government. It will more than pay for itself over time because of the potential savings in document search costs and time.

The Way Forward—Long Term: Possible Areas for Public Investment

- Large, planned infrastructural projects, such as the Third Runway Expansion at the Hong Kong Airport, land reclamation and extension of our rail and subway lines should be accelerated.
- A real effort to increase both public and private housing should be launched.
- Strengthening Hong Kong as the "International Financial Centre" for East Asia.
- Creating and realising synergies with the other cities in the Guangdong-Hong Kong-Macau Greater Bay Area.

Strengthening Hong Kong as the “International Financial Centre” for East Asia

- Development of an Active, Deep, Liquid and Wide Bond Market
- The Premiere Off-Shore Renminbi Centre
- An East-Asia-Wide Stock Exchange
- A Venture Capital, R&D and Start-Up Centre
- A Re-Insurance Centre for East Asia

The Way Forward—Long Term: Development of an Active Bond Market

- It is clearly important for Hong Kong to develop an active, deep, liquid and wide bond market, so that the Hong Kong Government and other entities can raise long-term funds easily and inexpensively.
- Moreover, the existence of such a market will greatly enhance the competitiveness of Hong Kong as an international financial centre. Hong Kong is usually ranked third in the world, after New York and London. What do New York and London have that Hong Kong does not? An active, deep, liquid and wide market in fixed-income securities, especially long-term fixed-income securities. Almost all asset management firms, family offices, insurance companies and pension funds invest in both fixed-income and equity. The Hong Kong market needs to beef up its offerings in fixed-income securities significantly in order to be able to attract more of these financial service providers to locate in Hong Kong.

The Way Forward—Long Term: Development of an Active Bond Market

- However, Hong Kong needs to offer much more than just green bonds. In order to create an active and liquid bond market, there has to be a sufficiently large volume of transactions and new issues, as well as a full variety of maturities—short-, medium- and long-term.
- The most promising place to start is for the Hong Kong Mortgage Corporation (HKMC), which is basically wholly-owned by the HKSAR Government, to issue HK$-denominated long-term fixed-rate bonds (say, up to 35 years), the proceeds of which are used to purchase qualified long-term fixed-rate owner-occupied residential mortgage loans from commercial banks that will act as originators and servicers in Hong Kong (up to a ceiling amount, of, say, HK$8 million).
- There will be heavy demand for such long-term fixed-rate HK$-denominated bonds from life insurers who need long-term HK$-denominated assets. (US$-denominated assets are considered as good as HK$-denominated assets as long as the HK$ remains pegged to the US$. But in another 30 years, who knows?)

The Way Forward—Long Term: Development of an Active Bond Market

- By amortising a mortgage loan over 35 years instead of 15 years, the monthly payments of the borrower will be more than halved. In addition, the borrower is not subject to the interest rate risk of a variable-rate loan over this long time horizon. The availability of these loans will greatly benefit the lower-income households by reducing their net cost of borrowing and increasing their monthly cash flows.
- In fact, even a simple refinancing of an existing mortgage loan of shorter maturity with a 35-year mortgage loan can put cash into the pockets of borrowers immediately and monthly thereafter. With improved cash flows, these households can increase their consumption and help speed up the economic recovery.
- These low fixed-rate long-term mortgage loans will also be particularly helpful if and when the Government contemplates the sale of its public residential rental units to their existing occupants.

The Way Forward—Long Term: Development of an Active Bond Market

- The present time is probably the most favourable for the promotion of long-term fixed-rate loans as the rate of interest on long-term fixed-rate bonds such as 30-year U.S. Treasury bonds are at a historic low. The rate of interest of 30-year fixed-rate U.S. Treasury securities is currently less than 1.5%.   The HKMC, with its credit guaranteed by the HKSAR Government, arguably should qualify for at least the same if not an even better rate than the U.S. Treasury, which means these mortgage loans can in principle carry a fixed rate of interest below 2%.
- Moreover, the yield curve is almost flat—the short-term rate is almost the same as the long-term rate. Thus, the borrower does not have to pay a higher rate of interest for a longer-term loan, which makes it much easier to sell the merits of a long-term fixed-rate mortgage loan.

The Way Forward—Long Term: Development of an Active Bond Market

- The development of an active and deep bond market can also enhance the role of Hong Kong in the Belt and Road Initiative. In the early phase of the Belt and Road Initiative, the emphasis is on infrastructural projects to enhance connectivity and promote electrification. Hong Kong's comparative advantage is not in the building of infrastructure or power plants, but is potentially in capital raising. As most of the Belt and Road infrastructural projects are capital-intensive projects with long payback periods that require long-term financing, it is absolutely essential for Hong Kong to develop the capability of long-term bond issuance and trading.
- Moreover, to the extent that some of the Belt and Road projects require Renminbi expenditures, Hong Kong is the ideal place to float long-term Renminbi-denominated bonds.

Creating and Realizing Synergies in the Guangdong-Hong Kong-Macau GBA

- Manufacturing is unlikely to return to Hong Kong itself any time soon. However, we should also note that there is today no manufacturing in the Silicon Valley either. Apple is located in Cupertino, the heart of the Silicon Valley, but the iPhones are all manufactured on the Mainland.
- Hong Kong and Shenzhen joining forces can be more than the Silicon Valley and NASDAQ combined because there will be not only capital and technology but also seasoned manufacturers, engineers and workers right in Shenzhen.

Creating and Realizing Synergies in the Guangdong-Hong Kong-Macau GBA

- Within the GBA, and certainly on the Hong Kong and Shenzhen Stock Exchanges, it should be possible to have both the Hong Kong Dollar and the Renminbi circulate in parallel. This is eminently feasible given all the digital payment platforms. The only condition is that on the stock exchanges, an investor has to sell the securities in the same currency that the investor has bought the securities. This is actually identical to the rules under Shanghai-Hong Kong Connect and Shenzhen-Hong Kong Connect.
- Moreover, using the block-chain feature of digital currencies, it is possible to make the Guangdong-Hong Kong-Macau GBA a truly free trade zone without inbound or outbound capital controls.

Concluding Remarks

- The social unrest in 2019 caused a loss of real GDP of 3.7% in 2019 and the COVID-19 epidemic caused a loss of real GDP of 6.4% up to the first half of 2020. For 2020 as a whole, the total loss due to the COVID-19 epidemic may be projected to be 11.4% of real GDP. On the assumptions of no more social unrest going forward and the COVID-19 epidemic under control, the Hong Kong economy may recover to positive growth in 2021.
- However, the economic recovery can be accelerated if the government takes the lead in increasing aggregate demand through suitable and timely increases in public investment expenditures. Several possible areas for public investment have been identified. While it may take a while before any public investment plan becomes a reality, the mere announcement of the plans by the Government will get the private sector to begin thinking, and working, even before the tenders are out and contracts are awarded. The time for the Hong Kong Government to act is now!