Combating Economic Downturn: How Can Hong Kong Emerge from Its Recession?

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Introduction and Background

- Following more than six months of social unrest, the Hong Kong economy has been further battered by the COVID-19 outbreak during the past four months. In 2020Q1, the Hong Kong economy contracted by 8.9% year-over-year, the third quarterly decline in a row, and Hong Kong is officially in an economic recession.
- The International Monetary Fund (IMF) has warned of a global recession with a 3% contraction in global GDP in 2020 (and contractions of 5.9% and 7.5% for the U.S. and Europe respectively, the worst since the Great Depression of the 1930s).
- The Mainland, which has just begun to emerge from the COVID-19 epidemic, also announced a contraction of 6.8% in 2020Q1, year-over-year.
- The HKSAR Government's latest economic outlook projects real GDP to contract by between 4% and 7% in 2020 as a whole.
- In the meantime, the standing of Hong Kong as an International Financial Centre has fallen from third to sixth place, behind New York, London, Tokyo, Shanghai, Singapore and just ahead of Beijing.

Introduction and Background: Rankings by Global Financial Centres Index

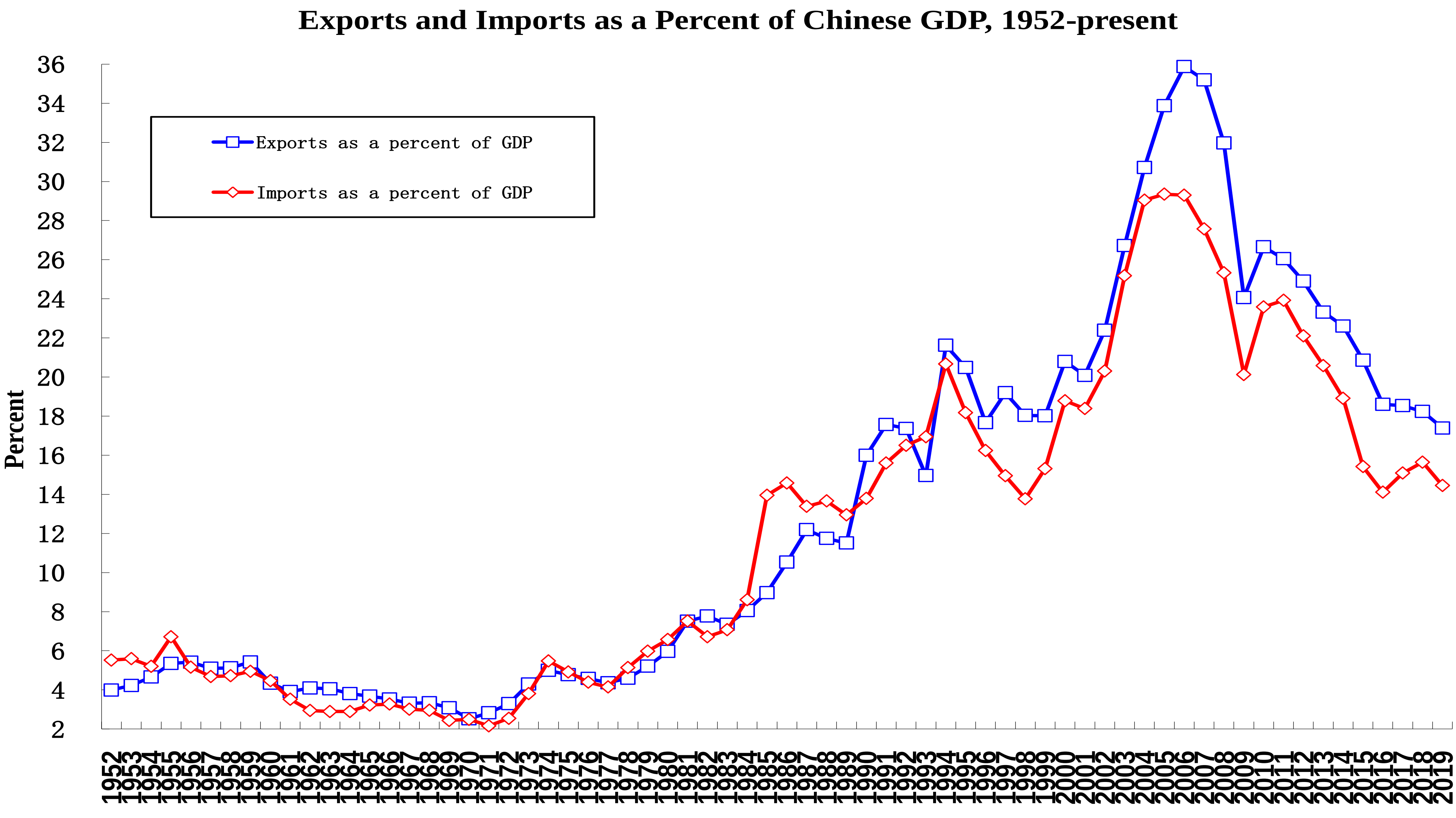
Table 1 | GFCI 27 Top 54 Ranks And Ratings

Centre	GFCI 27		GFCI 26		Change in	Change in
	Rank	Rating	Rank	Rating	Rank	Rating
New York	1	769	1	790	0	▼21
London	2	742	2	773	0	▼31
Tokyo	3	741	6	757	▲3	▼16
Shanghai	4	740	5	761	▲1	▼21
Singapore	5	738	4	762	▼1	▼24
Hong Kong	6	737	3	771	▼3	▼34
Beijing	7	734	7	748	0	▼14
San Francisco	8	732	12	736	▲4	▼4
Geneva	9	729	26	706	▲17	▲23
Los Angeles	10	723	13	735	▲3	▼12
Shenzhen	11	722	9	739	▼2	▼17
Dubai	12	721	8	740	▼4	▼19
Frankfurt	13	720	15	733	▲2	▼13
Zurich	14	719	14	734	0	▼15
Paris	15	718	17	728	▲2	▼10
Chicago	16	717	16	732	0	▼15
Edinburgh	17	716	29	701	▲12	▲15
Luxembourg	18	715	25	708	▲7	▲7
Guangzhou	19	714	23	711	▲4	▲3
Sydney	20	713	10	738	▼10	▼25

Underlying Trends

- The Mainland economy 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. The shares of exports in its GDP and inbound foreign direct investment (FDI) in its gross domestic investment have all been falling for quite a while. The role of Hong Kong as a bridge, conduit and gateway for international trade and investment with the Mainland has been vastly reduced, in part because of the rise of Mainland cities and ports that are competitive with Hong Kong.
- The share of exports in Chinese GDP has fallen below 20%. And since the total (direct + indirect) value-added content of Chinese exports is approximately two-thirds, the contribution of exports to Chinese GDP may be estimated to be approximately 13%, significant, but not overwhelmingly important.

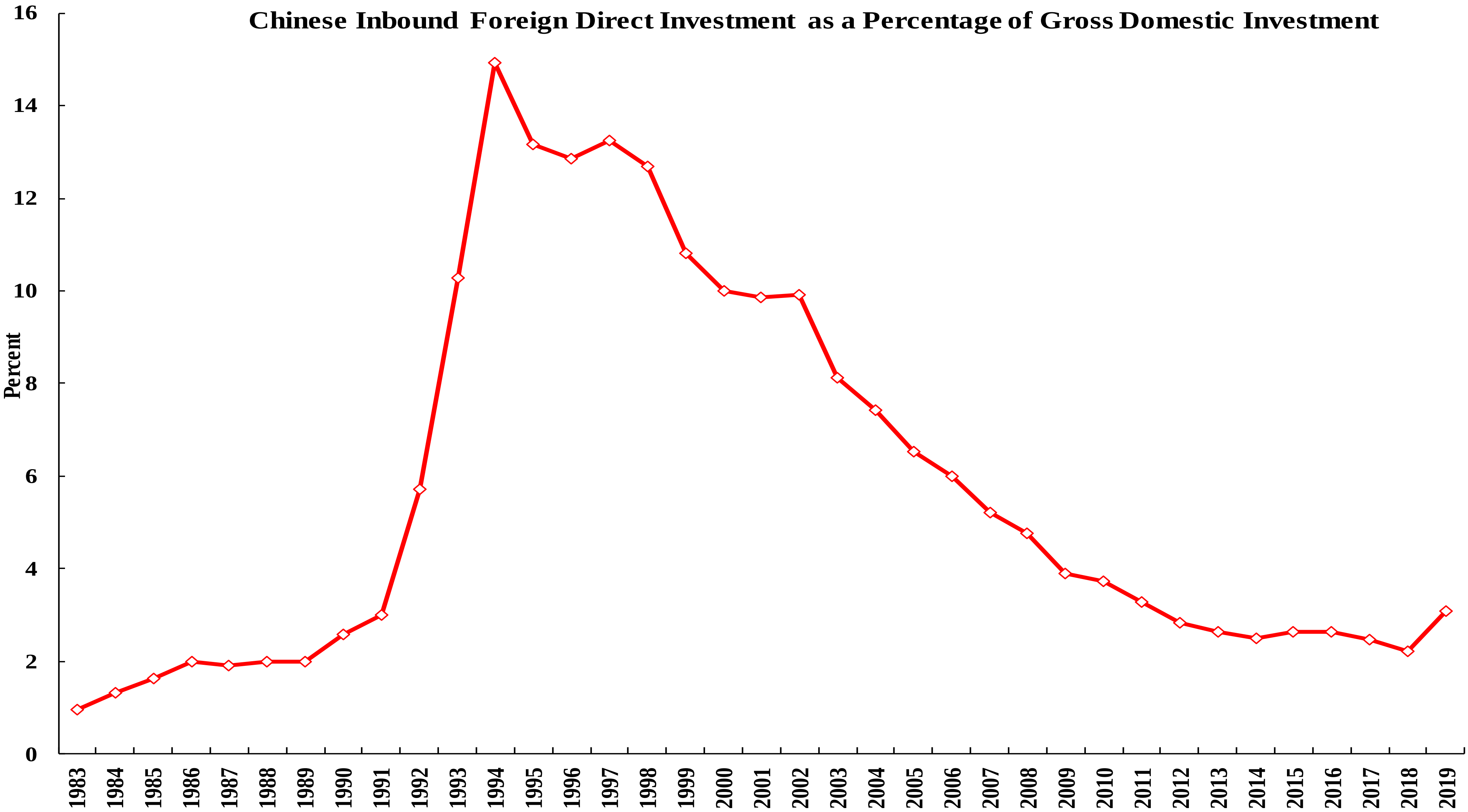
Exports and Imports as a Percent of Chinese GDP, 1952-present



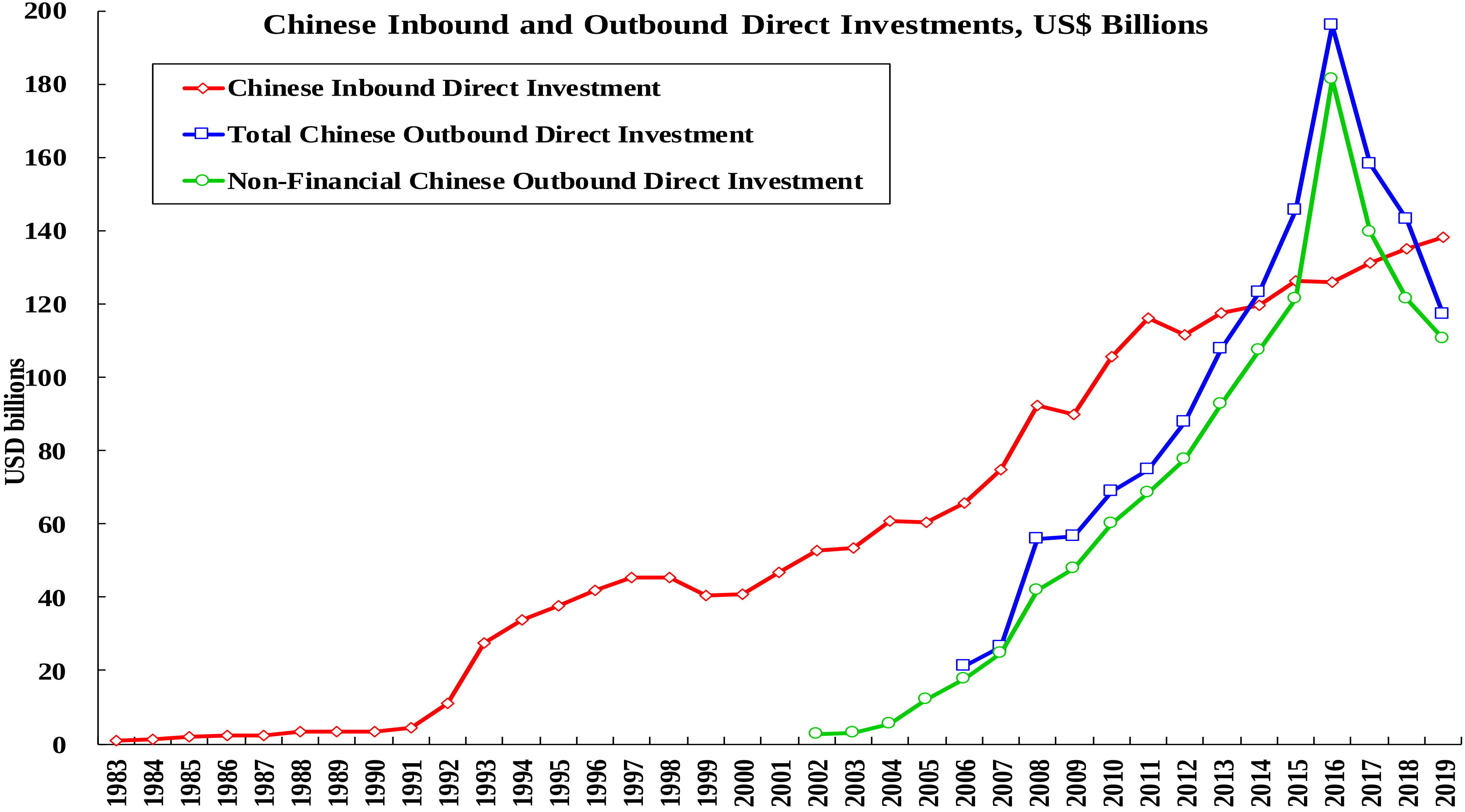
Underlying Trends

- The share of inbound FDI in gross domestic investment on the Mainland has fallen to 3%, not significant from a macroeconomic point of view. Chinese outbound direct investment has also been declining since 2016.
- The share of Mainland exports that is trans-shipped through Hong Kong has fallen from a peak of almost 70% to just above 10% as other Mainland ports become available. Similarly, the share of Mainland imports trans-shipped through Hong Kong has fallen from a peak of 40% to a little above 10%.

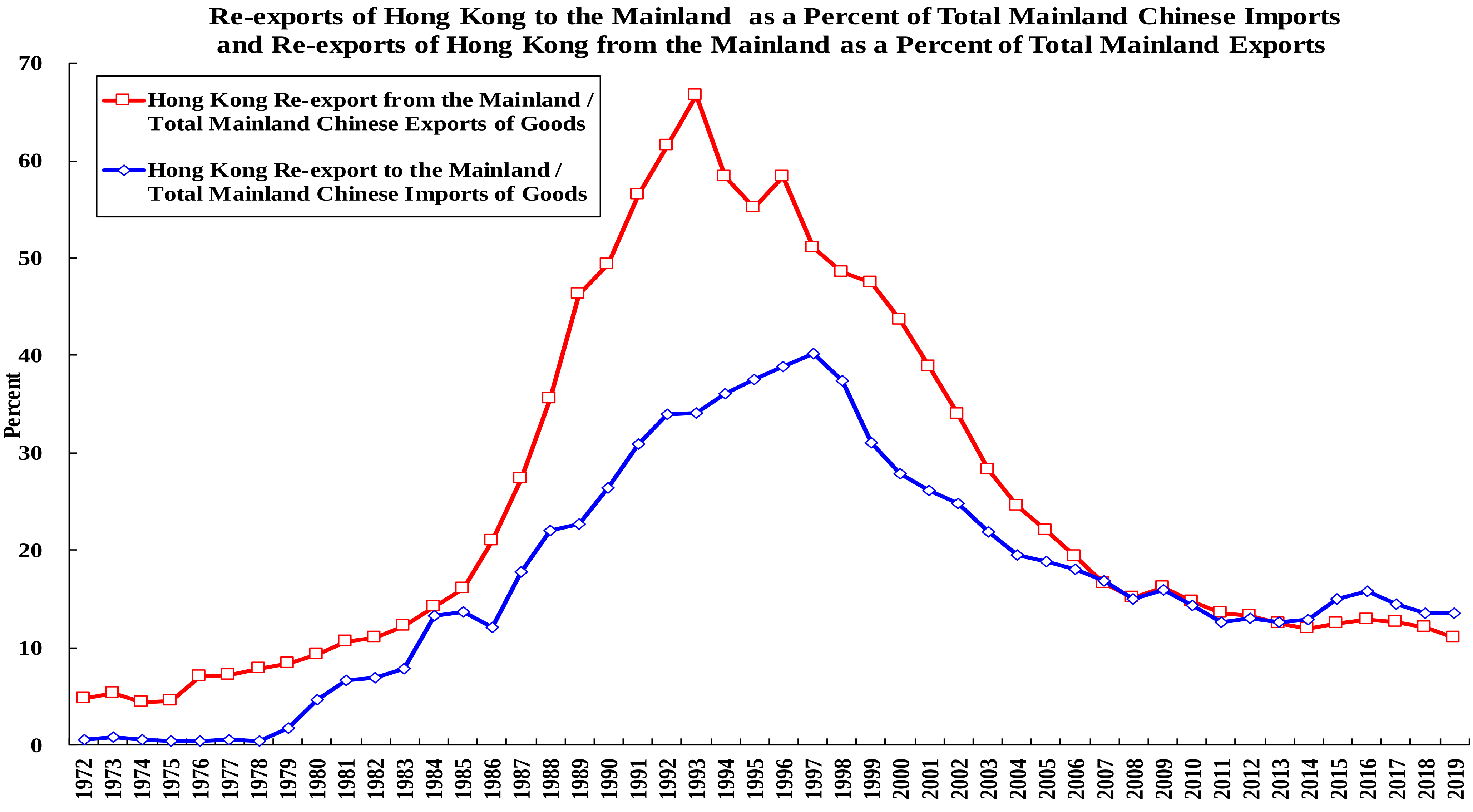
Chinese Inbound Foreign Direct Investment as Percent of Chinese Gross Domestic Investment



Total Chinese Inbound and Outbound Direct Investments, US$ billions



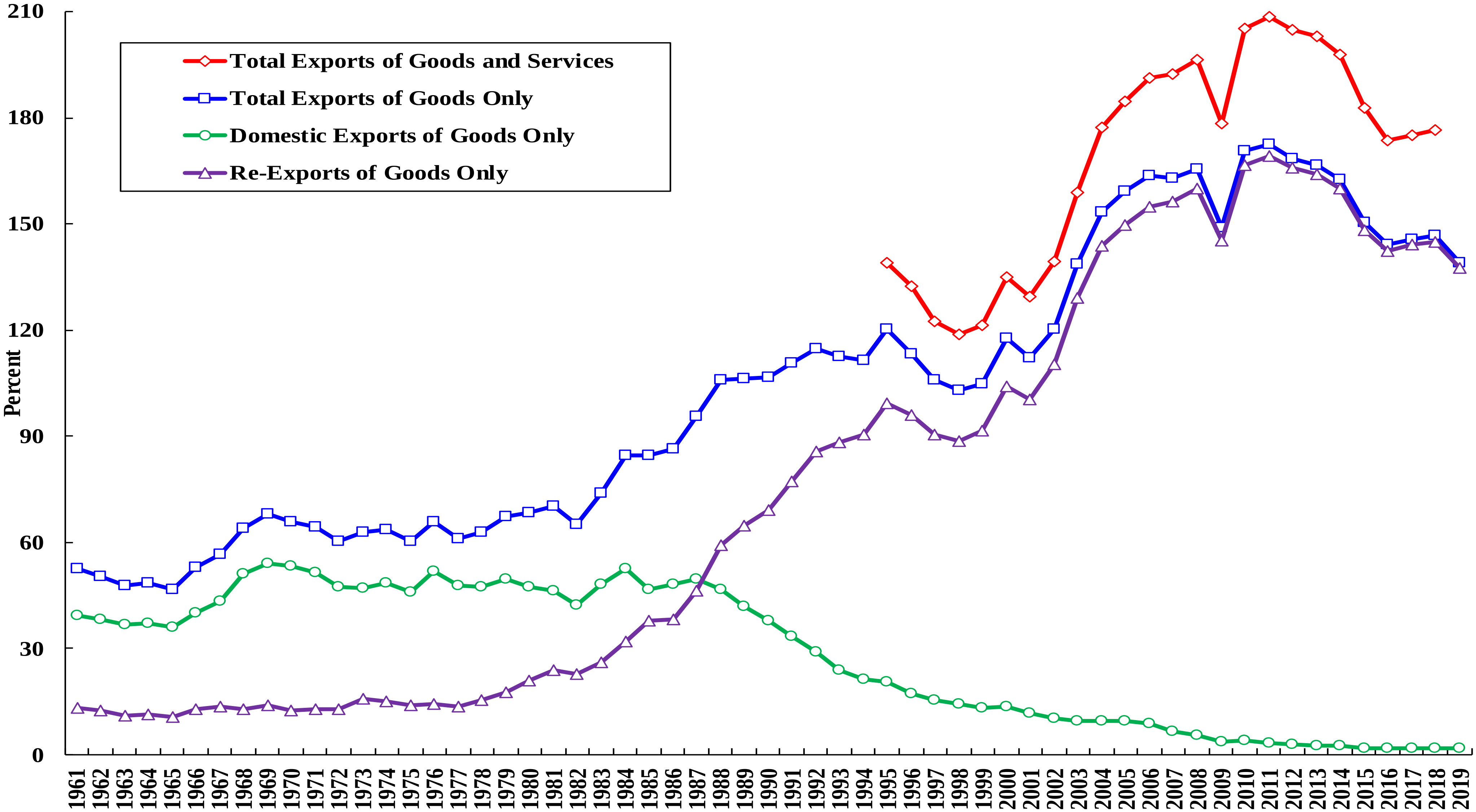
HK Re-Exports to and from the Mainland as a Percent of Mainland Imports and Exports



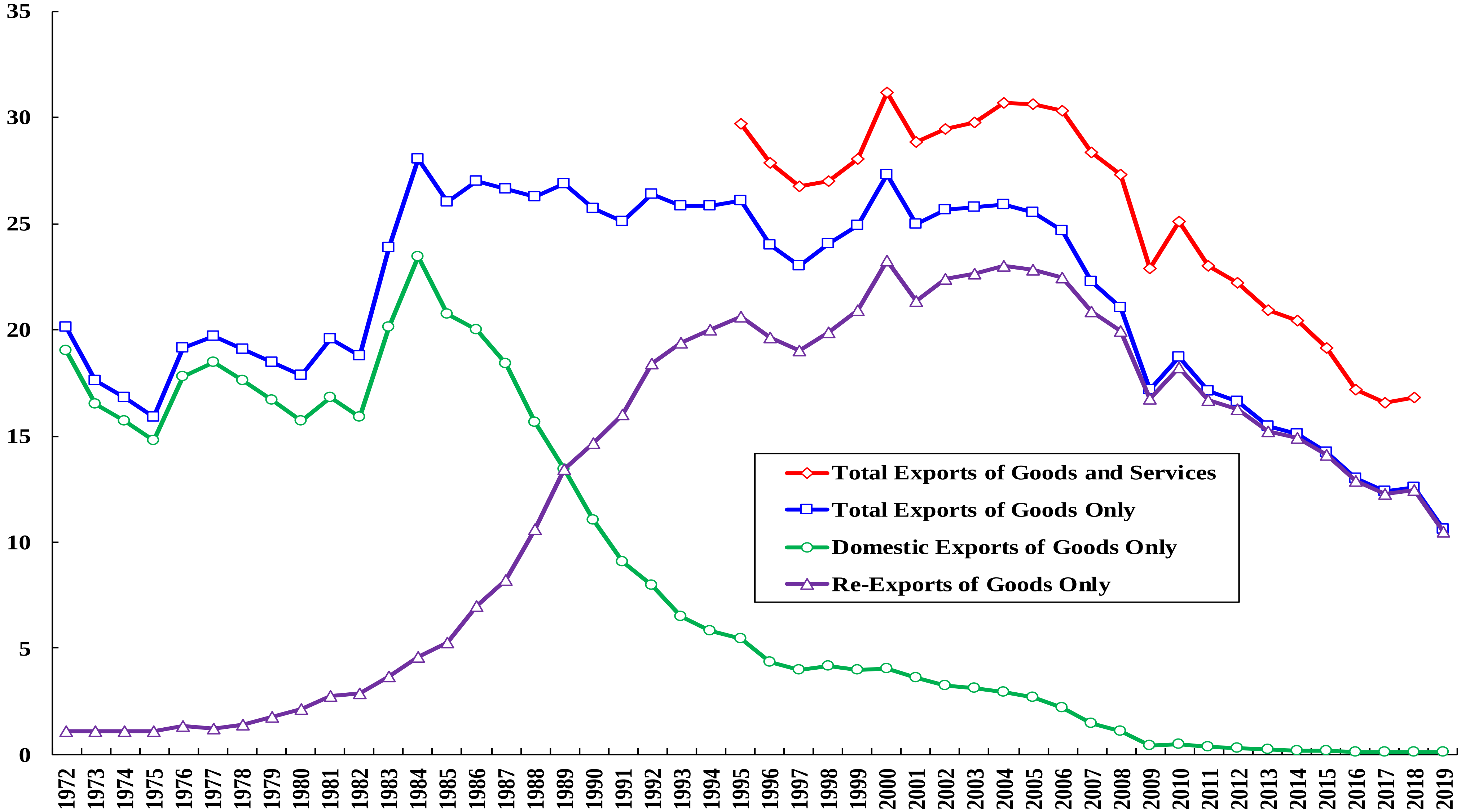
Underlying Trends

- It is inevitable that there will be economic, technological and geo-political competition between China and the U.S., the two largest economies in the world. The competition, manifested in the ongoing China-U.S. trade war, has also intensified because of the COVID-19 pandemic and the upcoming U.S. presidential election. This is likely to be the new "normal" going forward. Hong Kong has to take into account its "One Country" status in its behavior and actions.
- The social unrest in Hong Kong may also exacerbate the China-U.S. conflict and is unlikely to lead to any positive outcome for either Hong Kong or its people. It can only damage confidence and lower expectations about the future.
- Today, Hong Kong exports almost no goods, only services. Manufacturing, which has largely disappeared from Hong Kong, will not be making a comeback (if even Dongguan cannot afford to continue its light manufacturing, how can Hong Kong, with its much higher cost structure?)
- However, the Hong Kong economy has continued to be heavily dependent on the Mainland, starting from the supply of drinking water.

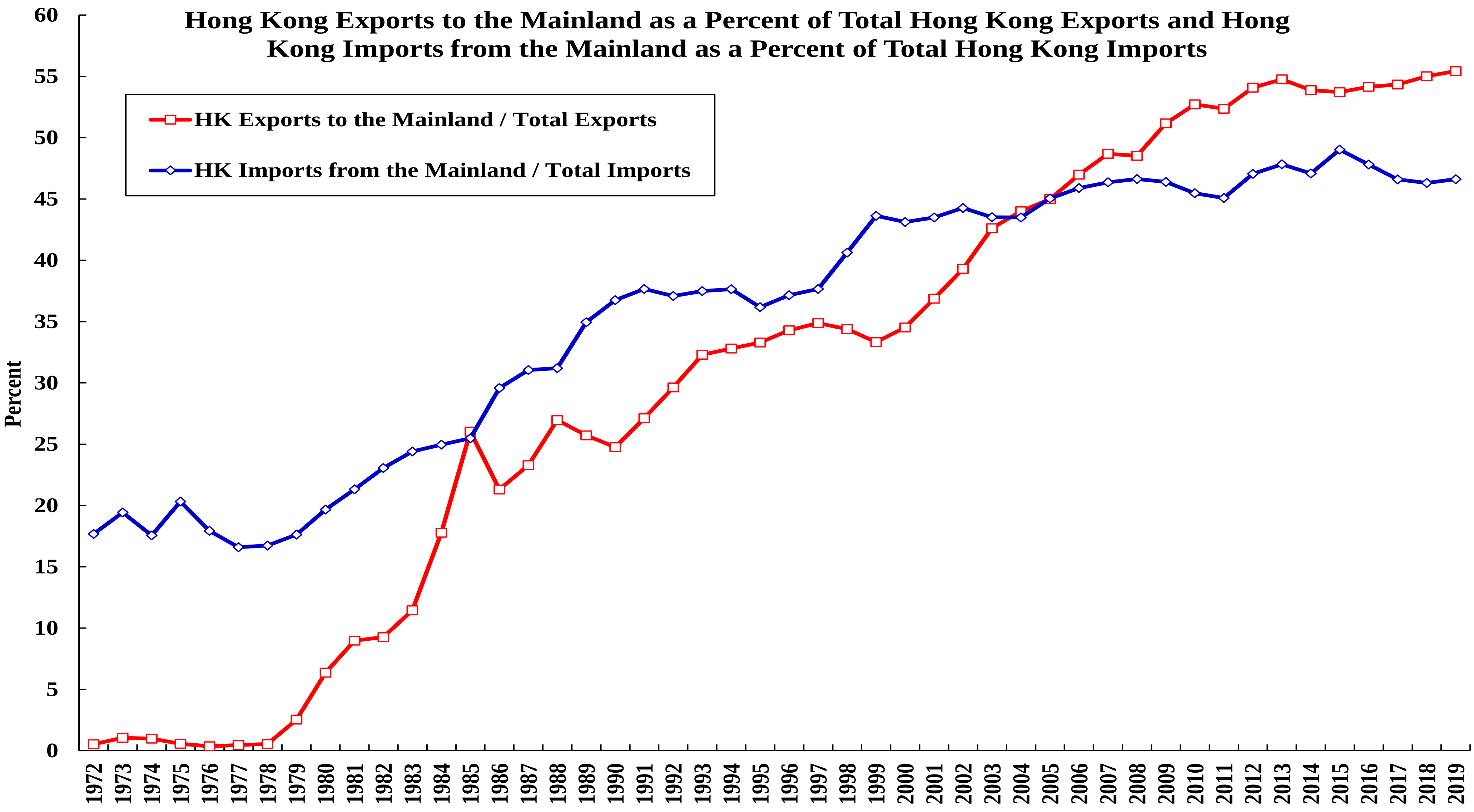
Exports to the World as Percent of GDP: Hong Kong



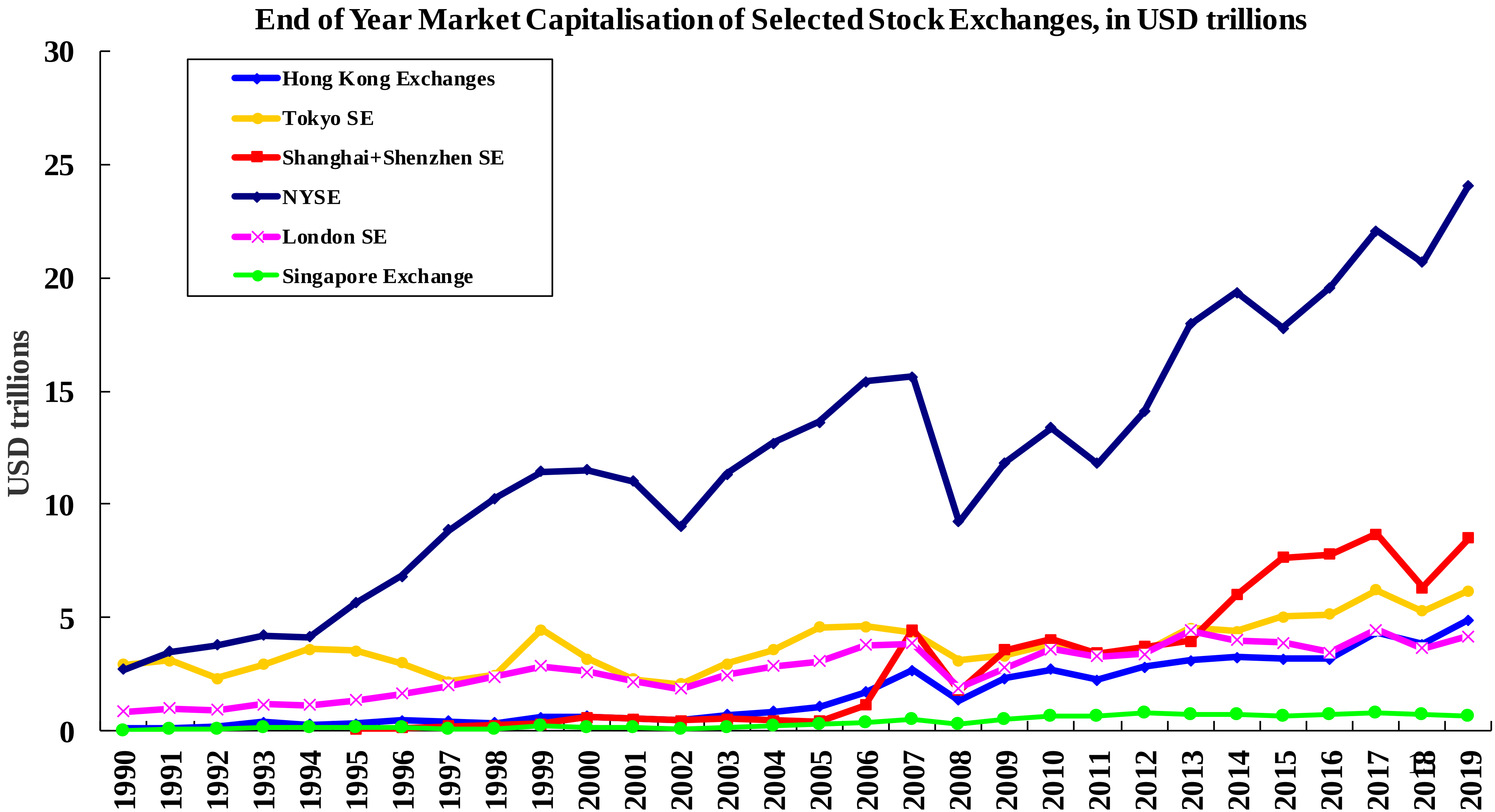
Exports to the U.S. as Percent of GDP: Hong Kong



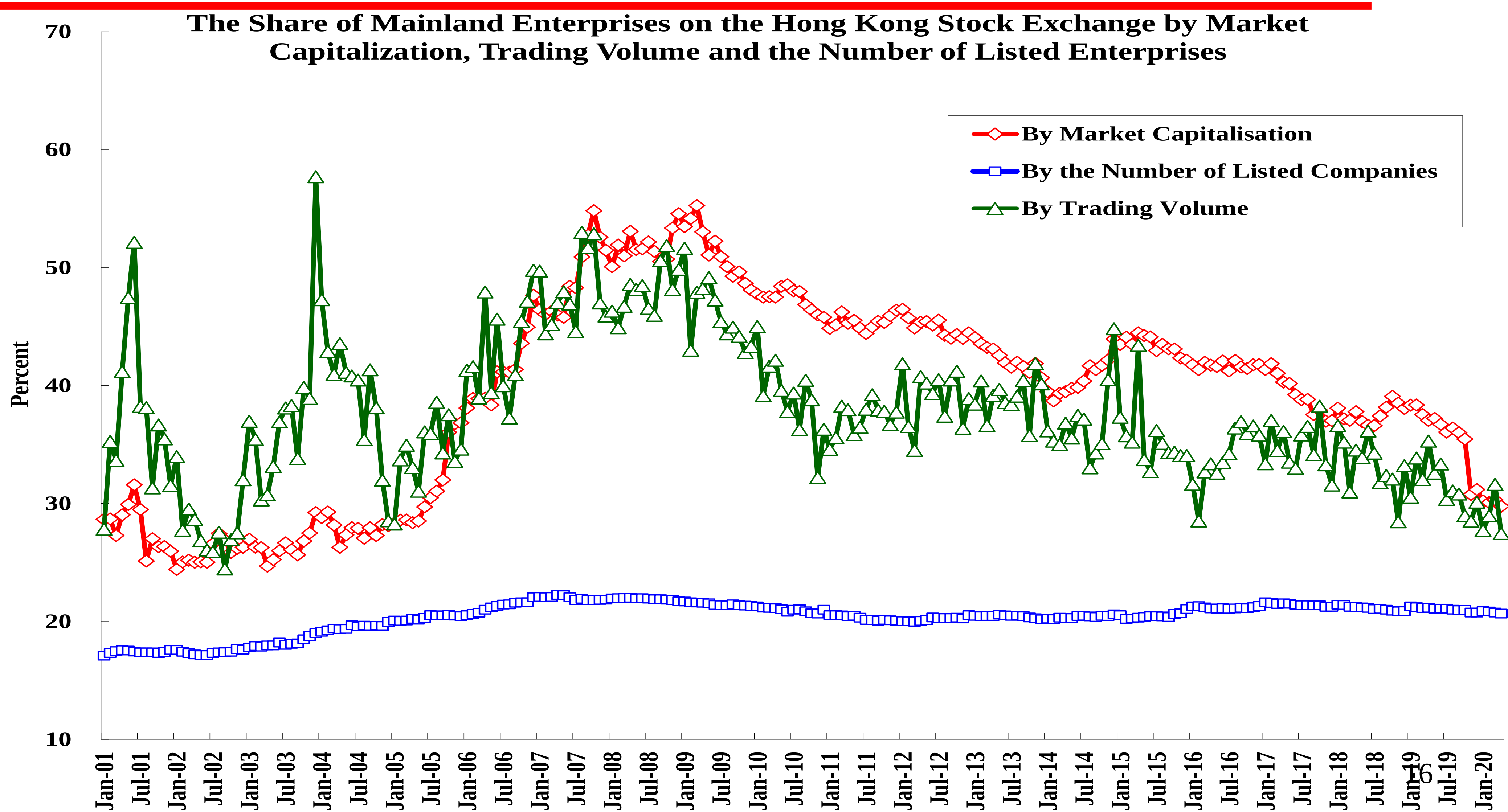
Hong Kong Exports to and Imports from the M'land as % of Total HK Exports and Imports



End-of-Year Market Capitalisation of Selected Stock Exchanges



The Share of Mainland Enterprises on the Hong Kong Stock Exchange



Hong Kong SAR Government Mitigation Measures

- To combat the economic downturn, the HKSAR Government has introduced several rounds of economic stimuli and relief measures, including cash payouts of HK$10,000 to every permanent resident of Hong Kong, and an "Employment Subsidy Scheme (ESS)" to subsidise employers to retain their employees and refrain from laying them off for six months.
- To ease the cash flow burden of individuals and firms, the HKSAR Government has also granted an automatic 3-month deferment of tax payments due.
- All these mitigation measures will be helpful in keeping the economy afloat amidst falling GDP and rising unemployment.
- However, all these mitigation measures, combined with a significant fall in government revenue due to the economic recession, will eventually result in a current-fiscal-year budget deficit of approximately HK$300 billion, or approximately 10% of the annual local GDP.

The Government Budget Deficit is Not a Problem for Hong Kong

- While this is high by Hong Kong or even international standards, it is completely affordable and can be financed from its past accumulated surpluses of approximately HK$1 trillion, without having to go into debt. It is totally justified in response to the severe economic crisis that Hong Kong faces today. The economy will not recover on its own, or at least will take too long a time. The government must act and act quickly.
- By comparison, the U.S. is likely to have a current-year budget deficit of approximately 18% of its GDP eventually, and its public debt is already over 100% of its GDP. Japan's current-fiscal-year budget deficit is 5.8% of its GDP, with a total public debt of more than 250% of its GDP (at its highest point, Japanese annual budget deficit reached 11% of its GDP, in 2010). Its average annual budget deficit since 1996 is 6.8%.
- Moreover, Hong Kong has almost no public debt and has a large accumulated surplus of close to HK$1 trillion. And it has ample unused borrowing capacity if it ever becomes necessary.

The Mitigation Measures Alone Are Insufficient to Turn the Economy Around

- However, while I fully support the government mitigation measures, they alone are not sufficient to turn the economy around. Direct public investments that increase both current domestic aggregate demand and future productive capacity are needed. They will be more effective in reviving the economy than a temporary employment subsidy alone and have a more lasting impact.
- In a sector facing little, no, or steeply declined demand, an employment subsidy alone is unlikely to induce more than a temporary retention of jobs, let alone the creation of new jobs. For example, Cathay Pacific and Cathay Dragon together are reported to have reduced their flight schedules by over 95%. It is difficult to see how they will be able to retain employees, even with an employment subsidy, if there is really nothing to do for a prolonged period of time.

The Mitigation Measures Alone Are Insufficient to Turn the Economy Around

- Hong Kong, with its “linked exchange rate system (LERS)”, cannot have an independent monetary policy. Unlike most other governments in the world, Hong Kong is not free to print money, or expand its money supply; in other words, it cannot do its own “quantitative easing”. Thus, Hong Kong can only use fiscal policy to stimulate the economy.
- At this time, the principal worry for Hong Kong should be whether there is sufficient domestic aggregate demand.
- One cannot assume that some of the traditional pillars of service industries in Hong Kong—entertainment, food and beverages, retail, tourism and travel--will bounce back automatically after the end of the COVID-19 epidemic. The rest of the world, with the exception of the Mainland, will be at various stages of serious economic recessions and will not provide the external demands for our services.

The Mitigation Measures Alone Are Insufficient to Turn the Economy Around

- While the Mainland economy will recover fairly quickly—with additional economic stimulus, it should be able to do 5% for 2020 as a whole—it is highly uncertain whether the Mainland tourists and even students will return to Hong Kong in large numbers soon because of the perceived unfriendliness and outright hostility of some segments of the Hong Kong population.
- Even Hong Kong residents themselves will be more careful and reserved in their spending, dining out and social gathering after weathering the epidemic.
- Moreover, "social distancing" will most likely continue to be practiced for a while, even after the epidemic, perhaps on a voluntary basis, because the risk of a resurgence of the COVID-19 virus in Hong Kong is real and there is currently no vaccine and no specific anti-viral drug that has been proven to be effective against the virus.
- Private fixed investment is likely to be weak as the future economic outlook is still quite clouded, for example, by the possible resumption of social unrest and rioting, even after the current epidemic is ended.

The Mitigation Measures Alone Are Insufficient to Turn the Economy Around

- More importantly, the employment subsidy scheme will only last for six months. What happens after six months, especially if domestic aggregate demand still remains weak? Hong Kong must think through and plan now as to what to do then. That is why increasing public investments is the most likely option because it can help to create jobs that are more permanent.
- And even before the public investments are implemented, their announcements per se will lift expectations, which will in turn help to lift the rest of the economy. They will do what the mitigation measures alone cannot do, that is, enhance public confidence and transform negative expectations about the future to positive ones.

Confidence and Expectations about the Future

- An economy is basically driven by public confidence and its expectations about the future. If public confidence is low and expectations about the future are negative, neither investment nor consumption can be strong.
- Expectations can sometimes be turned around by words, but in most cases, they can only be turned around by concrete actions.
- There are at least two famous examples of the powerful announcement effects of new policies—the Southern Inspection Tour of Mr. DENG Xiaoping in 1992 and the 4 trillion Yuan economic stimulus package of Premier WEN Jiabao in 2008. Both of them were able to change expectations overnight. The rest was history.

Confidence and Expectations about the Future

- The Government must try to restore public confidence and turn around the expectations of the households and firms. Concrete plans for public investments are credible words that can change expectations.
- In the near term, households and firms in Hong Kong must be assured that peace and harmony will be restored and law and order will be maintained. This is the only way for expectations to turn positive. Otherwise, whatever the government tries to do is just like rearranging the deck chairs on the Titanic. Hong Kong must be perceived by the outside world to be a place governed by the rule of law.
- In the medium to long term—the focus should be on the expectations of the prices of land and housing (and that means changing the expectations on supply, supply and supply).

Potential New Initiatives

- The government must undertake additional public investments at this time to shore up the aggregate demand in the domestic economy as all of export demand, household consumption and private investment will be weak.
- First of all, the government should accelerate investment projects already in the pipeline such as the Third Runway and the reclamation and construction of an artificial island east of the Lantau Island, and launch additional public housing projects.
- The government should facilitate the introduction of 5G mobile communication services in Hong Kong through the sponsorship and construction of a shared public network of 5G transmission towers, which will be a regulated monopoly open to all mobile telephone service providers on a paid-by-use basis. It can be financed by bonds. It should result in major savings for the consumers in Hong Kong because it avoids the construction of duplicative overlapping networks of 5G transmission towers.

Potential New Initiatives
Green Investments

- The government can also take advantage of this opportunity to retrofit all the public buildings for energy efficiency in both summer and winter, taking advantage of advances in materials, renewable energy (e.g. solar energy), and technology. It can also incorporate public health features such as automatic body temperature monitoring, automated doors and voice-activated lifts at the same time. All public buildings should be both "green" and "healthy".
- It will be an investment that pays for itself as the discounted future energy savings should exceed the initial one-time capital cost. In addition, it also contributes to the slowing-down of global warming.
- Moreover, the government can issue green bonds for this purpose and establish Hong Kong as the regional financial centre for the issuance and trading of green bonds.
- The government can also encourage other landlords large and small to do the same by allowing immediate (or even super-) expensing of "green" and "healthy" retrofitting costs.

Potential New Initiatives
Augmenting the Public Health Infrastructure

- In addition, this is also a good opportunity to augment the public health infrastructure in Hong Kong, for example, by building more public hospitals and elderly care facilities and expanding its medical and nursing schools.
- Hong Kong has done well in its fight against COVID-19. The mortality rate in Hong Kong among the infected, at 0.4%, is among the lowest in the world.
- However, this is not the time for complacency. What happens if COVID-19, or another virus, comes again? The probability is high that some new bacteria or virus will hit us again in the foreseeable future. So hospitals with isolation wards and up-to-date intensive-care-unit equipment are a very good public investment, as are additional places at our medical and nursing schools.
- In any case, these will be good investments for Hong Kong in both the short term and the long term, especially given our current long waiting times for various treatments at public hospitals and our aging demographics.
- The government should also develop a master-plan for the provision of elderly care, including the construction of elderly nursing homes that will contain facilities that satisfy the latest separation and isolation requirements.

Potential New Initiatives: Increasing the Supply of Land for Residential Use

- Increasing the supply of land for residential use is not a new idea; and it is neither easy nor quick; but it is a must. However, a credible commitment to a plan can change expectations of the future, lower the prices of land and housing, and give people hope.
- The initiatives should include: (1) reclamation and creation of an artificial island east of Lantau Island; (2) redevelopment of the Kwai Chung container terminals for residential housing; and (3) utilizing a small portion of country parks and green belts near already developed urban areas.
- Hong Kong has developed and used only less than a quarter of its surface area—and with only 7 percent for residential purposes. It should consider taking a couple of percentage points from country parks and green belts, which together occupy more than 50 percent of Hong Kong's surface area, and convert them to residential use.

Potential New Initiatives Enhancing Hong Kong's Status as an IFC

- It is important for Hong Kong's future to consolidate its position as the IFC for the Greater Bay Area (GBA).
- It can specialize in green financing for not only Hong Kong but also the entire Greater Bay Area. "Green" bonds can be issued and traded on the Hong Kong Stock Exchange by all the jurisdictions within the GBA in either HK$ or RMB.
- It should continue to serve as the primary offshore Renminbi centre.
- It should promote and welcome the return of Mainland enterprises listed overseas to a primary or dual listing on the Hong Kong Stock Exchange, subject to the requirements of the SFC and the HKEx.
- It should lead in the use of the "block-chain" technology to facilitate the settlement of cross-border transactions (without the mining and the encryption).

Potential New Initiatives
Promoting Owner-Occupied Housing

- Financial Secretary Paul CHAN mentioned in his budget speech the introduction of long-term fixed-rate residential mortgages. I think it is a great idea and should be implemented as soon as possible. It can greatly increase housing affordability and ease the housing cost burden of many lower-income families.
- What are the advantages of long-term, fixed rate mortgages?
- For the borrower, it is (1) significantly lower monthly payments—the repayment can be spread out over 35 years instead of 15 years; (2) a lower rate of interest—one can piggyback on the borrowing rate of a government institution, say, the Hong Kong Mortgage Corporation; and (3) no interest rate risk over the life of the loan because of the fixed rate.
- For the banker, it is (1) no need to commit capital and (2) earning a service fee for the life of the loan.

Potential New Initiatives
Promoting Owner-Occupied Housing

- How does it work? The commercial banks themselves cannot offer long-term fixed-rate mortgage loans because they do not have sufficient long-term fixed-rate deposits to cover the long-term fixed-rate mortgage loans.
- The Hong Kong Mortgage Corporation can take advantage of the currently very low long-term rates of interest to issue 35-year bonds at say 1.5% per annum. The proceeds can be used to buy qualified (owner-occupied, single-family, properly appraised, up to a maximum value of say HK$15 million) fixed-rate residential mortgages of 35-year maturity from commercial banks. (It may be prudent to require the originating bank to maintain a 3-5% ownership of the loan.) Moreover, these long-term mortgages should allow a loan to value ratio of 80 or even 90 percent. This will lower the monthly debt service payments of most households significantly because of the long maturity.
- Even borrowers with existing mortgages can benefit by re-financing, that is, converting their existing variable-rate mortgage loans to fixed-rate mortgage loans. This should put extra cash in the hands of these families through the increase in the loan to value ratio and the reduction in the monthly payments.
- With the current record low rate of interest, this programme should be pushed ahead at full speed.

Potential New Initiatives
Creation of Jobs That Cannot Move Away

- As I have often emphasized in the past—under economic globalisation, jobs, especially manufacturing jobs, have become very footloose. Any job that can move away will move away. We need jobs that will stay in Hong Kong, jobs that cannot move away.
- Tourism generates these jobs, but it will take a while for tourism to recover.
- The Hong Kong domestic market is not large enough, Hong Kong must leverage on the huge Chinese domestic market, or at least the Greater Bay Area market.
- What are some options?

Potential New Initiatives
Creation of Jobs That Cannot Move Away

- R&D and venture capital hub—together with Shenzhen, Hong Kong can develop into a combined Silicon Valley-NASDAQ for East Asia. The government must step up its funding of basic R&D at local universities and allow university faculty members to charge their salaries to government-supported research projects as in the U.S. Basic research is essential for break-through discoveries and inventions.
- To support the R&D initiative, the government must increase support for graduate studies in the higher educational institutions, so that Hong Kong can become a basic R&D hub, like Silicon Valley and Route 128 in the U.S.
- Returns to R&D depend critically on the size of the potential market and that is where the Mainland and GBA come in.
- Hong Kong can also try to become a top-notch healthcare hub for the Greater Bay Area (and a potential destination for medical tourism). This will require an expansion of the medical and nursing professions.
- Hong Kong also has the capacity to become a reinsurance hub for East Asia.

Concluding Remarks

- There are many things that Hong Kong can and should do.
- The government can augment domestic aggregate demand by undertaking public investments, public consumption, and other measures, examples of which have been given above.
- Hong Kong should also take advantage of its crises to map out a vision for Hong Kong's future within the framework of "One Country, Two Systems". It is time for the government to help the public by providing answers to the questions: "What should Hong Kong be like five years from now? Ten years from now? Twenty years from now?"
- "Positive non-interventionism" is a clever excuse for doing nothing, not a viable strategy in a rapidly changing world.
- Nurturing, recruitment and retention of human capital is critical for Hong Kong's long-term future.