



China's Hong Kong Challenge

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Student-led demonstrations calling for unadulterated universal suffrage from 2017 onward is a structural deterioration in the local politics of Hong Kong. In this brief piece, we try to lay out the contours of short-term impacts on and potential long-term implications for Hong Kong's and China's economy from the ongoing political volatility.

Over the near term, the Occupy Central movement is not going to be too damaging. We think it could shave off 10-15 basis points from Hong Kong's GDP growth this year. However, this drag could rise to as much as 25-50 basis points next year if, as we suspect, the underlying causes of political uncertainty remain unresolved. Most of the downshift in activity would come from lower consumption and retail sales, as well as a decline in tourism — the latter, in particular, depends heavily on mainland Chinese visitors.

What could compound Hong Kong's woes in the year ahead, however, are rising U.S. rates and a stronger US\$ — both of which would tighten financial conditions as the Hong Kong dollar remains pegged to the US\$, and as private leverage in Hong Kong has risen sharply. Chinese growth is slowing steadily as well, with growth risks skewed to the downside. Additionally, Hong Kong's heightened political volatility could delay countercyclical fiscal steps — such as boosting public housing, and infrastructure — and, thereby, aggravate growth risks.

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In contrast, headline Chinese GDP growth — over the near term — is likely to remain largely unaffected by the ongoing political volatility in Hong Kong. This is because China's export dependence on the Hong Kong market is small and unlikely to be impacted much by softer activity on the island. We continue to expect Chinese growth to slow to 7.3% year-on-year this year and to around 7% in 2015. The market consensus is currently in line with our projection.

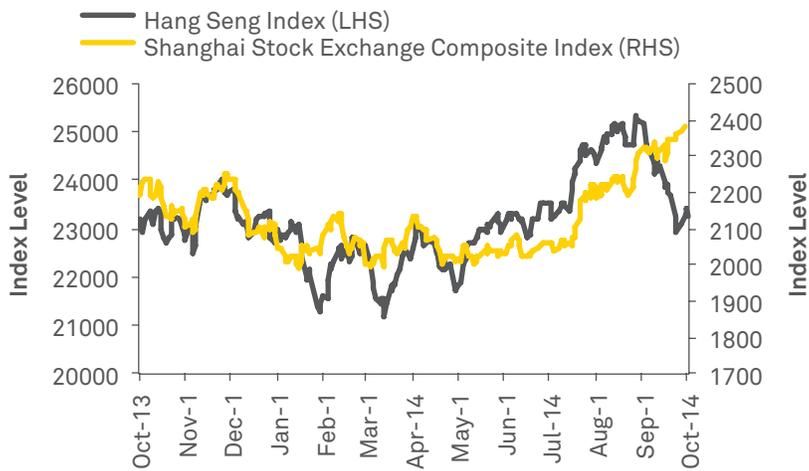
All told, tail risks have certainly come into focus. This is because the Chinese government has shown no signs of compromise, and the protestors' demands remain strident. Nonetheless, both sides have shown a degree of tactical restraint which accords with broader economic and financial stability. In view of this, we do not expect a "Tiananmen Square" style outcome in local politics, unlike 1989.

Nonetheless, Hong Kong's political gridlock could last a considerable length of time. It is difficult to project long-term regional or geopolitical implications with a great deal of precision. But we highlight below two trends that could crystallize.

First, the One-Country-Two-Systems framework that is the bedrock of Chinese sovereignty over Hong Kong will continue to be tested. This is important because it will affect attitudes and perceptions in Taiwan and could broadly raise antipathy about closer economic and political relations with Mainland China. This would be a blow for China's aspiration to use Hong Kong as a template for eventual re-unification with Taiwan. Dissident movements in other parts of China such as Tibet and Xinjiang could also draw inspiration from events in Hong Kong — raising pressure on the resolve and consistency of the Chinese central government's policies.

Second, we do not expect Hong-Kong style demonstrations to erupt on the mainland. This is because the pro-democracy movement in Hong Kong is portrayed, and likely perceived, as less than patriotic on the mainland. In addition, Chinese central government authorities have made strenuous efforts to either limit the flow of information or discredit what does get disseminated. Additionally, the absence of a harsh crackdown also limits any potential broader outpouring of sympathy.

Hang Seng Recovering After Steep Fall, Shanghai Stock Holds Up



Source: Bloomberg as of October 8, 2014.

CNH Recovering To CNY Level



Source: Bloomberg as of October 8, 2014.

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