China, P.R.: Hong Kong

Analyst: Rolf Danielsen. Tel : +46 8 763 83 92 E-mail :rolf.danielsen@seb.se

Hit by the double wham of political turbulence and the sharper than expected slowdown in Mainland China, Hong Kong is about to enter its first year of recession since the Asian crisis. While the city state has the resources to withstand such a set-back if proved temporary, the political upheaval has left many investors in disbelief that Hong Kong will ever be the same again prompting negative rating actions.

Country Risk Analysis and conclusions

Recent developments

Growth tumbles: Following two years of strong growth, some cooling of activity had been expected for 2019, but not as sharp as has been the case and not for the factual reasons. Already late 2018 there had been signs of worse to come and in the first quarter of the current year growth fell below 1% on a year-on-year basis (yoy). The weakness continued with third quarter economic expansion falling into negative territory of almost 3% yoy and there are few if any signs of improvement in the last quarter of the year. That means an economic contraction of about 1,5% for the whole year, a result that could repeat itself in 2020.

We were all wrong: This outcome is in stark contrast to projections made a year ago -- not only our own but all other observers who raised their voice at that time. And even more to the point, it was not triggered by the risk mostly highlighted, namely an overheated property market with sky-rocketing prices of residential units. A sharper slowdown in China and the global economy had been predicted but was not expected to shave off more than 1pp (percentage point) from the growth rate.

Large scale protest movement: The main event causing the slowdown in domestic demand components has been the political developments with a restive population staging months of large-scale demonstrations all over the city with the effect to disrupt traffic and business in particular related to retail and hospitality services. Since early June demands have been growing of fundamental changes in the way the city is governed aggravated by prospects of a future in an ever-closer relation to the communist government in Beijing. In part constrained by the latter, the city authorities were slow to respond but started at an early stage to yield to some of the demands of the protest movement although in a piecemeal fashion that probably brought more fodder into the dynamics of events.) Conf. Box 1.) May be, they were also under the fallacy that the protest movement would be slaughtered at upcoming local elections a week ago seen as a referendum on the authorities' legitimacy. Such hopes were mocked by the final election results showing a landslide victory for protest representatives and with the largest participation rate – 71% – ever recorded in such polls.

Fiscal stimuli: The government has recently made some attempts at cushioning the economic fall, including fiscal easing – cutting taxes and extending support to low income families -- while leaning on developers to speed up residential housing plans. As a result, the government budget will turn around sharply from a surplus of 1,5%/GDP in 2018 to a notable deficit in the current year. That deterioration is also due to automatic stabilizers with sales and other excise taxes plunging as retail sales in recent months have declined sharply by an average of 20% yoy in the July-

September period. The creditworthiness of the sovereign is still well protected by huge domestic assets reflecting the accumulation of fiscal surpluses over several decades amounting to an estimated 40% of GDP with almost no offsetting debt.

Monetary policy keeps the exchange rate steady: At the beginning of the protest movement in last June the exchange rate appears to have suffered under a bout of capital flight, but soon regained its strengths at a level slightly higher than at the beginning of the year seemingly. Since then it has remained quite stable seemingly unperturbed by a series of mass demonstration often turning into violence between police and the protesters. Most investors have maintained confidence that the de facto effective peg to the US dollar is not under any immediate threat being supported by massive reserves of the monetary authorities, worth more than two years of imports, while the balance of foreign trade in goods and services is actually poised for some increase.

The current account remains in surplus: Despite a sharp drop in the numbers of foreign tourists in recent months, in particular from Mainland China, the current account on the external balance is likely to post a larger surplus for the current year. That is much due to a steep drop in merchandise imports reflecting in part the softer economic outlook both in the global economy and in nearby China.

Outlook

Although Hong Kong is set for continued decline of economic activity next year, markets don’t seem to fear that this spells a new and unforeseen risk even though it may unleash a break in soaring property prices with implications for some developers and their creditors, including banks owned mostly by local or mainland investors. A legacy of prudent macroeconomic policies over decades have provided the authorities with ample ammunition to fight back and restore market confidence. As such an economic/financial crisis would likely be temporary, and the city would once again prove its ability to adjust even if the economic environment had changed fundamentally.

Political risks, however, were seldom subject to much scrutiny in the two decades since the city was turned over to the ultimate authority of China. The Hong Kong population themselves were seldom expressing much concern about the event. For the first time they were given some hope of democracy according to the Basic Law, the set of rules agreed between London and Beijing in the 1990s for the governance of the territory under Chinese authority. Even though this was only for the next 50 years, most people took solace from China’s post-Mao political development which inspired hopes that China eventually would turn into some kind of relatively liberal half-way democracy. The rulers in Beijing had already swallowed much political pride in allowing Hong Kong private property and business.

Two decades later much of that optimism is gone. A confluence of developments and events have opened eyes of many people that a different scenario could also roll out. First of all was the announcement by President Xi in 2017 that he had suspended the informal rule that no party leader could stand for re-election more than once which limited the total term in office to ten years. Some saw this as evidence of an intensifying power struggle at the top echelon of power in Beijing. Otherwise, few were able to offer a reasonable and more benign rationale for this decision. That underpinned the notion of rising unpredictability of political developments in the Mainland, in which shadow Hong Kong would find itself in in less than a generation. As important may have been recent years' sky-rocketing property prices in the city.

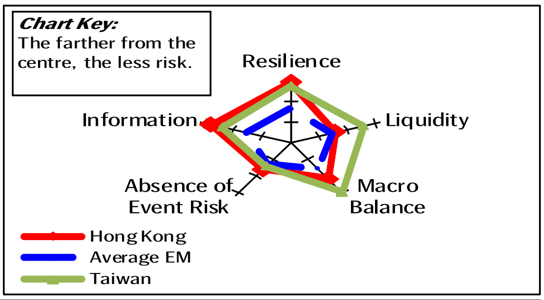
A year ago we noted that “*Political tensions [were] said to be simmering”* in part based on impressions from numerous visits to Hong Kong over the years, but also the gradually decline on the World Bank’s Governance indicator in the categories of “voice and accountability” and “political stability”. However, we did not put emphasis on this development to the extent that would have corroborated the recent negative rating actions on the sovereign. This underscores the treacherous endeavour of country risk predictions which can be overturned by seemingly innocuous events even against strong fundamentals, i.e. the "the shot in Sarajevo" type of incident.

After the recent landslide elections in favour of the opposition some calm has returned to the city. However, observers have since several months warned that business as usual may not be back for a long time and investors have reportedly began to look for other venues for enterprise. Even if order is restored also this time around, the popular anger exposed by recent months could explode again. Hong Kong as a paradise for setting up business could fade further. Negative sentiment could spread to eventually make experts and people with skills look for alternatives in the region thereby accelerating economic decline.

In the short to medium term, much depends on Beijing and Washington. In the US, Congress has just passed the Hong Kong Human Rights and Democracy Act which leaves the city vulnerable to American sanctions. It also lays out a process for the President to impose sanctions and travel restrictions on those who are found to be knowingly responsible for violations of internationally recognized human rights. This is most unwelcome by Beijing and may now put more spanner in the works for ongoing US-China trade negotiations which are likely more important to Beijing than Washington. Against the background of the high stakes made by Pr. Xi in claiming leadership for a life time, he may not be able to manage a climb-down vis-à-vis Washington for domestic reasons. In a worst-case scenario, ill-considered moves cannot be excluded from any quarters. The next few years may look calm although tensions will continue simmering under the surface.

Hong Kong: Risk Profile

Key Figures	2019
Population (millions)	7,4
GDP/capita ($1000)	50,9
Real GDP (% chg)	-1,4
Inflation (%)	2,1
Curr.Acc. Balance (% of GDP)	4,6
Reserves/imports (months)	7,0
Budget balance (% of GDP)	-2,4
Government debt (% of GDP)	0,1



External Ratings:
Fitch: AA /Negative
Moody's: Aa2/ Negative
S&P: AA+ /Negative

Peers:
Chile
Japan
Taiwan

Graph: The pentagon shows the profile of Hong Kong as typically "slim", i.e., strong on resilience and information, but only average on event risk, about at par with Taiwan. The large size of external liabilitie due to its global financial center status qualifies the liquidity indicator.

Ratings:

Fitch Ratings was the first of the three major statistical rating agencies to raise the alarm with a full notch downgrade from AA+ to AA and even placing the rating on negative outlook. That was followed by Moodys' a month later placing the sovereign in Aa2 on a negative outlook. Standard and Poors, by contrast, kept its rating in AA+ with unchanged negative outlook. The two negative rating actions referred to the stand-off between authorities and the population while also noting that the sovereign – although still strong -- might be impacted by a worsening business environment. That is even more important for country risk. Firms may now face a difficult balancing act between opposing demands from the population and the establishment. Choosing the wrong side could either mean losing business opportunities or being targeted by protesters.

Conclusion:

While waters are still exceedingly murky and the chain of events could go in directions not considered above, we hold that for several years going forward uncertainty will dominate Hong Kong to a much higher degree than before, and that this will have ramifications for the creditworthiness of many companies not only in the longer term, but also in a medium-term scenario. That is in contrast to sovereign credit risk that should be more shielded.

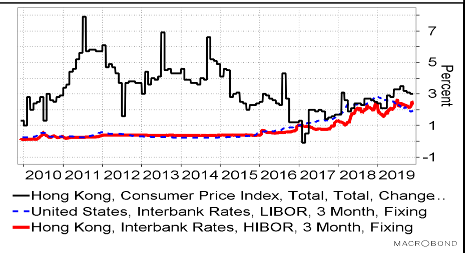
Hong Kong: Economic Indicators

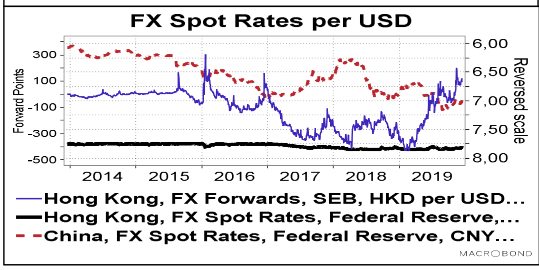
Macroeconomic	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
GDP real (% chg)	2,8	2,4	2,2	3,8	3,6	-1,4	-1,3	2,6
GDP (bn US$)	291	309	321	341	365	375	384	406
GDP/capita (US$)	40 467	42 656	43 900	46 313	49 033	50 946	52 832	54 688
Investments/GDP (%)	25	22	22	21	20	20	19	19
Trade/GDP (%)	364	332	316	322	321	322	326	331
Money & Prices								
CPI inflation (%)	4,5	3,0	2,4	1,5	2,4	2,1	2,0	2,0
Money, M2 (% chg)	12,2	7,4	5,7	10,5	5,4	4,6	4,8	4,5
Interest rates (%)	0,4	0,4	0,6	0,9	1,8	2,5	3,0	3,3
Stock prices (% chg)	2,7	4,8	-12,0	22,4	14,4	2,3	5,6	3,3
Exch. Rate (US$)	7,8	7,8	7,8	7,8	7,8	7,8	7,8	7,8
Government Finances								
Budget balance/GDP (%)	1,8	2,1	2,0	1,7	1,5	-2,4	-4,4	-3,4
Govt debt/GDP (%)	0,3	0,1	0,1	0,1	0,1	0,1	0,0	0,1
Balance of Payments (US$ bn)								
Current account	4,1	10,3	7,7	14,7	16,0	17,3	6,9	8,5
(% of GDP)	1,4	3,3	2,4	4,3	4,4	4,6	1,8	2,1
Export of goods	514	502	502	538	570	598	632	670
Imports of goods	546	525	513	562	601	631	667	707
Other current acct flows	36	33	19	39	47	51	42	46
Net FDI	-11,0	102,5	57,7	21,5	22,1	36,2	21,0	8,3
Debt service requirement	760	760	760	760	760	760	760	760
Net other capital flows	-737	-849	-822	-779	-777	-790	-742	-756
Chg in intl reserves	16	24	3	18	21	23	46	21
External Debt & Liquidity (US$ bn)								
Reserves	278	302	305	323	344	368	413	434
Gross external debt (% of GDP)	332	329	338	374	362	353	390	403
Gross External Debt	967	1017	1086	1276	1319	1322	1498	1637
o/w short term debt	666	662	667	643	619	603	598	598

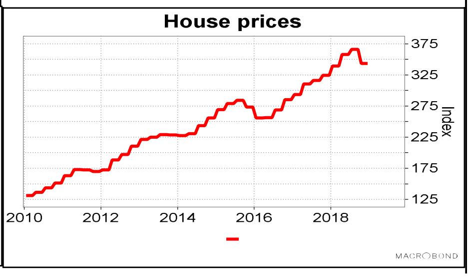
*Source: OEF (Oxford Economic Forecasting) and SEB estimates. *IMF forecast*

Rating history					
Fitch (eoy)	AA	AA	AA+	AA+	AA+
S&P (eoy)	AA	AA+	AAA	AA+	AA+
Moody's (eoy)	AA1	AA1	Aa2	Aa2	Aa2

Type of government:	Quasi democratic election system
Next elections	Legislative elections in 2020, executive elections in 2022
Other:	
Latest PC deal	None
Recent IMF programs	None







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