



# Hong Kong - One Country, Two Systems

August 2019

## *How will the ongoing civil unrest in Hong Kong impact its economy and relationship with China?*

The protests in Hong Kong first seen in March and April this year have escalated notably since June. They are in response to a bill that would explicitly allow extraditions from Hong Kong to Greater China - including the mainland, Taiwan and Macau.<sup>1</sup>

Hong Kong protestors are concerned that, should the extradition bill be made law, it could change the “One country, two systems” policy (one of Deng Xiaoping’s constitutional principles formulated in the 1980s) amid fears mainland authorities will take the advantage to extradite Hong Kong residents.<sup>2</sup>

Over the last nine weeks the riots have grown in their intensity, with increasing acts of vandalism and lawlessness.<sup>3</sup>

We believe the situation could continue to escalate unless the Hong Kong authorities can restore order. This weekend could be a key milestone as to whether the situation begins to subside or worsen further.

We could still see some form of unrest until the National Day of the People’s Republic of China on 1st October - the 70th Anniversary of the founding of the People’s Republic of China.

Will China use military force? While many suspect China could use force to intervene, we do not believe this is likely.<sup>4</sup> Economic action from China, such as banning Cathay staff involved in the protests from flights to mainland China, can be more persuasive. In our view, China does not want to be perceived as a military bully and it can use more subtle methods of persuasion.<sup>5</sup>

1. <https://www.ft.com/content/2063019c-7619-11e9-be7d-6d846537acab>

2. <https://www.economist.com/the-economist-explains/2019/06/30/what-is-chinas-one-country-two-systems-policy>

3. <https://www.theguardian.com/world/2019/aug/03/hong-kong-police-fire-teargas-in-clashes-with-protesters>

4. <https://www.bbc.co.uk/news/world-asia-china-49148762>

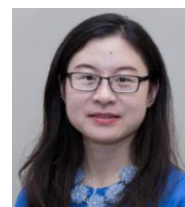
5. <https://www.scmp.com/news/china/politics/article/3022200/china-bans-cathay-pacific-staff-involved-hong-kong-protests>

INSIGHT



**Christina Bastin**  
Portfolio Manager

Christina joined Muzinich in 2013 and is an experienced portfolio manager with a distinguished career in corporate credit spanning 25 years. Prior to joining Muzinich, Christina held various credit/trading roles at Deutsche Bank including managing portfolios of bank risk. Before that she was a Credit Analyst at Schroders Investment Management and Commerzbank. Christina also worked for Fitch Ratings (1995-2000) where she was responsible for rating Korean banks during the Asian crisis in 1996 - and Japanese banks during their banking crisis. Christina holds a BA from the University of Oxford and an MA from the University of London. She was also awarded the Yamamuro Trust Foundation Scholarship for a 1yr International Politics programme at Keio University, Tokyo. Christina is fluent in five languages.



**Tracy Zhao**  
Senior Credit Analyst

Tracy joined Muzinich in 2016. She is a Senior Credit Analyst focusing on Asian emerging markets. Prior to joining Muzinich, Tracy spent 2 years at Aozora Asia Pacific Finance focusing on Syndication Loans across a range of sectors in the Greater China region. Previously, she was an Equity Analyst with a private fund. Tracy earned a Bachelor’s Degree in Economics from Shanghai Jiaotong University and a M.Ec. from the University of Hong Kong.

## The Economic Impact on Hong Kong

Hong Kong derives 20% of its GDP from tourism and retail.<sup>6</sup> There were protests in 2014 when the “Occupy Hong Kong” movement led to a disruption in retail for almost three months. Even so, the economic impact during this period was minimal.<sup>7</sup>

Many commentators look back to 2014 to extrapolate the potential impact of these protests. We believe the economic impact may be far greater if the situation escalates. The recent shut down of Hong Kong’s airport may result in the loss of 13,863 tons of cargo transportation and around US\$1.2bn loss in value.<sup>8</sup> We have also seen a reduction in tourists to Hong Kong, weaker retail sales and lower hotel occupancy rates.<sup>9</sup>

Thirty years ago, around the time of Hong Kong’s handover to China, Hong Kong was an essential gateway to China which needed it as a conduit. We believe today is different. Foreign investors are now looking at entering China directly and it appears Hong Kong’s importance to the West has diminished.

Conversely, we believe Hong Kong’s dependency on China has increased and the autonomous region is relying more and more on tourism and investment from China.

In a sense the economic dependence and blurring of lines, where China ends and Hong Kong begins, speaks for itself. Symbolic is the high-speed train from Hong Kong to China, the huge “Greater Bay Area” investment programme of the People’s Republic of China designed to develop increased infrastructure and create a huge international trade/finance hub of 50m residents around Hong Kong, Shenzhen, etc.<sup>10</sup>

We believe the government will do all it can to preserve safety and confidence in Hong Kong as a financial hub and we have not seen any disruptions to our day-to-day trading operations with Hong Kong based entities. However, with no current end in sight to the protests, it is difficult to judge the long-term effects on Hong Kong, both from an economic and political perspective.

6. Report from Capital Economics - China Economics Update 12th June 2019

7. IBID

8. <https://m.nbd.com.cn/articles/2019-08-13/1362327.html>, based on RMB/USD exchange rate as of 14.08.19

9. Muzinich research, <https://www.scmp.com/magazines/post-magazine/travel/article/1962471/look-past-reasons-fewer-tourists-visit-hong-kong>

10. <https://www.dezshira.com/library/legal/development-plan-guangdong-hong-kong-macao-greater-bay-area.html?1551174387>

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