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ECONOTE No. 88 Hong Kong: A quantitative analysis of the impact of the politics of violence 30/11/2019

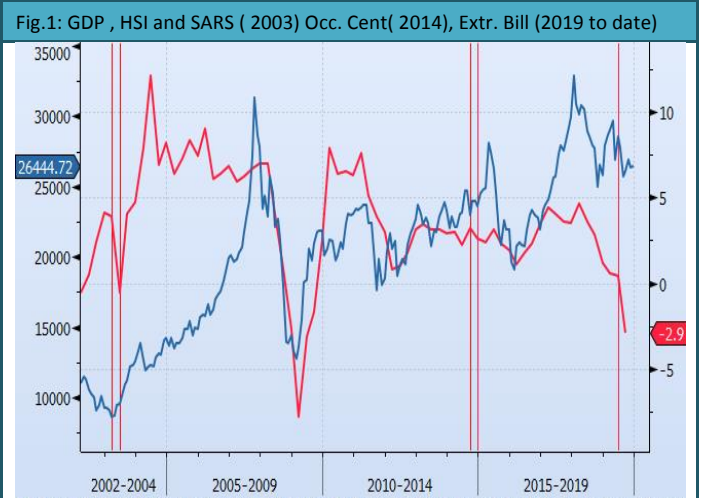
Summary	Investment Conclusions
The November District elections in HK confirmed in numbers what was known-the disaffection of over 55.0% of the electorate with the current administration and with China's perceived position towards political reform in Hong Kong. What was surprising was that up to 41.0% (possibly even nearly 45.0%) of the voters supported pro-establishment positions. The violent demonstrations have impacted tourism and retail sales, but far more importantly, impacted confidence in the capacity of Hong Kong to recover. The pessimistic view sees the start of Hong Kong's demise as a key financial and tourist center. We analyze and quantify the economic and financial impact of the events in the last 6 months in terms of future prospects also drawing from diverse historic examples. The question of property will be examined in a separate report. We also examine neutrally and dispassionately the likely political developments going forward.	As the HK economy was already decelerating for nearly 12 months before June 2019 when the protests began, it will be difficult to apportion the share of the instability on the current deceleration. Nonetheless the instability added to, and will prolong the recession but most definitely did not start it. How bad the recession will be will depend on how long the violence continues and how the political impasse is resolved. However we believe even if the instability persists for another 6 months this will not be sufficient to place Hong Kong's position as a major financial and tourist center in irreversible decline. History is replete with examples of cities and countries, which suffered a great deal worse than HK and still managed to recover or find different trajectories for their development.

Paying the bill-the damage done so far.

First: As indicated, Fig. 1 shows that HK's GDP growth had been decelerating since the start of 2018, and hence the riots which started in June 2019 can not possibly be blamed for triggering the decline but, definitely making it worse. **Second:** Technically HK is now in recession, with two quarters of qoq negative growth occurring within the period of unrest. The rest of the figures in the table below tell the same story with retail sales and confidence (below 50.0) collapsing. **Third:** Contrary, however, to these trends, as the table and Fig. 1 show, the USD pegged HKD has not come under pressure, with forex reserves stable to rising and with the HSI hardly in crisis levels. **Fourth: Q.** How bad can it get? **A.** Not as bad as it is imagined. Fig. 1 shows that SARS pushed GDP growth just below 0.0% although on a yearly basis the economy grew at 1.7% in 2002, 3.1% in 2003, the year of SARS, and then rebounded to 8.7% in 2004. During 2003 the qoq growth was -0.1%, -2.4%, 6.1% and 1.1% with only two quarters qoq negative growth. During the 2008-9 crisis the economy grew at 2.1% in 2008, then shrank by 2.5% in 2009 and rebounded by 6.8% in 2010.

	June	July	Aug	Sept	Oct
GDP qoq	-0.5			-3.2	
Retail yoy%	-6.7	-11.5	-22.9	-18.2	-24.3
Confidence	47.9	43.8	40.8	41.5	39.3
Reserves, USD ml	445.7	448.4	432.8	431.7	440.6
USD/HKD	7.81	7.82	7.84	7.83	7.83

The "Occupy Central" period in 2014 had only one qoq of negative growth in 3Q at -0.2%, and overall the economy grew by 2.8%. The government now expects the economy to shrink by 1.3% during the fiscal 2019-20. Historically speaking this is modest, but the main concern here is the negative expectations as to Hong Kong's future. Turning now as to what the financial markets are telling us. The HSI is not anywhere near its 2008-9 lows, while the USD/HKD did not need a rescue or exceptionally high interest rates to stay pegged. Indeed the forex reserves have fluctuated but never entered a falling trend.



Source: Bloomberg

History lessons on the economics of violence and force.

The Fact Box shows three cases of extreme physical and financial destruction making the point, that, even in extreme cases, economies are not instantly destroyed and that recovery is possible. The Nazis kept an amazingly resilient military production even under a torrent of bombs while N.Vietnam survived massive bombing in the process of expelling the US from S.Vietnam. Greece is nearer to a more "normal" case, as it does not involve war. The necessary reforms and austerity programs were imposed on Greece from outside, by an implacable combination of the EU+ECB+IMF. This was in order to bring the country to fiscal rectitude which took nine consecutive years 2008 to 2016. During this time the maximum GDP growth recorded was 0.5% in 2014 and the minimum -10.8% in 2011 with the rest of the years all recording negative growth rates. Greece faced all this and survived intact as a functioning democratic and continuously reforming state and society, after nearly ten years of shrinkage. The question asked now is, if Hong Kong can face several more months of unrest and economic cost. The answer is clearly yes, especially as this is not an issue of recovery from the destruction of

Fact Box: Some irrelevant but interesting comparisons from history.

Nazi Germany: Strategic bombing started in Mar. 1940 (UK) and Jan. 1943 (US). Dropped 2.77 ml tons of bombs. Civilian deaths 353,000, 7.5 homeless. Industrial military output rose continuously from Feb 1942 to May 1943 and then remained flat to Feb 1944 with Germany surrendering in May 1945. **Vietnam:** The US intervened to stop N.Vietnam occupying South, (1964 to 1975), with US defeated. Bombing of Vietnam was triple that of WW II at over 7.0 ml tons of bombs dropped. The longer term economic and social impact on Vietnam was minimal "US bombing does not have a robust negative impact on poverty rates, consumption levels, infrastructure, literacy or population density through 2002. This finding suggests that local recovery from war damage can be rapid under certain conditions" (E.Miguel & G.Roland-The long term impact of bombing Vietnam, NBER Jan, 2006) **Greece:** Fiscal crisis in 2008 coupled with orderly default and three rescue packages by the EU led to a decade of austerity with recovery from 2017 onwards

Of eventually recovering confidence. We take absolutely no position for or against the protesters and the government but simply appraise the situation coldly and based on facts. We have no faith whatsoever in pious platitudes such as "Hong Kong always recovered and will do so this time". History never repeats itself, but notions of instant destruction of the economy and of financial markets have no historical basis. The "9-11" attack on NY City raised similar fears of "destructive decline". As Fig. 2 shows the financial impact was such that erasing the dates from the chart would leave no evidence as to when the famous attack took place! Countries decline, cities decline but over decades, if not centuries, and not overnight. After all the material infrastructure of Hong Kong is unharmed, notwithstanding the trashing of dozens of MTR stations and of a University. **We leave last the issue of the impact of the crisis on property of which there are plenty of signs of falling prices and rents. As we consider property to be in the heart of the current crisis, we will set aside a separate report on this topic. In brief, property is not only part of the problem but it will have to be part of the solution.**

Fig.2: US, S&P 500, GDP, impact of Sept.11 2001



Source: Bloomberg

The strategy and the tactics of violence: A step-by-step analysis

This is an analysis of the conflict ("negotiations") between a segment of the population of Hong Kong (broadly 55.2% of the voters as shown by the District elections of Nov. 2019) and the governments of Hong Kong and of the PRC. **This analysis takes no sides and neither assumes that one case or the other is just or fair.** First, the conflict is asymmetrical as the protesters demand from the government but have nothing to offer in return, except to cease protesting. **Second**, the tactics of the protesters moved from peaceful and "legal" demonstrations to violence, leaving aside the argument which side triggered first the violence. **Third**, the protesters state that their demands are not negotiable and the government states that, bar one demand granted, the rest will not be. **Fourth**, negotiations where both sides state "non-negotiability" are not negotiations as there is nothing to negotiate about. **Fifth**, this state of affairs invariably drives both parties to confuse tactics with strategy. The strategy of the demonstrators is to obtain 5 (or 4 ?) demands and their tactics, at present, are mostly violence against mostly public goods, while the government adopts a passive-active position by not offering anything while countering/suppressing the tactics of violence. **Sixth**, it has to be asked whether the tactics of violence will achieve the strategy aims especially as the violence is targeted at public physical property which, theoretically, belongs to all citizens of Hong Kong and, hence, can not be "traded" in return for something. **Lastly**, appraising the effectiveness of the tactics in achieving the aims of the strategy is crucial here, as the negotiation is asymmetrical and the only option available to the protesters is to stop or change their tactics and, thus, the risk of confusing and merging tactics with strategy. The government can continue to exploit this asymmetrical negotiation. **Conclusion**, it is likely that the tactics of both sides will change while the aims of the strategy (the demands) of the protesters' remain unchanged.