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Hong Kong's 'Prague Spring' To Hasten Trump-Xi Trade Deal

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In a further sign that the US has abandoned its post-Cold War liberal interventionist foreign policy -- (Somalia, The Balkans, Kosovo, Iraq I & II, Afghanistan and Libya), in favor of a realist policy of restrained non-interventionism, US President Donald Trump and Chinese President Xi Jinping are ironically now more likely to ink a massive trade deal on the back of the crackdown in Hong Kong. Mr Trump's (and even Mr Obama's) reticence to intervene directly in Syria, Yemen, Crimea, or more recently on Khashoggi (Saudi Arabia), Iran's ship seizures or on North Korea, have all combined to signal to China, that it can go ahead with a crackdown on the Hong Kong protesters, without suffering any major backlash from Washington DC - a 21st century version of the 1968 Prague Spring. With his re-election handing in the balance, Trump is likely to move to clinch a trade deal with China in exchange for a neutral US stance on the Hong Kong crackdown. China's massive agricultural imports from the US Midwest and the Dow Jones Index remain critical for Trump's 2020 reelection.

The issue

On Monday August 12, the Hong Kong airport came to a standstill after demonstrators occupied the area calling for formal cancellation of Fugitive Offenders and Mutual Legal Assistance in Criminal Matters Legislation (Amendment) Bill proposed by the government of Hong Kong (which the demonstrators say occurred on back of informal request by China). If enacted, it would allow the Hong Kong authorities to detain and extradite people who are wanted in countries/territories that it does not have extradition agreements with, including China and Taiwan. In practice it would allow HK residents and visitors to fall under the jurisdiction of Chinese courts, which are under the control of Chinese Communist Party (CCP) and which encompasses criminals but also political dissidents as well.

To put it in perspective, Hong Kong would see its legal system now ranked 18th out of 126 global jurisdictions to be governed/influenced by China whose system is ranked 86th, according to World Justice Project (WJP) Rule of Law Index 2019 edition. Alas, there is a severe risk that the rule of law in Hong Kong would be eroded, which would contravene the “two system, one country” formula agreed at the 1997 UK-China handover of the territory. It threatens also Hong Kong’s status as the premier financial center which uses English common law as the basis for most contracts and arrangements.

The demonstrators also demand the release of those arrested and other democratic reforms to be considered.

The background

Background to the current dire situation can be attributed to several factors. Such as the stupendously fast economic growth that has catapulted China to the second biggest economy, allowing its leadership to mete out stringent demands from foreign companies and governments to adhere to their rules/views. Another factor is that the relative importance of Hong compared to Shanghai and Shenzhen has been transformed; Hong Kong now lags in terms of port throughput, daily turnover and market capitalizations of their respective stock markets. Hence Hong Kong is becoming just another big city in China’s view.

This relative decline of Hong Kong has been long in the making, as illustrated by the performance of stock prices of top HK property companies which have underperformed leading Mainland Chinese peers since the 1997 handover. This has taken place despite the stupendous price appreciation (most expensive property market per sq. ft. in the world), capital/people inflow from China and oligopoly status among the big property names.

A third factor is that there is now a new generation, Hong Kong millennials, who have not lived under British rule but are now facing an economy where the richest households are now earning about 44 times what the poorest family earns. When these millennials reach middle-age in 2047 – (the 50-years period per UK-China agreement) – they will face major demographic hurdles due to low fertility rates and a massive pension liability. The protests are therefore as much about economic insecurity of the millennials as it is about political freedom.

Escalation

To gauge the seriousness of the situation on the ground, the Hong Kong and Macao Affairs Office (HKMAO), which officially handles matter on these two former colonies, and who has not given a briefing ion 22 years has done so thrice in the last fortnight. On Monday August 12, the HKMAO liked the situation in Hong Kong to “terrorism”, with 190,000 soldiers (excluding the 6,000 soldiers based in HK) and 12,000 policemen in Shenzhen, haven undertaken a public demonstration drill.

The sensitivity about the issue is also evident by the Chinese authorities request to Cathay Pacific, the flagship HK airline operator, to remove any staff involved in demonstrations to flights to China (2 ground staff were sacked, and 1 pilot grounded).

US embassy staff who had talked to demonstrators were pictured in Chinese media with personal details, triggering a strong rebuke from official sources in the US. And Versace, the clothing company, was forced to apologize after a t-shirt depicted Hong Kong and Taiwan as social media picked up as separate countries and was heavily criticized.

The local business community hopes for stability, and many of its leading names signed a petition in support of China.

Prague Spring 1968 moment

As the demonstrations are continuing, the crucial question is what to expect next. The people on the ground, particularly analysts/strategists at investment banks, are likely to be engaged in extreme form of self-censorship or bullish bias as any negative comment/worst case scenario could render their employer losing out future business deals, cut off from trading or even loosening licenses in China. This information asymmetry means that the markets are not well primed for what may ensue next. Continued capital markets volatility around Hong Kong is very likely.

Oct 1 marks the National Day in China and this year it coincides with the 70-years anniversary of People's Republic of China. It is unlikely President Xi Jinping will tolerate the issue remaining unresolved beyond that. He would be losing face, opening unwanted discussions about his leadership qualities, and in the worst case allowing some factions in the top Communist Party hierarchy to start to plot a formal challenge to his reign.

The consensus view is that once the students are heading back to their schools in early September, momentum will fade, and things will return to normal again.

Perhaps, but a non-consensus DaMina Advisors view is that Hong Kong is facing a Prague Spring 1968 moment. In January 1968 the newly Czechoslovak elected leader, Alexander Dubcek, started to initiate several democratic reforms, including a revised constitution to guarantee civil rights and liberties and plans for democratization of the government. Dubcek claimed he offered "socialism with a human face." On August 20, Soviet Union armed forces invaded the country and quickly occupied it. Hard-line communist leaders re-took their positions, reforms were cancelled, and Dubcek was deposed as a leader. As a result, the country was forced to endure Communism, Soviet meddling in domestic affairs, and relative economic stagnation compared to developed Western European economies for the next 25-years. Hong Kong is at such a moment. China will move in to finally consolidate its hold. With Brexit looming, and the UK looking for new trade deals, Britain can not intervene in any meaningful way either. A total consolidation of Hong Kong into China has begun.

Financial impact

With over $550bn of foreign investments parked in bonds and equities in Shanghai and Shenzhen markets, a crackdown on Hong Kong may see renewed capital flight. On top of that there are hundreds of billions in the Hong Kong market as well. A knee-jerk reaction would ensue, and many foreign funds invested in China may begin to face tricky questions related to ESG-principles (Environmental, Social and Governance) which are turning into a mandatory qualification for funds in Europe and the US.

Hong Kong's status as the premier investment center could be challenged, prompting firms to reconsider their presence/size of their operations in Hong Kong, opening up the prospect that competing centers, such as Singapore and perhaps London (particularly in a hard Brexit scenario where UK needs to find alternative service income from beyond EU) would win favor.

There is also a still smaller chance that a prolonged crisis could see the Hong Kong dollar peg to the US dollar readjusted, triggering strong readjustments in the global FX-market.

Hong Kong problems boost Trump

President Trump has been passive about the potential of a Chinese military clampdown, evident by a comment he made more than a week ago: "Something is probably happening with Hong Kong, because when you look at, you know, what's going on, they've had riots for a long period of time. And I don't know what China's attitude is. Somebody said that at some point they're going to want to stop that. But that's between Hong Kong and that's between China, because Hong Kong is a part of China. They'll have to deal with that themselves. They don't need advice."

However it is likely any kind of Chinese invasion will be broadcasted live covered by the largest cohort of foreign journalists in Asia (the Foreign Correspondent Club of Hong Kong is home to a who's who of news anchors/journalists) and subsequently viewed by hundreds of millions of viewers in the US/globally. The effect of this would be a trickle down where the public would be updated about the finer points about Chinese politics and economics, including the on-going China-US trade war, China's status as a foreign currency manipulator and the new INDOPAC strategy pursued by the US military. Consequently, President Trump is likely to make a U-turn and capitalize on any adverse event ahead of the November presidential election in 2020.

The 2020 election may very well turn on US-China relations, with the concerns about Russia falling behind. There is increased strong bi-partisan support for a stronger, more critical-China view. China may yet even be tempted to meddle in the US election to ensure that its deal with Trump is not thrown asunder.

History offers stark lessons for China.

While the Soviet Union was able to control Czechoslovakia and other satellite countries after 1968 for another 20 years, a series of global events - including the end of the Bretton-Wood system, the oil shock and technological advancements (manifested by the Star Wars program under President Ronald Reagan in the 1980s) - undermined the fundamentals of the Soviet Union leading to economic collapse. However, the rise of AI and cutting-edge information technologies may yet mean that a post-Hong Kong crackdown on China may yet extend China’s geopolitical remit, further isolating Taiwan.

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