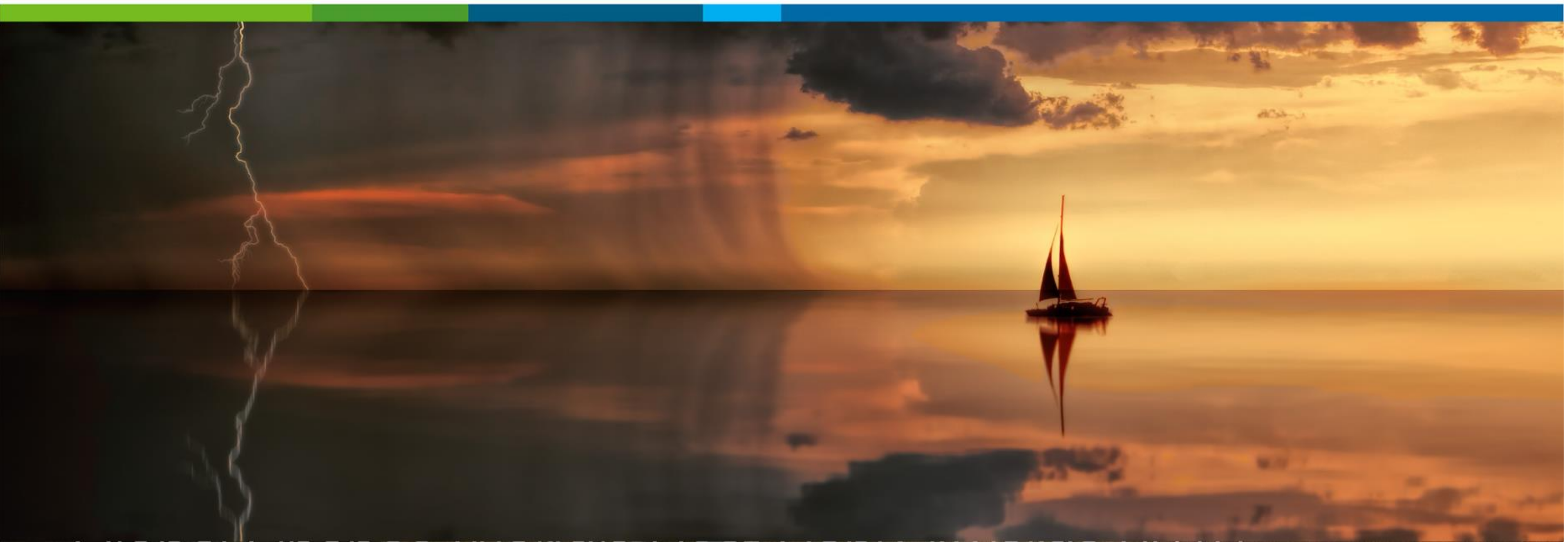

Hong Kong: A perfect storm

It's been a tough few quarters for Hong Kong – it was already badly battered in 2019 by the US-China trade war and local protests; after suffering a deep coronavirus-induced contraction in the first quarter of this year, Hong Kong appears to have little cushion left to weather a global recession.

With no hope of an imminent external-sector recovery, we recently lowered our 2020 GDP growth forecast for Hong Kong to -4.8 per cent from -2.4 per cent, our second downgrade since the coronavirus outbreak began. Lockdowns across the world have caused global demand to slump, diminishing the chances of even a modest rebound in Hong Kong's external trade, tourism, business investment and financial activity anytime soon.

Domestically, Hong Kong's coronavirus outbreak is likely to remain relatively contained due to continued community and policy vigilance, but the rising threat of imported cases and an accelerated increase in the unemployment rate are likely to dampen spending further. We now see unemployment rising from 3.7 per cent in February to 5.2 per cent by the end of 2020 (versus 5.0 per cent previously).

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Policy response: going counter cyclical

At the time of writing, the government has announced three rounds of relief measures since the outbreak, worth over HKD280 billion or 10 per cent of GDP in total. Key initiatives include a cash pay-out of HKD10,000 to every adult permanent resident, and an HKD80 billion Employment Support Scheme, which are wage subsidies (50 per cent of wages, capped at HKD9,000 per worker per month, for a period of six months) to

tapping into its deep HKD1.1 trillion fiscal reserves, in our view.

eligible employers to retain their employees, in return for employers undertaking not to implement redundancy.

Having run fiscal surpluses for 15 straight years, the government can afford to go counter-cyclical by tapping into its deep HKD1.1 trillion fiscal reserves, in our view. But with the government now projecting a FY21 budget deficit of 9.5 per cent of GDP versus 4.8 per cent prior, fiscal reserves are expected to fall between the HKD800-900 billion range. This means that pressure for fiscal consolidation is likely to rise in the coming years. The focus may turn to possible government bond issuance and the urgency of identifying new revenue sources and growth drivers once economic normalcy returns.

Local interest rates have already fallen this year, based on dovish Fed expectations. Short-term liquidity concerns have kept banks nervous, and short-end HIBOR supported, but we otherwise see HIBOR staying low for much of 2020, as global central banks see no urgency to normalise interest rates or reverse quantitative easing.

Aggressive monetary easing globally should eventually lift an open economy like Hong Kong, but this is more likely in 2021, after bankruptcies and a peak in unemployment.

Politics – unresolved social tensions

The coronavirus outbreak has likely only paused the protests in Hong Kong that have caused much disruption to the economy. Social tensions could re-escalate, especially with more potential flashpoints on the horizon, including upcoming Legislative Council (Legco) elections in September. The pro-democracy camp is likely to ride on the momentum of its District Council election victory last year, but the hurdle to securing more than half of the Legco seats is much higher than for District Council seats.

Currency outlook

The Hong Kong dollar (HKD) has been supported by rate differential and safe-haven flows. However, Hong Kong's worsening fundamentals (weak loan demand, a light IPO calendar) could return to hit the HKD once the coronavirus-fuelled panic in broader asset and credit markets subsides.