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# U.S. CHINA

Special Report

## THE NATIONAL SECURITY LAW
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Cathay Bank

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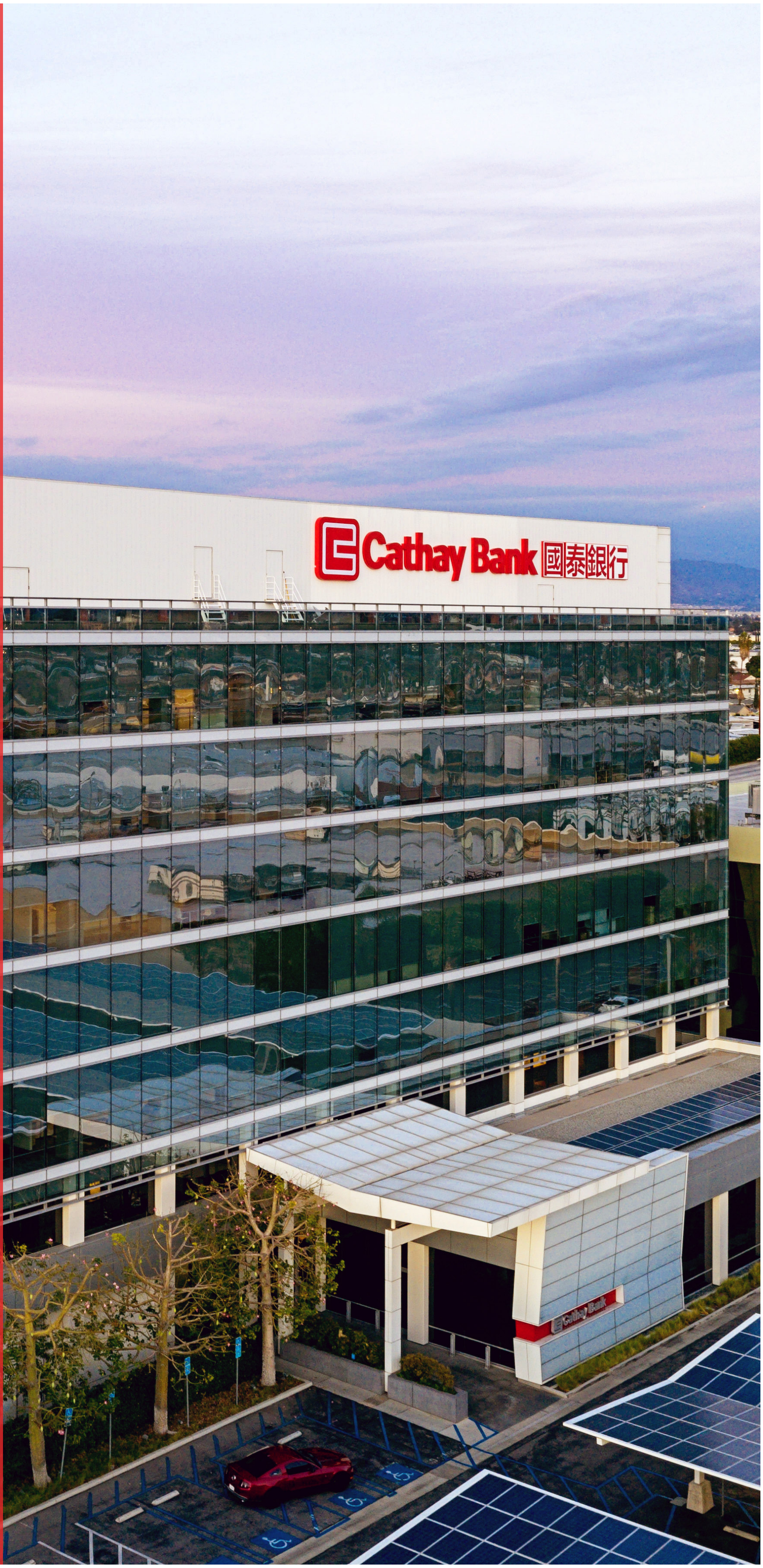

# THE ECONOMIC IMPLICATIONS OF THE NATIONAL SECURITY LAW

By William Yu, Economist, UCLA Anderson Forecast
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The new Hong Kong National Security Law, passed unanimously by China's National People's Congress on May 28, modifies the Hong Kong Basic Law, which was adopted by a previous National People's Congress in April of 1990. This change may have profound effects on the economic relations between the United States and China. In this essay, we focus only on the economic aspects while acknowledging that the longer-run geopolitical aspects may be much more important than the short-run economic consequences discussed here.

While the U.S. points to the National Security Law as a violation of the Sino-British Joint Declaration that Hong Kong would act as if it were a separate economic and political entity until at least 2047, China points to civil unrest in Hong Kong. Hong Kong Chief Executive Carrie Lam stated that the new law was to "safeguard national security," and as such, it is a necessary step. Moreover, China points to civil unrest in the U.S. and the Trump Administration's statements with regards to it as being one-and-the-same. Although we don't know how all of this will play out, it seems likely that the new security law will be implemented, and as likely that the U.S. will respond with restrictions and sanctions on China.  If we suppose the highest level of economic escalation, that of the loss of the Hong Kong Special Administrative Region (HKSAR) designation for Hong Kong by the U.S., a loss of designation foretold by the report from Secretary of State Pompeo to the U.S. Congress on May 27, what might be the economic consequences?

There are two aspects of the Hong Kong economy that relate to U.S./China economic relations. The first is the trade between Hong Kong and the U.S. This is trade that is not subject to the tariffs imposed by the U.S. on Chinese goods. A loss of status means that Hong Kong exports to the U.S. would be subject to these tariffs. In 2019, the total amount of imports into the U.S. from Hong Kong was $16 billion which amounts to 0.5% of U.S. imports from the rest of the world and 2.8% of total Hong Kong exports. It is not at all clear that the U.K. and the E.U. would also remove Hong Kong's Special Administrative Region status in response to the National Security Law, and therefore we will assume this is not relevant here. About half the exports are goods that do not have Section 301 tariffs against them. Thus, even though the tariffs would likely mean higher prices for U.S. consumers, there is not likely to be a significant reduction in Hong Kong exports. However, Hong Kong is a city with a trade deficit (-$29 billion) with the U.S. and that is potentially at risk with the end of HKSAR.

The second, more important aspect of Hong Kong for U.S. China economic relations is Hong Kong as a financial center. U.S. companies use Hong Kong as a base of operations for foreign direct investment in China. Of the total FDI in China, 72.1% comes from companies based in Hong Kong. Of course, not all of this, perhaps not even the majority, is from the U.S. Nevertheless, if Hong Kong is no longer believed by potential investors to be a city-state with an independent reliable judiciary to enforce the property rights of foreign companies investing in China, even if this is ultimately not the case, there will be a move of those firms away from Hong Kong. The alternatives are Taipei, Singapore, Tokyo, and Seoul. Each of these present increased costs relative to Hong Kong. These increased costs imply less FDI into China from the U.S.

Is China willing to accept this outcome? The evidence thus far is in the affirmative. Thus, the implication of the imposition of the National Security Law is quite simply a further decoupling of the two economies. U.S. firms lose profit opportunities and Chinese firms lose a source of investment capital. For the U.S. investor, marginal investments in China would no longer be profitable, and the level of cross-border financial activity would diminish. A declining financial sector in Hong Kong would move China further away from the RMB being accepted as an international currency because, for a large part of the world economy, there would no longer be a quasi-China financial center with the legal structure to support it. While we have not analyzed the implications with respect to the Hong Kong dollar nor the Hong Kong economy per se, the obvious implication is for a weaker HK$ and for slower if not negative economic growth.

In short, the loss of HKSAR status with the United States would result in less economic activity in both countries, the loss of Hong Kong as a trans-shipment port for China, the derailment of the RMB as a potential world currency, and an increase in the U.S. balance of trade deficit. While the analysis in this communication is based on speculation about future political actions, the risks are not. To be sure, until those political events unfold, events that might in fact lead to more cooperation and a modification of the law, or the implementation thereof, that would satisfy Washington, expect a defensive move on the part of firms in finance and trade outlined here.