

Hong Kong: Impact of losing special status from US

(This note was first published on May 31 this year - its conclusions still hold following the US announcement on restrictions on exports of sensitive items yesterday).

The US is stripping Hong Kong's special status under US law. What does it mean from an economic perspective? The focus has been on trade but the impact is more on the use of US technology



A bit of background

Hong Kong is losing its special status from the US, according to Mike Pompeo, the US Secretary of State. But the details are still missing.

The United States-Hong Kong Policy Act in 1992 gave Hong Kong favourable trading terms with the US. This act identifies Hong Kong as a separate customs territory from Mainland China.

Hong Kong's exports to the US were around US\$39 billion in 2019, amounting to 7.6% of Hong Kong's total exports, but down around 15% of the total in 2018. US imports into Hong Kong were around US\$27.3 billion, equivalent to less than 5% of Hong Kong's total imports in 2019, and down about 8% from 2018. These falls in trade flows were mostly due to the trade war between China and the US. As Hong Kong has a very tiny manufacturing sector, its exports are almost all re-exports. We will explain in the latter part of this note how industries are affected by potential trade-related policies imposed by the US.

Direct investment from the US into Hong Kong was US\$37.3 billion as of the end of 2018, which was equivalent to less than 2% of total direct investment into Hong Kong. The increase in investment by the US was US\$2.5 billion in the same year, which was around 2.3% of the total increase in direct investment. But this amount could be underestimated if US companies invest in

Hong Kong through companies registered in other locations, eg, Bermuda and Cayman Islands. For this reason, we will use the number of US companies that have regional headquarters in Hong Kong as a proxy for US investment in Hong Kong.

But first of all, the biggest threat is on the use of US technology.

? Impact on technology

The removal of the special status could mean more restrictions on technology transfers between the US and Hong Kong.

That is because, after the removal of the special status, the same policy applied to Mainland China on technology transfers should, in theory, be applied to Hong Kong. This is "export control" in technical terms. Put simply, the US government can ban US companies from selling technology products and services to Hong Kong-based companies.

According to [the media](#), about 70% of cybersecurity products in Hong Kong originate in the US.

The ban should not be limited to cybersecurity products. It could have a very deep and wide impact on Hong Kong companies and individuals' daily lives, even though technology and innovation is not the key industry of Hong Kong.

Unlike Mainland China, Hong Kong does not manufacture products, so the technology threat is not in terms of producing advanced technology products. Instead, Hong Kong companies provide telecommunication and technological services that rely on technological products. These range from mobile applications that are put on US mobile companies' platforms for the use of US companies' telecommunication products in business and the technology applications for those products.

This will be especially true if the technology products could have dual-use, ie, both commercial use and military use, which is at the core of the technology war between the US and Mainland China. There are many technologies that could have dual-use.

Because the impact could be very damaging, there is some doubt about the stringency with which the US would enforce the special status on technology transfers as this would also hurt US companies and their reputation. We believe more countries will try to find alternatives to US technology from now on as a back-up plan, in case there is a sudden ban on using US technology.

➔ Impact on investment

The removal of the special status should not have much impact on investment by US companies in Hong Kong unless there is retaliation in terms of sanctions from Mainland China on US entities based in Hong Kong, which is unlikely. But the trade war between China and the US will be a negative factor for US companies choosing Hong Kong as their regional headquarters.

Many US companies choose Hong Kong as a destination for their regional hub because of the low corporate and individual tax rates and the HKD linked exchange rate system, which is essentially a peg to the USD, that benefits US companies by avoiding FX risks.

Moving out of Hong Kong also means that these companies have to relocate their regional headquarters to other locations in Asia. The uniqueness of Hong Kong's linked exchange rate

system is not replicated by other economies in the region. As such, we do not think there will be a large-scale relocation of US companies away from Hong Kong.

US companies are at the top of the list of regional headquarters in Hong Kong. In 2019, Hong Kong had 278 regional headquarters of US companies, equivalent to 18% of Hong Kong's total regional headquarters (1,541 entities). Even so, US companies scaled back their investment in Hong Kong in 2019. These companies include financial institutions, technology companies, and treasury centres of some manufacturing companies. They are important for the financial sector of Hong Kong. Some US companies that have businesses in Mainland China have a funding pool in Hong Kong for better allocation of funds in various parts of their global business.

The trade war has also had an impact on US companies choosing Hong Kong as their regional centre. Some US companies scaled down their investment in China when the trade war and technology war began. There were 4% fewer regional headquarters from the US in 2019 compared to 2018. But even that did not change the landscape of US companies being at the top of the list of those with regional headquarters in Hong Kong in 2019. However, an intensification of the trade and technology war between China and the US could gradually change this landscape. In a few years time, there could be more Mainland China companies headquartered in Hong Kong than US firms.

Impact on Hong Kong trade as a re-export centre

On trade, we focus on the most critical part that could be affected by the removal of the special status.

Most of the media reports have focused on trade, that is Hong Kong's exports to the US, which will then have the same tariff rates imposed as Mainland China's exports. But we have to keep in mind that Hong Kong has almost no manufacturing sector, so it is re-exports that are the key part of Hong Kong's exports of goods.

For example, Mainland China's exports passing through Hong Kong to the US are subject to a tariff rate that applies to Mainland China. That is, in terms of tariffs, there should be no difference in terms of special status.

But there is a "[first-sales rule](#)" that makes Hong Kong more important to Mainland China during the trade war. According to the Hong Kong Trade Development Council, [the use of the first-sales rule has risen a lot](#) since the trade war between the US and China.

- With the first-sales rule, exports to the US that go through more than one location will be charged duties based on the price of the initial sales. For example, when a Chinese exporter sells goods to a Hong Kong re-exporter at a lower price, then the Hong Kong re-exporter (eg, a subsidiary of the Mainland China company located in Hong Kong) sells at a higher price to a US importer, the tariff will be based on the first transaction. As such, the tariff paid could be lowered when there is a throughput via Hong Kong.
- When Hong Kong's special status is removed, a Hong Kong re-exporter might not be treated as a "second leg" of the export to the US. Mainland China's exports will search for another "second leg". As a result, Hong Kong's port and logistic businesses are likely to experience some decline.

How much are these re-export activities? According to the [Hong Kong Trade Development Council's](#)

[report in April 2020](#), around 8% of Mainland China's exports to the US, and around 6% of Mainland China's imports from the US, went through Hong Kong in 2018. For comparison, Hong Kong's total exports amounted to US\$533 billion, of which around US\$39 billion was exported to the US in 2018, according to the Census Department of Hong Kong.

Hong Kong's overall exports to the US with the tariff rates imposed on Hong Kong after the removal of the special status will certainly fall due to the absence of the role in "first-sales rule". Again, this damages the port, shipping service and logistic industries. But [these industries have been hurt anyway since the start of the trade war](#) between Mainland China and the US.

GDP growth depends on US policies and China's retaliation

As we said at the beginning, banning the use of US technology is the real threat to Hong Kong when the special status is removed. Businesses related to technology will be hurt if there is a ban on using US technology. The impact can vary a lot in terms of GDP. We need to see the exact policy changes from the US to gauge this damage.

The removal of special status is not going to have a meaningful impact on US companies setting up regional offices in Hong Kong. But the trade war between China and the US has been a negative factor that increases the hurdles of US companies doing business with Mainland China, and therefore the need for a treasury centre in Hong Kong diminishes. This gap will be filled by Mainland China companies. In this sense, the trade war could lead to the Hong Kong economy relying more on Mainland China.

Port, shipping services and logistics will be affected by the removal of the special status, but they are already in bad shape following the trade war between China and the US.

The uncertainty on the Hong Kong economy does not only depend on how the US shapes its policies towards Hong Kong after the removal of the special status, but also on Mainland China's possible retaliation, which could be a mix of economic and political policies toward the US. We may revise our GDP forecast later depending on the policy changes revealed by the US, and also the impact of protests on retail sales and the relaxation of social distancing measures on employment.

For now, our GDP forecast is -4.1% for 2020.