

For discussion on
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**PANEL ON COMMERCE AND INDUSTRY,
PANEL ON ECONOMIC DEVELOPMENT,
PANEL ON FINANCIAL AFFAIRS**

**The Impact of the Trade Conflict between
China and the United States on Hong Kong's Economy**

PURPOSE

This paper briefs Members on the major developments of the trade conflict between the United States (US) and the Mainland, as well as the Government's assessment on the economic impact on Hong Kong and follow-up actions in respect of the latest circumstances.

US' Trade Protectionist Measures

2. The US and the Mainland are respectively the world's largest and second largest economies, and are Hong Kong's important trading partners¹. In 2017, the total merchandise trade of Hong Kong with the Mainland and with the US amounted to HK\$4.136 trillion and HK\$543.9 billion respectively. In the same year, total merchandise trade between the Mainland and the US amounted to around US\$636 billion², among which around US\$45.3 billion (about 7%) routed through Hong Kong. Many companies in Hong Kong have direct investment in or a lot of economic ties with the two places.

¹ In terms of economies, the Mainland and the US are respectively Hong Kong's two largest trading partners. If the Association of Southeast Asian Nations (ASEAN) and the European Union (EU) are taken as a single trading entity, Hong Kong's top four trading partners are in the order of the Mainland, ASEAN, the EU and the US.

² According to statistics of the US Department of Commerce

3. The Government has been closely monitoring the various trade protectionist measures imposed by the US as well as developments of the trade conflict between the Mainland and the US, and their impact on Hong Kong's economy, in particular the additional tariff measures by the US arising from the reports of the "Section 232 investigation"³ relating to the threatening and impairment of US national security by global imports of steel and aluminium products as well as the "Section 301 investigation"⁴ concerning the Mainland's intellectual property issues.

US' "Section 232 Investigation" Reports

4. The US Department of Commerce (DoC) released on 16 February 2018 the "Section 232 investigation" reports relating to the threatening and impairment of US national security by imports of steel and aluminium products. The reports recommended that the US President considered imposing quotas or additional tariffs on imported steel and aluminium products covered in the investigation. One of the recommendations is to subject aluminium products imported from five economies (including Hong Kong)⁵ to a tariff at 23.6%.

5. There are only a very small number of companies in Hong Kong producing and exporting aluminium products to the US. In 2017, Hong Kong's total exports of the aluminium products covered by the investigation to the US amounted to only US\$38 million, representing 0.23% of the total import of aluminium products into the US. Hong Kong has no domestic exports of the steel products covered by the investigation to the US. In 2017, our re-exports of the concerned steel products to the US amounted to US\$1.76 million only. Our minimal exports of steel and aluminium products to the US could by no means threaten the US national security. We therefore consider that the above unilateral measures proposed by the US are discriminatory and unfounded, and cause injustice and harm to the relevant companies in Hong Kong.

6. Subsequent to the release of the investigation reports by the US, the Government had through various channels followed up the matter with the US and at the World Trade Organization (WTO). On 27 February, we filed our

³ I.e. the investigation by the US Secretary of Commerce authorised under Section 232 of the Trade Expansion Act of 1962

⁴ I.e. the investigation by the US Trade Representative authorised under Section 301 of the Trade Act of 1974.

⁵ The five economies are Mainland China, Hong Kong, Russia, Venezuela, and Vietnam.

formal representation to the US Administration to register our objection to US' measures which were unilateral, unfounded and inconsistent with WTO rules. We also informed the trade at the first instance and met with the major local chambers of commerce and the American Chamber of Commerce in Hong Kong to ascertain the impact of the US' actions on the trade. After the meeting, the five major local chambers of commerce⁶ issued a joint statement to support the Government's follow-up actions. We also repeatedly registered our grave concern on the issue at the WTO platform.

7. In early March, the US President announced his decision to impose tariffs of 25% and 10% on globally imported steel and aluminium products respectively from 23 March. Certain economies were excluded or temporarily excluded from the measures.

8. The Government does not agree to the US' measures. The tariff measures are not only inconsistent with WTO rules, but also detrimental to Hong Kong's legitimate rights and interests. In this connection, the Secretary for Commerce and Economic Development met with the Consul General of the US to Hong Kong and Macau and requested the exclusion of Hong Kong from such improper measures. The Hong Kong Economic and Trade Office in Washington DC also reiterated Hong Kong's position and request to relevant US authorities. We issued subsequently a note to the US again to reiterate our request for excluding Hong Kong from the tariff measures. The Government has been keeping in touch with the affected trade, and providing advice and assistance to manufacturers who intend to make representation to the US DoC to exclude their products from the tariffs. As of today, the US has not excluded Hong Kong from the tariff measures on the concerned steel and aluminium products.

9. Hong Kong is a free trade entity and a staunch supporter of the multilateral trading system. As a founding member of the WTO, Hong Kong always adheres to the commitments and rules of the WTO agreements. We staunchly support the multilateral trading system with other WTO Members and are against any restrictive trade measures that are inconsistent with WTO agreements. Apart from registering our grave concern on the tariffs at various meetings of the WTO, we have made formal requests to join as third party the

⁶ The Federation of Hong Kong Industries; The Chinese Manufacturers' Association of Hong Kong; The Chinese General Chamber of Commerce; The Hong Kong General Chamber of Commerce; and The Hong Kong Chinese Importers' and Exporters' Association.

consultations requested by China, India and the EU respectively with the US under the WTO Dispute Settlement Mechanism in order to safeguard Hong Kong's interests. Subject to developments, we do not preclude the possibility of making a direct request for consultations with the US.

US' "Section 301 Investigation" Report

10. The US Trade Representative (USTR) published on 22 March the "Section 301 investigation" report concerning Mainland's intellectual property issues, and subsequently in early April a preliminary proposed list of more than 1,300 tariff lines of Mainland products, including aerospace, information and communication technology, and machinery, etc., to be subject to an additional 25% tariff.

11. After collecting public comments, the US announced on 15 June a revised list of Mainland goods worth US\$50 billion for an additional 25% tariff. The first batch, which took effect on 6 July, covered 818 items, worth about US\$34 billion, in the proposed list announced in early April. The remaining 284 items worth about US\$16 billion, including products relating to aerospace, information and communications technology, etc., will undergo further public comment and hearing process before a determination on the finalised tariff list and effective date.

12. In response to the US' measures, the Customs Tariff Commission of the State Council announced on 16 June that it would impose an additional 25% tariff on 659 items of US imports worth about US\$50 billion. Among them, 545 tariff items of US goods worth about US\$34 billion, covering agricultural products, automobiles and seafood etc., took effect on 6 July. The implementation date of the tariff on the remaining 114 items (including chemicals, medical equipment, and energy products etc.) would be announced later.

13. Although the measures proposed under the "Section 301 investigation" are not directly targeted at Hong Kong, as an open economy, Hong Kong will also be affected. According to preliminary assessment -

- In respect of the US tariff lists, about HK\$53 billion of the concerned Mainland products were re-exported via Hong Kong to the US in 2017, accounting for 19% of all Mainland goods re-exported via

Hong Kong to the US, and 1.4% of Hong Kong's total exports of goods. Most of these goods (over HK\$40 billion) are likely among the 818 items affected in the first stage.

- As for the Mainland's counter tariffs against US imports, about HK\$11.7 billion of the concerned US products were re-exported via Hong Kong to the Mainland in 2017, accounting for 16% of all US products re-exported via Hong Kong to the Mainland, and 0.3% of Hong Kong's total exports of goods.

14. The US President announced on 18 June that he had directed the USTR to prepare a list of Mainland goods worth US\$200 billion for an additional 10% tariff in response to the Mainland's countering tariffs implemented on US goods. On 10 July, the USTR announced a proposed tariff list of 6 031 items covering a broad range of Mainland imports, including agricultural and aquatic products, chemicals, machinery and equipment, automotive parts, yarns, fabrics, batteries and consumer products such as televisions, refrigerators, air conditioners, furniture, handbags and travel goods. The USTR will collect public comments on the tariff proposal before 17 August and hold public hearings between 20 and 23 August before making a decision. The Government is now assessing in detail the impact of the proposed tariff list on Hong Kong's trade.

Direct Economic Impact on Hong Kong

15. The direct impact on the Hong Kong economy arising from the US and Mainland's additional tariffs will manifest mainly in trade activities. In particular, the US' additional tariffs on imports from the Mainland would affect re-export of Mainland products via Hong Kong to the US and Hong Kong's offshore trade involving Mainland products destined to the US. Other economic activities that support US-China trade involving Hong Kong (including Hong Kong's exports of raw materials and semi-manufactures to the Mainland, part of which will be used for producing goods to be exported to the US) will also be affected to a certain extent.

16. In 2017, Mainland products re-exported via Hong Kong to the US amounted to around HK\$278 billion, constituting 7.2% of Hong Kong's total exports of goods. As mentioned in paragraph 13 above, it is estimated that 1.4%

of Hong Kong's total exports of goods is affected by the tariff measures announced by the US in mid-June (not including the latest proposed tariff lists announced by the US covering US\$200 billion worth of Mainland imports). Taking into account other trade and economic activities mentioned in paragraph 15, the impact of the US' tariff measures on Hong Kong's economic growth this year would be a drag of around 0.1-0.2 percentage point. Such impact is limited when compared to the economic growth forecast of 3-4% for the whole year. However, individual companies involving in the re-exports and offshore trade of affected Mainland products to the US may face more severe challenges.

17. US products re-exported via Hong Kong to the Mainland accounted for about 2% of Hong Kong's total exports of goods, smaller than the trade flows in the opposite direction (i.e. 7.2%), of which only a small fraction would be subject to the Mainland's countering tariff measures. As mentioned in paragraph 13 above, the value of re-exports subject to Mainland's counter-measures is estimated at 0.3% of Hong Kong's total exports of goods. Moreover, the Mainland will very likely seek alternative import sources and Hong Kong is also very likely to continue to be the intermediary for these trade flows. Thus, the negative impact on Hong Kong arising from Mainland's counter-measures should be small.

18. As for the latest tariff list announced by the US proposing an additional 10% tariffs on Mainland goods worth US\$200 billion, a much broader merchandise trade flows through Hong Kong are involved. Depending on whether and when the US' tariffs would be implemented, it is expected that the direct implications on Hong Kong's economic growth will be reflected later this year and next year. With the intensifying conflicts between the US and the Mainland, uncertainties in the external environment have increased markedly. This could weigh on the global economic sentiment as well as future trade and investment growth. The local economic sentiment and asset market will also be under pressure and the impact on Hong Kong's economy will be more obvious. We must therefore get prepared.

Support Measures to the Trade

19. Since the USTR's announcement of the proposed tariff lists, the Government has been in close liaison with the trade. The Commerce and

Economic Development Bureau and the Trade and Industry Department (TID) have met with the trade many times. After the US' and the Mainland's tariff measures took effect on 6 July, the Secretary for Commerce and Economic Development met with major local chambers of commerce and small and medium enterprises (SME) associations⁷ again on 10 July to gauge the measures' impact on the trade. In general, representatives of the trade associations considered that the direct impact of the first stage of tariffs on 818 items imposed by the US on 6 July to the trade was limited, but they were concerned with the impact of the tariff measures on the overall trade and investment sentiment. As for the US' latest proposal of imposing additional 10% tariff on Mainland goods worth US\$200 billion, since a wider range of product types are covered, there would be an impact on the trade to a certain extent if it is eventually implemented. The trade associations have already reminded their members to get prepared for the challenges ahead arising from the tariff measures by the Mainland and the US, in particular with respect to cashflow management, financing, etc. The trade associations will further consult their members on the impact of the tariff measures. In light of the US' announcement on 10 July of the tariff list of goods worth US\$200 billion, the Secretary for Commerce and Economic Development will meet with the trade again on 16 July.

20. The Government will continue to closely monitor the US' trade protectionist measures and the latest developments of the trade conflict between the Mainland and the US and their impact on Hong Kong's economy. We will also keep the trade informed in a timely manner through commercial information circulars and other channels, and liaise closely with them. In this regard, TID has set up a one-stop help desk for better communication with and dissemination of information to the trade.

21. Besides, the Government endeavours to assist the trade in responding to changes in the business environment and their operational needs. Amid the trade war between the Mainland and the US, it is particularly important to assist the trade to develop new markets and diversify risks. In this connection, the Government will advance the launch of the ASEAN Programme under the Dedicated Fund on Branding, Upgrading and Domestic Sales to August 2018 to

⁷ Chambers and associations participated at the meeting included the Hong Kong General Chamber of Commerce; The Federation of Hong Kong Industries; The Chinese Manufacturers' Association of Hong Kong; The Chinese General Chamber of Commerce; The Hong Kong Chinese Importers' & Exporters' Association; Hong Kong Small and Medium Enterprises Association; The Hong Kong General Chamber of Small and Medium Business; and Hong Kong Chinese Enterprises Association.

provide funding support to individual non-listed Hong Kong enterprises to undertake projects for enhancing their competitiveness and furthering business development in the ASEAN market. Enterprises could obtain a maximum funding of \$1 million on a matching basis for carrying out up to ten ASEAN projects, with the funding ceiling per project being \$1 million.

22. In addition, the SME Loan Guarantee Scheme launched in 2001 and administered by TID provides loan guarantee to SMEs to help them secure loans from participating lending institutions for acquiring business installations and equipment or meeting working capital needs of general business uses. The maximum amount of loan guarantee for each SME is \$6 million. Based on the maximum guarantee ratio at 50%, the corresponding loan amount is \$12 million. The maximum guaranteed period of each loan is five years. Each SME is allowed to recycle the guarantee once for acquiring new loan after it has fully repaid the loan backed up by the guarantee. Since the launch of the Scheme and up to end-March 2018, a total of 31 023 applications have been approved, involving a guarantee amount of about \$25 billion.

23. The Hong Kong Mortgage Corporation Limited launched the special concessionary measures under its SME Financing Guarantee Scheme to provide 80% loan guarantees at concessionary fee rates. The Government provides a total loan guarantee commitment of \$100 billion for the measures. The maximum loan amount to be guaranteed for each enterprise is \$12 million. The application period of the special concessionary measures has been extended six times to end February 2019 to help enterprises tide over their liquidity needs, grasp economic opportunities and boost their competitiveness.

24. The Hong Kong Export Credit Insurance Corporation (ECIC) encourages and supports export trade by providing Hong Kong exporters with insurance protection against non-payment risks arising from commercial and political events. The ECIC is committed to supporting SMEs, and the tailor-made Small Business Policy (SBP)⁸ offers SMEs policy fee waiver, premium discount and a range of flexible arrangement. In view of the escalating trade conflict, the ECIC announced on 25 June special enhanced measures, including (a) to increase the number of free buyer credit assessment from 3 to 6 for each Hong Kong exporter; (b) to provide additional pre-shipment cover for free to SBP holders who are affected by the US tariff measures; and (c) to arrange free seminars and talks

⁸ SBP is applicable to Hong Kong exporters with annual sales turnover less than HK\$50 million

for its policyholders and Hong Kong exporters to enhance their understanding on international trading rules and the terms and details for drawing up a contract, risk mitigation measures and actions to be taken in case of payment default or buyers' failure to take delivery of goods.

25. The Hong Kong Trade Development Council will organise free seminars with experts helping the trade understand the relevant trade measures and possible responses, and will also continue to help the trade develop emerging markets and transfer production base through organising trade missions, business matching services, etc.

Maintaining Financial Stability

26. The escalating trade conflict between the Mainland and the US as well as that between the US and other economies have created uncertainty for the financial market and added volatility to the stock market. If there are further protectionist measures, the global economic outlook and corporate earnings of the related sectors could be clouded. Trade conflicts would also affect economic growth and inflation outlook in the US, thus bringing uncertainty to the pace of the US Fed's rate hikes and capital flows. The Hong Kong banking sector could also be affected through the credit and liquidity risk channel should trade conflicts further escalate and persist into the medium to long term.

27. Nevertheless, with a deep capital market and robust regulatory regime in place, Hong Kong's financial system is well placed to navigate the risk. The Government and financial regulators will continue to stay vigilant and closely monitor the market situation with a view to ensuring financial stability.

Securities Market

28. Supported by a regulatory regime which has been developed to ensure resilience against market volatility, the Securities and Futures Commission (SFC) is well prepared to deal with extreme market situations. It monitors the market with vigilance and works closely with the Stock Exchange of Hong Kong (HKEX) and the Hong Kong Monetary Authority (HKMA) to address potential systemic issues, in particular, ensuring that the trading and risk management systems of HKEX can adequately handle shocks under extreme market situations.

29. As regards supervision of intermediaries, SFC is closely monitoring returns under the Securities and Futures (Financial Resources) Rules to detect risks of increasing margin financing or possible over-leveraging in the market. Stress testing is conducted to gauge the possible impact on brokers' financial positions, operations and settlement status in particular during periods of extreme volatility. SFC also maintains close dialogue with HKEX as regards the settlement status of exchange participants. Licensed corporations are closely supervised to ensure that their liquidity needs are rigorously evaluated and contingency plans have been developed to weather market-wide or idiosyncratic stress.

Banking System

30. With the further strengthening of regulation in the aftermath of the global financial crisis, the banking system in Hong Kong is marked by high resilience against adversity. Currently, it has an overall liquidity coverage ratio of around 150% and capital adequacy ratio of over 19%, which are among the highest in the world. As for Mainland-related loans, the majority of the Mainland-related lending was for state-owned enterprises and non-Mainland multinational companies. Around one-third of the Mainland-related loans are secured with tangible collateral or bank guarantees while another one-third of the loans are covered by other forms of guarantee. As of the end of March 2018, the overall classified loan ratio of the Hong Kong banking sector's Mainland-related lending portfolio stood at 0.60%, much lower than the long-term average of 2.0% of the overall non-performing loan ratio of the banking sector since 2000. The overall asset quality remains at a healthy level and credit risks remain manageable. HKMA regularly conducts on-site and thematic supervisory reviews and stress tests on banks to ensure that the banking system has sufficient capital and liquid assets to weather shocks.

31. So far, Hong Kong's money market has not seen any major impact stemming from the trade tensions between the Mainland and the US, and the Hong Kong dollar currency market has been operating smoothly, with liquidity in Hong Kong's banking system remains ample. HKMA will continue to closely monitor the changes in the foreign exchange market and the local money market, maintain the stability of the Hong Kong dollar exchange rate and provide liquidity support to banks if necessary. Our more than US\$430 billion worth of foreign exchange

reserves provides a powerful line of defence for Hong Kong's monetary and financial stability.

32. In view of the possible impact of uncertain external economic outlook on the lending business in Hong Kong, HKMA is now closely monitoring the lending statistics from the banking industry. According to the latest statistics, total loans of the banking sector grew by 3.6% in the first quarter of 2018. Although the growth moderated to 0.7% between April and May, the growth in trade finance reached 4.1% during the same period. The total credit facilities granted to SMEs remained stable in the first quarter of 2018. It appears from the statistics available so far that the trade dispute has yet to exhibit a significant impact on banks' lending business. HKMA will keep a close watch on market development and require banks to manage their lending business and credit risk with prudence. Banks are also reminded to support the financing needs of SMEs to the extent permitted under their credit policies and risk management principles.

Conclusion

33. Since the conclusion of the General Agreement on Tariffs and Trade, and the subsequent establishment of the WTO 20 years ago, the international community has been promoting global trade liberalisation by reducing tariffs and removing trade barriers. The additional tariff measures first initiated by the US and followed by countering measures introduced subsequently by other economies including the Mainland and the EU have brought uncertainties to the originally stable international trade situation, and represent a big setback in the international trade arena. Trade war benefits no one. We hope that the US could return to bilateral consultations and resolve the trade disputes through established mechanisms under the WTO.

34. Recently, uncertainties in the external environment as a result of the trade conflicts have increased markedly. This could weigh on the global economic sentiment as well as trade and investment growth and, may affect local economic sentiment and subject the asset market to pressure. If trade friction continues to escalate, the direct and indirect impact on Hong Kong's economy will certainly be bigger and more obvious. We must therefore get prepared. The Government will continue to closely monitor the developments and assess their potential impact on Hong Kong's economy and trade. We will keep the

trade informed of the latest information in a timely manner and communicate closely with them so as to make appropriate response. We will also actively safeguard the interests of Hong Kong companies and our overall trade interests through the WTO platform, and reserve the right to take all necessary actions under the WTO mechanism.

**Commerce and Economic Development Bureau
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