



VIEW FROM THE PEAK

HUMANS AREN'T DONE YET

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View from the Peak Expert Series

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The Hong Kong Protests: What is the end game?



Jude Blanchette holds the Freeman Chair in China Studies at the Center for Strategic and International Studies (CSIS). Previously, he was engagement director at The Conference Board's China Center for Economics and Business in Beijing, where he researched China's political environment with a focus on the workings of the Communist Party of China and its impact on foreign companies and investors.

Synopsis

Jude argues that Beijing is prepared to use deadly force to end the Hong Kong protests if it sees a threat to its control of Hong Kong, and to its regime. The decision is likely to come within weeks, or sooner, if the demonstrations resume in force. Xi Jinping could defuse the crisis by making targeted concessions to the protesters, including the removal of Chief Executive, Carrie Lam, if he feels enough self-confidence, and can avoid the appearance of caving to the protesters. Better governance in Hong Kong to address housing, inequality, and other social concerns would help. Despite the Trump administration's clumsy attempts to link a peaceful resolution to the protests to the trade dispute, they are unrelated issues.

Anything actionable?

It is naïve to believe that Hong Kong was not already heading down a path of being fully absorbed into the Communist State. While adherence to the Basic Law, the legal barrier between the Hong Kong of old and its integration into the mainland will continue, the reality is that Beijing's dominance over the territory is on an unstoppable path. While troops on the ground will fast-track the notion that the agreement forged between Deng Xiaoping and Margaret Thatcher isn't worth the paper it is written on, the shock to the globe, politically and financially will be acute. While the economic fallout is uncertain i.e. will US consumers alter their spending habits if Hong Kong is repressed by military means, there is little doubt that markets will plummet and that is something the consumer will worry about.

The images of Chinese troops on the ground in Hong Kong would lead to the sort of market dislocation that we only see once every several years. The sort of violent correction that we

witnessed after the Brexit referendum. Putting my personal sadness to one side, the PAP patrolling the streets in Hong Kong is the sort of geo-political shock that leads to liquidity vacuums and a flight into safe haven assets. This should not be confused with selling based on weak German or Chinese data or Federal Reserve commentary that is deemed to be too hawkish given the prevailing economic outlook. It is the sort of panic reserved for situations where the consensus amongst investors is that the global order of things has structurally shifted and not for the better.

Even with a peaceful resolution, a structural rebound in Hong Kong assets is hardly assured outside of the obligatory short squeeze. As Jude and I discuss in detail, many of the concerns of the protestors go beyond the extradition bill and hark back to the 2014 Umbrella Movement with its focus on universal suffrage. However, these protests have their roots in many of the populist movements we have seen since Occupy Wall Street with issues such as income inequality, affordable housing and job opportunities for the young being concerns as acute as they are anywhere in the world.

I have advocated for the past several months that Beijing should do what Beijing does best and throw money at the problem. Hong Kong residence appreciate the Hong Kong government has ample room for fiscal expansion that could provide a sharp increase in the supply of affordable housing and boost the social safety net. This seems like a straightforward remedy to some of the concerns of the protestors but naturally the vested interests of Hong Kong's elite will fight any increase in land supply. The 65% decline in property values post the land supply expansion in 1997 by then Chief Executive CY Leung is still seen as a ruinous decision by an economy that remains dependent on the world's most expensive housing. That said, something needs to be done and if Beijing is faced with a fiscal remedy to stem the protest, then the fall in property prices is a small price to pay.

Either way, Hong Kong property stocks should structurally fall over the course of the next several years. The damage to Hong Kong's reputation will be permanent and continue the exodus of companies choosing the safety of Singapore, a country well away from the prying eyes of Beijing.

Hong Kong equity shorts are a must have hedge for any speculative equity portfolio. It is the ultimate beta risk to global equities, and I hope that Jude is wrong with his assessment that paramilitary intervention is likely. There is no valuation level that would compel even the most optimistic investor to buy Hong Kong equity or credit given the systemic risk hanging over the head of Hong Kong.

A Failure of Governance and Collapse of Legitimacy

Paul: Jude, you recently published an article in *Foreign Policy* with the provocative title: “How Close Is Hong Kong to a Second Tiananmen?” How did it come to this, with Hong Kong facing its biggest political crisis, arguably, since 1983?

Jude: The crisis reflects mounting frustration in Hong Kong about control by Beijing, but also Hong Kong’s failure to provide inclusive governance that addresses the challenges faced by normal Hong Kong people. There’s been a breakdown of trust between the protesters and Beijing leadership; neither respects the other’s legitimacy. It’s important to see this in perspective because there has been a tendency to focus narrowly on a few immediate issues, but these are proximate rather than underlying causes. One could rewind the clock 150 years to understand the genesis of the crisis, or to 1984, or to 1997, when the handover occurred.

For our immediate purposes, the crisis has been building since early June when the extradition bill was introduced. For many people, the bill showed Beijing was moving far too rapidly toward overrule. This occurred at a time of mounting frustration in Hong Kong. The frustration is about control by Beijing, but even more important, it flows from Hong Kong’s failure to address the challenges that normal Hong Kong people face in terms of affordable housing, income inequality, and pressures from mainland tourism. Many issues have intersected to bring us to this point where there’s an utter breakdown in trust, and where the perceived legitimacy of the Hong Kong government has collapsed. Carrie Lam is widely seen as inept -- in Hong Kong, in Beijing, and internationally. The protesters don’t trust Xi Jinping and the Beijing leadership, which they see as neo-imperialist, belligerent, and intolerant of Hong Kong self-rule.

For their part, the Beijing leadership is no longer willing to accept that the protesters are making legitimate demands, if this was ever the case. As legitimacy has collapsed, we’ve seen a spiral of aggressiveness on all sides – from the protesters, from the police, and from Beijing. The looming question is whether Beijing will tolerate increased protests, or will they unleash the People’s Armed Police, China’s domestic security services, which are massing on the southern border in Shenzhen.

Paul: The precursor to the current circumstance was the Umbrella Movement five years ago. How has the protest evolved, and what are the protesters’ core complaints? Is it the extradition law or is it bigger than that?

Jude: It’s important to frame this not necessarily as an extension of the Umbrella Movement, which started in the fall of 2014, and which the authorities dismantled by early 2015. I will return to this dismantling because that contributed to the current situation. Frustration over the Umbrella Movement’s failure to achieve more fundamental change is spurring protesters now to be more radical; it is much more than the extradition bill. In connection with the latter, please note the bill has not been withdrawn but has simply been shelved. The protesters have gone beyond demanding that the bill be withdrawn: They’re calling for:

1. The extradition bill to be withdrawn

By Paul Krake

2. Carrie Lam to be sacked.
3. They want the Hong Kong government to stop calling the protests "riots."
4. They're asking for an independent commission to investigate police actions, which have escalated significantly from the tactics used against the Umbrella Movement.
5. Universal suffrage in the election of the Hong Kong chief executive.

These are the "five demands."

Legacies of the Umbrella Movement

There are three legacies of the Umbrella Movement playing out now. First is the switch to pop-up, or flash demonstrations, as a way to avoid being hemmed in by legal injunctions. The authorities quashed the Umbrella Movement by using cease and desist orders to block protests in set locations. The same phenomenon recurred on August 12th – an injunction was imposed against protests at the Hong Kong airport. By Wednesday, the protesters had complied and moved away from the airport. With the pop-up model, protesters go unannounced into a site, organize a flash protest, and disband.

Second, some protesters are adopting more extreme tactics. In one instance, at the airport, raw video feeds show a Global Times reporter beaten and hogtied by protesters, after the reporter was accused of being a government spy.

Third, the police have grown much harsher in their tactics, including openly firing teargas into the subways. On Tuesday night, a police officer pointed his gun at protesters after he was cornered and warning shots have been fired. Both sides are showing much less restraint.

Paul: Are the protesters acting more aggressively in part because they lack recognized leaders? Are the protests more volatile as a result?

Jude: There is no core, trusted leadership. No leader has the authority to moderate the behavior of the crowd. That is absolutely a factor. One reason for the vacuum is that many potential leaders have been jailed, while many veterans lack legitimacy because their moderate tactics didn't deliver fundamental changes. Beijing regarded the collapse of the Umbrella Movement as a success because it was halted before it could blossom. The result, however, was that now many protesters believe moderation has been discredited.

Another problem is the absence of institutions capable of mediating the dispute. There is instead a trifecta of distrust among the protesters, the Hong Kong government, and Beijing. Members of the Hong Kong elite could create a forum for negotiations, but that hasn't occurred.

The Elephant in the Room: Would Beijing Use Troops in Hong Kong

Paul: Your article in *Foreign Policy* raises a frightening prospect in describing the Chinese leadership's propensity for violence when it sees no other option. How does Beijing view the protests, and how do they see the likely array of outcomes?

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Jude: Here is the thesis of the piece: It has a breathless title, which I did not choose, suggesting that Beijing is preparing for another Tiananmen Square. The article does not assign a probability to Beijing unleashing its forces in Hong Kong. Rather it argues Beijing has never been so concerned about its reputation that it has stopped it from unleashing military force when it feels its basic legitimacy or territorial integrity are threatened.

Beijing is saying it's willing to use troops against Hong Kong. That's why it's massing soldiers on the southern border. It's odd for people to argue that my view is China would never use troops, when it has already said it will do so. Even if some observers regard this as bluster, the leadership feels it is making a credible threat. They regard it as credible because they have shown willingness to use troops when threatened, even if they would prefer not to do so.

An Existential Choice

In terms of history, 1989 is instructive because it shows Beijing does not think it was a mistake to unleash the People's Liberation Army on the Chinese people. They recognize Tiananmen was incredibly costly. They would like to do everything possible to avoid a recurrence, but the party has never expressed remorse or the view that it had other options. In their view, the choice was binary – allow the protest to grow into a full-blown political movement that threatens the regime, or else unleash violence. Hong Kong has not yet reached that stage, but it is possible -- given the progress of the movement, and the reaction in Beijing -- that it could reach the stage, in a matter of days or weeks, where Beijing feels it has to make an existential choice.

Paul: What do you think of the counter-argument that the world has changed since 1989, that Xi Jinping is a more careful leader, and that China will find a way to coopt the protesters and defuse the situation – perhaps by spending lavishly to increase affordable housing, address income inequality, and improve job prospects for students?

Jude: That is a terrific argument. Let's concede that we are all obliged to make highly speculative guesses about what Beijing will do. It seems clear that the leadership sees itself facing a sea of bad options. The most significant constraint against the use of force is Hong Kong's role as a global financial capital, unlike Beijing in 1989. Hong Kong is the locus for the wealth of the party elite. The city is critical as both storehouse and facilitator for the wealth the party, including senior leaders, has achieved through rent-seeking over four decades. As my colleague Scott Kennedy at CSIS has noted, if the financial records of China's party elite stored in Hong Kong came to light, the revelations in the Panama Papers would pale by comparison. That revelation would destroy the party. More than anything else, Hong Kong's financial significance is weighing on them.

If the leadership is looking at military action, the cost side of the ledger is tremendous. That must give them massive pause. Still, if it were not a possibility, why does Beijing feel it has a credible threat in massing the People's Armed Police on the border? Why do that if they thought it would be evident that it was bluster? Certainly, people in Hong Kong see the possibility of PAP coming in. When Beijing feels this quasi-secessionist movement threatens Beijing's control over Hong Kong, it will act.

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The Taiwan Factor

Here is another element on the cost side of the ledger, which bolsters the argument that Beijing will find another way out: the Taiwanese election in January 2020. If the CCP moves against Hong Kong, it hurts pro-Beijing candidates. How could candidates go to the Taiwanese people, who now enjoy significant autonomy, and make the case for reunification if China crushes the protests in Hong Kong? The Hong Kong situation is absolutely working in favor of the Democratic Progressive Party.

Paul: How does the Kuomintang (KMT) respond?

Jude: The KMT can only hope Beijing finds a quick way to settle the Hong Kong crisis so it doesn't become a key election issue. In recent days, everyone in Taiwan is watching Hong Kong closely. There is no good option for the KMT now because taking a stand is fraught for an array of reasons. Depending on how it unfolds, the question will be how the KMT addresses the Taiwanese people to show outrage at Beijing's actions while it avoids alienating Beijing.

The Failure of Global Leadership

Paul: For the UK, and elsewhere, where is the foreign disapproval of how China is behaving in Hong Kong? Does the world care?

Jude: It has been interesting to see the muted response from the UK. There was an MP who spoke of granting UK citizenship to the protesters but there have been no formal measures. The US stance has been worse. The Trump administration response has been ham-fisted, and Trump's own comments have been incoherent. Some US officials, most prominently Commerce Secretary Wilbur Ross, have called the situation an internal matter. Ross depicted US options as binary -- do nothing, or invade Hong Kong. That is not a creative response on an issue at the heart of core US beliefs. It should be easy for the administration to say the US is watching closely, and would strongly condemn any step by Beijing to hamper the rights of Hong Kong citizens. Instead, we've seen confusing, ignorant statements by Trump and talk about Xi Jinping negotiating one-on-one. The world cares, but it is unclear how to respond, and US leadership is crucial. More inaction and confusion is likely from the global community.

Paul: Can the US link the Hong Kong situation to tax treaties or use Hong Kong as a bargaining chip in trade negotiations, or are these matters unrelated?

Jude: These matters are in fact related because Trump has linked trade in an unclear way to a Hong Kong solution. This is not the first time he's linked an external issue to the trade talks. First, he did it with the extradition of Meng Wanzhou, the CFO of Huawei. Second, he did it in connection with North Korea, and now with Hong Kong. In connection with tax treaties, note the existence of the Hong Kong Policy Act of 1992, which grants Hong Kong separate status from mainland China in matters of trade with the United States. Some members of Congress have threatened to withdraw that special status if there is military action. Still, no one has come up with a credible list of potential US steps to raise the cost to Beijing of action to crush the demonstrations. The Trump administration lacks credibility with Beijing to link a Hong Kong

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resolution to a trade deal. Beijing has rightfully concluded that the US is not serious about finding a resolution on the trade issue. In the absence of progress toward a trade accord, there is no prospect for a link to a Hong Kong resolution.

The New Neo-Mercantilism

Paul: How should we think about Beijing's strong-arming of corporates like Cathay Pacific and HSBC in Hong Kong? Should we consider Beijing's treatment of these companies as precursor to an unreliable entities list based on trade?

Jude: Over the past year, Beijing has stepped up pressure on certain companies to pass tests of loyalty. Brands like hotels or airlines are obliged to make tiny but symbolically significant changes, for example, in how their reservation websites treat Taiwan or Hong Kong on dropdown menus. The pressure on Cathay Pacific and the resignation of the CEO represents an inflection point because the penalties have been less – until now we have not seen senior corporate leaders fall because of this.

On the US side, given the tendency to focus on the larger US-China strategic competition, the government is also pressing companies to pick a side -- either a firm works on behalf of the United States and its national security, or not. Firms and investors are obliged to consider a new landscape in which sovereigns, especially China and the United States, expect companies to express nationalist loyalties. Companies face a much tougher road ahead as these flashpoints in the US-China relationship multiply, and governments call out firms for disloyalty.

The new landscape requires more sophisticated processes within the companies. Similarly, portfolio managers investing in Chinese companies, for example, are obliged to institute more sophisticated processes for understanding their investments. There have been instances when western investors belatedly discovered that one of their portfolio companies had a Communist Party member on the board. In other instances, they discovered their investments included companies operating in Xinjiang that provided surveillance technology for the detention of Uyghur Muslims. These flashpoints are becoming a permanent feature of doing business and investing.

Paul: Coach, the fashion firm, for example, came under pressure for precisely this sort of issue, plus the new cybersecurity law is another big worry for firms doing business in China. The complexities are multiplying for firms doing business in the US and China.

Jude: In connection with data privacy, China and the US are forcing many new choices on firms. Consider CFIUS's divestment actions this year against the dating app Grindr and PatientsLikeMe, the health data company. That woke a lot of people up. It was shocking that the Committee on Foreign Investment in the United States would demand that a US company unwind its Chinese investment on national security grounds. That step shows the level of scrutiny that US and Chinese governments are bringing to bear on companies.

At the root of the trend is an incredibly expansive view of national security. These concerns now extend from traditional concerns like critical infrastructure to include things like personal data

and culture. The US government is worried about the role of Chinese money in Hollywood; that's been linked to national security in light of how Hollywood firms censor themselves. This expansive view of national security means companies must be vigilant to avoid being caught by surprise.

Is the PRC's 70th Anniversary on Oct. 1 a Deadline for Beijing?

Paul: As the 70th year anniversary of the founding of the People's Republic of China is coming on Oct. 1, will the big anniversary affect China's response to Hong Kong?

Jude: A big military parade is planned in Beijing to mark the anniversary. Territorial integrity is a core part of the founding of the PRC, the final casting off of imperialist oppression. It's awkward to have that celebration when there is a protest movement undercutting both those claims down in Hong Kong. Some observers say Beijing will run out of patience on Oct. 1 or get much tougher on Hong Kong after that date. It seems unlikely that Beijing operates with such artificial timetables. It seems more likely that the Chinese leadership will come to a resolution in a matter of days or weeks as they will not allow another month or month and a half of this to continue. They are certainly aware of the Oct. 1 anniversary, but it seems more likely they want to stop the protests as soon as possible. The real factor is whether the relative lull in protests lately will persist, or whether the protests will strengthen again. If it resumes in force, Beijing is unlikely to wait until Oct. 1.

Paul: What steps would calm the situation and get the students to go home? How does Hong Kong return to the status quo of say six months ago, when there were grumblings, but they remained under the surface?

Jude: Beijing has two options. Either its bluff has to work, and the protestors declare victory and live to fight another day. Or Beijing has to make a concession. It need not be all the concessions the protesters are demanding, even though that is their current definition of victory. If Beijing were to replace Carrie Lam with a candidate credible to both sides, that would help a great deal.

Framework for Dialogue?

Much more of a wildcard is whether Hong Kong's elite can create a credible framework for dialogue and negotiations. That could be a commission to investigate the entire situation and recommend solutions. Barring a change in the attitude from one of the major parties, the protests will continue. A concession from Beijing on Carrie Lam would be the swiftest way to convince the protestors to declare a mini victory, and step back.

The start of the school year soon is another factor, though it will not be as critical as some say in diminishing the protests. That would be a temporary factor. A key question is how much confidence do Xi Jinping and the leadership Beijing have in themselves? If Xi Jinping has enough self-confidence that he can make a minor concession without appearing to cave to the protestors' demands, then there is a path toward dialogue and a solution.

Paul: And what about a budgetary response, a sharp increase in social housing and the like?

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Jude: The ultimate solution would address a long list of issues ranging from housing to education to income equality. These are long-term, structural issues. If Hong Kong announced a robust spending plan tomorrow, it would be cheered. But that doesn't get to the heart of protesters' demands, which are about Beijing, of the Hong Kong government answering to Beijing, and how the police are handling the protesters. A social program must be part of the package but that's not going to defuse the situation.

Paul: Thanks, Jude

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