

# Hong Kong crisis exposes impossible contradiction of China's economic growth

Hong Kong's crisis comes at a treacherous moment, up to its neck in China's credit bubble



Image 1 of 3

Student protesters chant democracy slogans in Hong Kong Photo: Paula Bronstein/Getty Images



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China's Xi Jinping cannot make any serious concessions to Hong Kong's democracy movement. The Umbrella Revolution spreading from the affluent Island to the poorer quarters of Kowloon is an existential threat to the Chinese Communist Party.

"If he were to give way, it would set off contagion across the mainland," said George Walden, a veteran British diplomat who survived the Cultural Revolution inside China and later negotiated Hong Kong's future with Deng Xiaoping. Beijing has already blocked all images of the protests in the Chinese media as a political quarantine measure.

"Xi Jinping has a horror of what happened to the Communist Party in the Soviet Union. If things get seriously out of hand, he may mobilise 'patriotic

compatriots' (Beijing-controlled agitators) on the streets. In the end he will bring out the troops, if he has to," he said.

President Xi will surely play for time, hoping the protests will fizzle as Hong Kong's business elites try to rein in their unruly children, or try to buy them off quietly. But he cannot yield. "The authorities see this as a matter of life and death, a fuse that can take down their world," said Zhao Chu, a Chinese columnist and star on Weibo - China's Twitter.

Whether it escalates to full coercion depends on whether Hong Kong's poor join the students in serious numbers. We know from the "Tiananmen Papers" that Deng Xiaoping was willing to let the democracy protests run for a while in 1989, until workers threatened a general strike and set up their own blockades. The real massacre was at Beijing's Gongzhufen and Muxidi crossroads, three miles west of Tiananmen Square, where the students were gathered.

"The next few days are key. It will determine which way the silent majority goes," said Jonathan Fenby, a former editor of the South China Morning Post, now at Trusted Sources. "Most of Hong Kong's 7m people prize stability. They may think these militant youths are trouble-makers, but they don't like being pushed around by Beijing either."

The students did win a victory in 2012, blocking the imposition of China's "patriotic education" in Hong Kong. That is where Joshua Wong - the star of today's protests - cut his teeth. It may have given him false confidence. He is now listed as a "threat to internal stability" by Chinese state security.

That triumph came at the end of the Hu Jintao era, a time of drift, corruption and a pervasive belief that uber-growth would last forever. Xi Jinping is a different animal, leading a different country. All can now see that China has picked the low-hanging fruit of catch-up growth, and has reached the limits of credit.

Mr Xi is China's most ruthless leader since Mao Zedong. He has purged his enemies one by one, whether Bo Xilai in his Chongqing fiefdom or former security chief Zhou Yongkang, all in the name of Party ethics. He has revived Maoist "self-criticism sessions" to tighten his grip.

He chairs the Central Military Commission - unlike his weak predecessor - and has imposed an "absolute loyalty" test on the army high command. He has clamped down on dissent in the Uighur regions of Xinjiang with an iron fist. A chill is spreading through Chinese academia and through Weibo.

Some in Britain urge a pressure campaign, demanding that Beijing adhere to its vague promise of "universal suffrage" for the people of Hong Kong, not quite the same thing as free elections, though this was never clarified. The

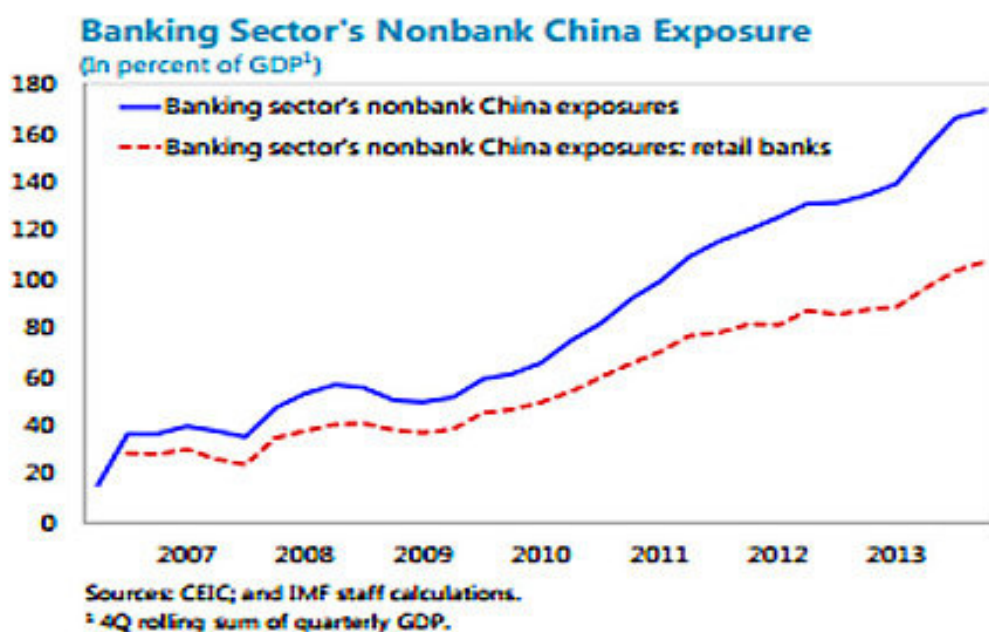
chorus of tut-tutting -- bordering on liberal infantilism -- is misguided on every count.

China's state media is already trying to discredit the students as tools of Western agitation, just as the Kremlin has exploited the (inconsequential) presence of EU and US diplomats in Kiev's Maidan Square to portray Ukraine's home-grown revolution as a Nato coup, more readily believed than you might imagine.

Western meddling in Hong Kong would risk a dangerous rupture with an Asian superpower, pushing Mr Xi closer towards Russia at a time when the global democratic order is uncomfortably close to disintegration, and all over an internal clash within Chinese sovereign territory that is entirely outside our control, whatever our personal sympathies.

Britain has no claim to moral high ground. This is not because London refused democracy for Hong Kong while in charge. It could not safely have created a local parliament in the 1960s, 1970s, or 1980s - as it did in other colonies - because such a move might have precipitated a Chinese invasion, an "afternoon's business" for the People's Liberation Army, in the words of Deng Xiaoping.

It is because the handover deal was always an obfuscation, intended to disguise the lack of real agreement over the terms, with Britain hiding its embarrassment behind a moral mask. "The British and the Chinese pulled the wool over everybody's eyes. Now the day of reckoning has arrived," said Mr Walden.

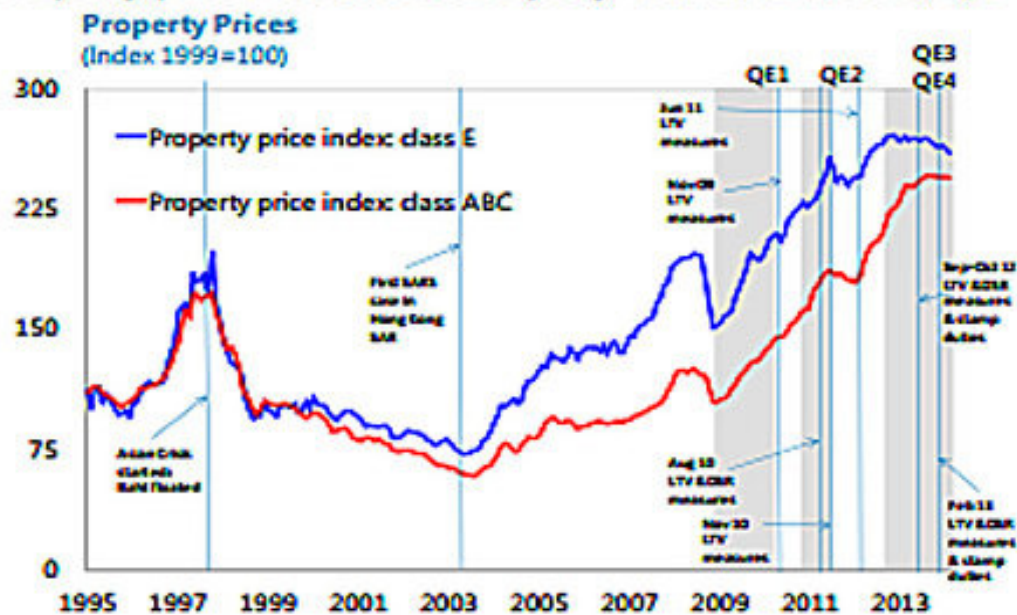


For Hong Kong, the crisis comes at a treacherous moment. The enclave is up to its neck in China's credit bubble, channelling \$1.2 trillion in hard currency

loans to Chinese companies. The International Monetary Fund said the "extreme tail event" of a credit shock in China would "entirely wipe out capital in Hong Kong's banking system".

Hong Kong's own housing boom is vertiginous, caused by importing the Fed's zero-rate policies through a dollar-peg. The global property monitor of the Bank for International Settlements shows that prices have risen 70pc since 2008.

### *Property prices accelerated rapidly with the onset of QE*



Some Chinese firms have turned to Hong Kong to circumvent credit curbs on the mainland: others have been playing the "carry trade", borrowing in dollars to buy Chinese property or yuan assets. This has turned bad. Chinese house prices have been slipping for the past five months.

The carry trade was a one-way bet when Fed liquidity was holding down the dollar, but everything has changed. The Fed is now the enemy as it prepares to tighten. The dollar is roaring back, threatening to break its 30-year downtrend. Hong Kong faces a dollar squeeze.

For China's Communist Party, the Hong Kong drama exposes the impossible contradiction of its policies. Xi Jinping launched a radical reform blitz at the Party's Third Plenum last November, vowing to break the grip on the giant state-owned companies, sweep away a tangle of price controls and move to a "mixed ownership economy". He wants to free China from its obsolete development model - shutting down steel foundries and other relics of the investment bubble, still running at 48pc of GDP - and make the leap to a rich, hi-tech, consumer society.

Yet at the same time he is doubling-down on a one-party, one-ideology, authoritarian state. This is untenable. Hong Kong demonstrates the iron law that demands for freedom rise with economic sophistication. Shanghai, Guangzhou, Beijing, Tianning and Chengdu are not that far behind. A report by China's Development Research Centre in 2012 warned that the economic leap forward will fail, leaving China stuck in the "middle income trap", unless Beijing embraces the whole package of modern free thinking. What it meant was democracy. "The government's dominance in key sectors, while earlier an advantage, is in the future likely to act as a constraint on creativity. The role of the private sector is critical because innovation at the technology frontier is quite different in nature from catching up technologically. It is not something that can be achieved through government planning," it said.

Xi Jinping will have to choose. It is obvious which of the two objectives will be sacrificed if political dissent spreads, and this has huge implications. Global banks and investment funds have already pocketed Mr Xi's Third Plenum rhetoric as if it were a done deal, as if it were assured that China will follow Taiwan, Korea and Japan into the elite per capita league, the economic colossus of the 21st century. Yet nothing is assured.

The protest may sputter out. Mr Xi may find some way to placate Hong Kong without giving any real ground. Yet there must be a high risk that this stand-off will escalate, or recur in crescendo of episodes, leading to a political freeze across China, with all that this implies. Mr Xi may find that his party is following the Soviet Communist Party after all, step by step into economic decline.