COMPROMISING A CAPITALIST ENCLAVE: CHINA'S UTILISATION OF THE HONG KONG ECONOMY

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Compromising a Capitalist Enclave: China's Utilisation of the Hong Kong Economy

by
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Declarations

I, Sarah E.M. Beattie, hereby certify that this thesis, which is approximately 39,000 words in length, has been written by me, that it is the record of work carried out by me and that it has not been submitted in any previous application for a higher degree.

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Abstract

This thesis investigates China's use of the Hong Kong economy taking as its framework China's reliance on Hong Kong to act as its international financial centre. China has consistently addressed Hong Kong from the standpoint of Hong Kong's utility to the Chinese economy, from the initiation of China's economic reforms through the negotiations for Hong Kong's sovereignty as well as in the current post-1997 regime as Hong Kong operates under China's auspices. Hong Kong is a vital component of China's own economy because the enclave manages a majority of its trade and investment flows. Hong Kong is able to serve the Mainland precisely because of its international standing as a free-market, capitalist enclave. However, while China will want to keep the territory in its current incarnation (and this intent is signified by the promises of the Basic Law), it is China's involvement in the territory which poses the greatest threat to Hong Kong's status quo. Particularly, Chinese government-owned companies in Hong Kong have characteristics which set them apart from any other type of foreign businesses in the territory. These business interests provide an alternative avenue of power in the territory for the Chinese government, a representation which is susceptible to abuse because of the access it provides to Chinese decision-makers and the Mainland economy. The tension created by the dichotomy between the socialist and capitalist economic systems is vulnerable to exploitation, which could ultimately compromise Hong Kong's economic integrity. The crux of the problem for Hong Kong lies in forging a relationship with its new ruling power which will maintain the territory's independent identity and autonomy, which are crucial to maintaining investor confidence in Hong Kong. Through an analysis of Chinese investment, Hong Kong is shown to be an economy which is increasingly internalised by the mainland.

List of Tables and Figures

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1. Introduction

Scope

Hong Kong's economic and political relationship with the People's Republic of China (PRC, hereafter simply referred to as China or the Mainland) is determined by China's use of the quasi-autonomous territory's trade and financial mechanisms to benefit its own economy. In historical terms, it is a unique circumstance that an advanced, capitalist financial centre has had its destiny controlled by a developing country lumbering under an authoritarian, communist government. Hong Kong's stability is an issue of primary importance to the wider global economic community because of the international role the territory has developed in trade and finance. Hong Kong's future under Chinese rule is without precedent, and therefore there are no guidelines to help construct scenarios of the future. China is forging a new path in its management of Hong Kong, and doubtless there will be beneficiaries and victims in the wake of the changes of regimes.

Hong Kong's relationship with China is best analysed from the context of China's economic policy toward the territory. A unique relationship has formed between unlikely partners which is based upon the one entity serving its master: China has and will continue to use the capitalist enclave to strengthen its position on the world stage. China's utilisation of Hong Kong has consequences for the territory in terms of its integrity and the maintenance of the territory as a free, open economy. Therefore, the model, in the widest sense of this word, of this relationship that is in the process of being shaped strongly invites investigation. More precisely, the relationship between China and Hong Kong provides a model as to how a socialist country uses capitalism to develop its own economy and strengthen its state-owned corporations.

The relationship between China and Hong Kong informs how both entities interact with the world economy. China's agenda throughout the past twenty years has been to nurture Hong Kong as a moneymaking venture for the Mainland to help it become an international economic actor. No other developing country benefits from the presence of a financial powerhouse under its auspices, and this advantage will help catapult China into the realm of major economic players. The smaller actor will be somewhat subsumed by the larger actor, giving up some of its own identity to serve the goals of the master country.

As the Hong Kong and Chinese economies have increasingly integrated for the past twenty years, Hong Kong has served in the capacity as China's financial centre. Business activity in the territory will be profoundly affected by the changing nature of the Hong Kong economy as it becomes a capital outlet for business interests in China. China's policy toward Hong Kong stems from a sustained, concerted effort to realise economic gains by engaging the international marketplace. While maintaining socialism as its guiding principle, the Chinese government must encourage massive growth in order to modernise its developing nation, and to do this it must attract foreign capital as well as encourage the expansion of its own native companies. However, China is systems-deficient and is unable to organise certain economic transactions and relationships because the mechanisms for handling foreign capital are still largely undeveloped. Chinese companies which are state owned are finding avenues of growth in Hong Kong that are restricted in China. Because China is Hong Kong's sovereign, however, there are ramifications for Chinese company involvement in the Hong Kong economy.

China's leaders believe much of Hong Kong's economic success relies upon the extent to which it is able to serve the Chinese economy. Foreign interests use Hong Kong as a springboard into China, and as long as there are good investment opportunities, then China believes Hong Kong will thrive on the capital it manages for China. In this China-centrist view, Hong Kong's success, as based upon the freedom of information, the rule of law, and the hard work of its citizens, is marginalised. What matters is China's own growth; Hong Kong fulfills its *raison d'etre* through its service to China's economy. This view was expressed by Qiao Shi, former head of the National People's Congress (NPC) of China, when he noted before the 1997 handover that the Hong Kong economy would be alright as long as the Chinese economy performed well. (Yahuda, 1996, 93)

Fieldwork

To gain a better understanding of the Hong Kong economy and study firsthand its operations as an international financial centre, fieldwork was conducted over three weeks in Hong Kong in October 1997. To gauge the economic integration of Hong Kong and China, my research programme while in Hong Kong involved conducting interviews with government officials and members of the community, as well as gathering data on Hong Kong's economy from various government bodies and private organisations. I also collected data on the Hong Kong divisions of large Chinese conglomerates, or red chips, to examine the extent to which Chinese companies have invested in Hong Kong.

Interviews were conducted with a broad spectrum of people active in the Hong Kong economy both in the private and public sectors. Interviews with government officials included the Deputy Secretary for the Treasury, Mrs. Carrie

Lam, who was in charge of overseeing the 1997 transitional arrangements for the government budget. I also met with Mr. Chad Leechor, head of Economic Research at the Hong Kong Monetary Authority. Mr. Leechor reaffirmed that the Hong Kong government would defend the exchange rate at all costs, and had absolutely no plans to devalue the HK$ or de-link it from the US$. Another important contact was the director of China trade at the Hong Kong Government Trade Department, whom I questioned on the trading relationship between Hong Kong and the Mainland.

In the private sector I conducted an interview with Ms. Jeannie Cheung, head of China research at Paribas Equity Asia, a fund management firm. I discussed with Ms. Cheung the role of the Chinese companies in the Hong Kong economy. Ms. Cheung candidly confirmed the desire of the red chips to acquire capital, as well as production and managerial experience, through their involvement in the Hong Kong economy. Other interviews included the former editor of the Economist Intelligence Unit's Business Asia and the director of Asian Infrastructure Fund Advisers.

I carried out research at the American Chamber of Commerce (AmCham), which is the only Chamber of Commerce in Hong Kong that allows any company to join regardless of its national origins. AmCham compiles its own data regarding business activities in and attitudes about the Hong Kong and Chinese markets, and I was able to acquire some of this data for purposes of my research. I also spent considerable time at the Hong Kong Trade Development Council Library, which stocks enormous amounts of material relevant to Asian business and trade. At the HKTDC Library I accessed both primary source (company annual reports, published government data) and secondary source (trade publications, journal articles) materials.

Research along similar lines in Britain included attending a conference foı businesses interested in investing in Hong Kong. I interviewed Sir David Wilson, Governor of Hong Kong from 1985-1990, which gave me a fascinating insight into the running of the territory during the years after Britain had agreed to hand back Hong Kong to China. I also met with Sir John Cowperthwaite, former financial secretary in the territory, with whom I discussed the Hong Kong's economic autonomy under Chinese rule.

Investigating the Chinese economic presence in Hong Kong is a difficult task. The extent of Chinese involvement in the Hong Kong economy is troublesome to calculate because China does not keep official records of its investment in the territory. Furthermore, Hong Kong does not have any constraints on shifting funds, nor does it keep any records on capital flows in and out of the territory. The problem is compounded by the fact that some Chinese companies with operations in Hong Kong are set up illegally, without the consent of the appropriate government office in China. Some Chinese businesses use Hong Kong companies or other foreign companies as a front for their own organisations. Still other Chinese investments in Hong Kong are not even formal companies at all but individuals pursuing their own economic interests: this can encompass informal 'businesses' which divert goods from Chinese factories to the stalls on the Hong Kong market streets or Chinese individuals investing in Hong Kong's stock exchange or property market. Unofficial capital outflows such as these often make a 'round trip' through Hong Kong in order to be reinvested in China disguised as foreign investment, which is subject to special breaks and incentives on the Mainland.

The point to be made is that not all Chinese investment is captured by data records, and therefore it is useful to supplement the analysis of such investments with interviews and reports. The following research into Chinese business involvement in the Hong Kong economy emphasises qualitative methods of analysis, although quantitative evidence is utilised to illustrate certain investment activities. Again, analyses of the Hong Kong economy and the ways in which it serves the Mainland are grounded in both qualitative and quantitative evidence. Research methods such as interviews contribute an important dimension to one's understanding of the data and are often important in ascertaining the motivations behind decisions or actions which are reflected in reported statistics. This view is expressed by Fielding and Fielding (1986, 27) in their assertion that 'qualitative work can assist quantitative work in providing a theoretical framework, validating survey data, interpreting statistical relationships and deciphering puzzling responses, selecting survey items to construct indices, and offering case study illustrations.' Field research was therefore vital in contributing to a more thorough conceptualisation of China's use of and involvement in Hong Kong's economy. Research in Hong Kong provided an insight into grey areas and allowed a richer, better grounded approach to the analysis of its economy than would have been possible by an arm's length examination.

Themes of existing literature

There are two primary schools of thought which are perpetuated in the extant literature on Hong Kong. The first is fulsome in its praise for China's handling of Hong Kong. This literature cites China's participation in a negotiated settlement; the special diplomatic dispensation of creating Hong Kong as a Special Administrative Region (SAR) with quasi-autonomy under Chinese sovereignty; the guarantees for the maintenance of the status quo drawn up in the Basic Law, Hong Kong's constitution; and China's deft handling of the territory post-1997, most notable in

China's absence from the daily life and governance of the territory. The contending school of thought encompasses the China critics who are less than confident in China's ability to deftly manage the territory. They point to China's heavy-handedness in dictating the style and content of Hong Kong's government, the abuse of power when it comes to exploiting economic ties and silencing the press, and China's emphasis on territorial integrity in support of which it has not hesitated to use military power. China's official party line has always been that Hong Kong belongs to China, and maintaining Hong Kong as a part of China will be an utmost priority in any Chinese regime.

In the discussions on the future of Hong Kong, however, rarely are China's intentions viewed in the light of how China can engage the territory as a capitalist economy to its own advantage. The literature either argues that China can only benefit from Hong Kong if it adopts a hands-off approach, or that China's active involvement in Hong Kong would irrevocably damage the territory's economy by introducing the worst elements of socialism. This dissertation posits that China derives innumerable benefits from having a capitalist enclave on its doorstep and that it will work to keep Hong Kong functioning as it is, thus the great care invested in assuring the status quo for the next fifty years. In this context, however, far from adopting a hands-off approach, China actively employs Hong Kong for purposes of generating trade and capital for the Mainland, especially through the operations of Chinese conglomerates in the territory. China benefits from Hong Kong as an international business community, and China has taken steps to ensure that Hong Kong operates under a business-minded government and in an atmosphere that is conducive to investment. This does not preclude China taking advantage of economic opportunities in the territory and using the enclave's systems to foster growth on the Mainland.

Whether China is viewed as benign or threatening, the existing literature has tended to focus on China's political motivations for regaining control of Hong Kong. There was, however, a very strong economic rationale for China to pursue sovereignty of the territory. In fact, an economic perspective has governed China's policy toward Hong Kong both pre- and post-handover. While some literature has claimed that China has acted capriciously in its dealings with Hong Kong, in fact one need only to start from an economic framework to see that China consistently has addressed Hong Kong according to Hong Kong's economic utility to China. It is with an understanding of China's invariable economic policy toward the territory that Hong Kong's relationship with China can be analysed more profitably and the future of the territory better conceptualised.

China's engagement with Hong Kong

China's development is informed in part by Hong Kong's capitalist markets. Hong Kong's utility to China resides in its capacity to channel capital to the Mainland, and its future depends on its ability to realise this purpose. Hong Kong proved itself useful to China throughout the century by acting as an economic link for China with the rest of the world. China has no such corresponding economic powerhouse which is capable of managing the country's capital requirements. Shanghai, once an important business centre, suffered at the hands of the Communists and is not in a position to assume the mantle of servicing foreign capital for the Chinese economy. When China began to reform its economy in the late 1970s, China's currency was not convertible, its stock markets were non-existent, and the banking system laboured under the burden of supporting state-owned industries while trying to minimise inflation. At the time, Hong Kong had already managed financial transactions on behalf of the Mainland, and so China turned to the city to act as its financial centre. China knew that it would be decades before any one of its cities could acquire the territory's attributes.

Currently, China is not equipped to mimic the success that Hong Kong has achieved, nor is it ideologically prepared to let certain capitalist systems develop unfettered on the Mainland. The Communist regime must justify its rule economically by providing an improved standard of living for the people, and therefore it is heavily dependent upon growth to maintain stability and control of the nation. The Chinese Communist government, in order to maintain power, must justify the socialist system to the populace; by definition it cannot advocate capitalist growth without undermining its own authority. However, it has found that socialism by itself has not brought the growth that keeps the Chinese economy going but that it is foreign investment and certain private market operations that are providing the fuel for the economy and are helping indigenous companies to expand.

China's understanding of Hong Kong is bounded by the model of how Hong Kong has served China, and thus China has made Hong Kong an integral part of its economy. Hong Kong's value to China lies in its ability to further the growth of the Chinese economy, for example with the capital which is raised in the territory for Chinese businesses and projects. China's new national economic policy, when the issue of Hong Kong's return to China was first raised by Britain in the late 1970s, was to implement a series of reforms which would allow China to catch up with industrialised nations. As the financial systems and the business community in Hong Kong were of great importance to China, its leaders conceived of a role for Hong

Kong to play in terms of helping to speed up the modernisation process. It is no small coincidence that when China had begun to open its economy and had started on a path of market reforms, Hong Kong's return to China became an issue. That Hong Kong should be a part of China's process of reform and opening up was apparent from the beginning, and China was eager to realise this potential.

Cognizant of the role that Hong Kong had previously played in China's economy, especially with furthering its trading activities, China wanted to harness this economic power and use it to the benefit of China's own growth. It is from this stance that China negotiated with Britain for the return of Hong Kong and attained sovereignty of the territory. China's reliance on Hong Kong to service capital and manage trade continues to dictate the government's policy toward the territory post-handover. In this sense, then, China's behaviour has not been capricious but systematic. China has applied consistent pressure on Hong Kong to hone the desired economic relationship. This pressure was exerted against Britain during the negotiations in the form of threats of unilateral action, it was brought to bear again as China hand-picked a business-orientated government for the territory, and it is manifested in the form of Chinese companies muscling their way into the Hong Kong economy.

China wants to transform its developing country into a world economic power, but it cannot do this without outside assistance and investment. China has a crucial reliance upon Hong Kong to help attract this capital as well as to continue to act as an entrepot for much of China's trade. Hong Kong's system offers reduced transaction costs vis-à-vis China in the form of an advanced legal system, which aids the negotiating of contracts; a modern, international stock market and banking system, which facilitates access to capital, loans, and foreign exchange; a density and range of businesses in one relatively compact community; an open information industry; and a modern infrastructure. Each of these components contributes to the building of investor confidence in the territory.

China is not handling Hong Kong with kid gloves, then, but is actively engaging it in a strategic play to have Hong Kong become an integral part of China's development. China has engaged Hong Kong from one main premise: that Hong Kong is the source and conduit for much capital destined for China. Hong Kong as a development tool for China is meant to aid and not to corrupt, to contribute to the growth of China's economy and businesses and not to induce upheaval. In this role Hong Kong is supposed to act as a sieve, or a window for China to the world, filtering through that which is beneficial to the national economy and suppressing subversive ideas. Subsequently, China would like Hong Kong to be benign in its political activity and virtually non-existent in its political influence on the Mainland. China has set a certain role for Hong Kong to play in the future of a united China, and China has worked to ensure that Hong Kong will not deviate from these defined perimeters, notably by setting up a business-orientated government system in the territory. In the negotiations for the handover of Hong Kong, China showed that it was willing to act unilaterally in order to have a political system in place which was acceptable to China.

China's official policy toward Hong Kong, that of 'one country, two systems', explains the dogged determination of China to keep capitalism from dominating or replacing the socialist mores which China's leadership holds dear. So while China is willing to use capitalist methods and systems, it will not allow capitalism to depose socialism as the prevailing economic paradigm in the still largely developing country. This is made evident by the name under which reforms have been conducted in

China, socialist market reforms, and by the numerous statements from party officials that socialist goals and values should guide the reform path. (Ling, 1996, 13)

Progression of the argument

China uses Hong Kong because it is economically expedient to do so. China's economy undoubtedly benefits from a capitalist financial centre acting as its window to the world. While this relationship also benefits Hong Kong, it can be problematic because of the tensions which exist between the capitalist and socialist economies. These tensions are open to exploitation, and this is the primary danger to Hong Kong's international standing and competitiveness. Hong Kong ultimately is not the master of its own fate, and its future path will be largely determined by the purpose China expects Hong Kong to serve. Beginning with an examination of how Hong Kong came to be passed between British and Chinese hands and the political structure under which Hong Kong is governed, the following chapter will show that China orchestrated a specific role for Hong Kong to play in Chinese economic development. By adhering to this pre-conceived notion of how Hong Kong was to serve the Mainland, China systematically organised the manner in which it would acquire and govern the territory. Throughout the handover process, China's methods were consistent with its understanding of Hong Kong's economic utility.

Because China is a developing country, it lacks many of the mechanisms which would allow it to manage foreign capital. The third chapter outlines features of China's economy and reveals some of the hurdles which prevent China from fostering an advanced financial market on the Mainland. At the root of China's problems are the debt-ridden state-owned corporations; the fallout from closing these enterprises would involve mass unemployment. As a direct result of the liquidity generated for the purposes of supporting the state-owned enterprises, the government struggles to control inflation to prevent the economy from spinning out of control. Consequently, China's currency is not fully convertible, and stock market activity is restricted. China's nascent systems are ill equipped to deal with the enormous need in the Chinese economy for foreign investment, of which Hong Kong is the main source.

Diametrically opposed to China's burdened economy is the efficient Hong Kong market. What China lacks in terms of financial systems Hong Kong is able to provide with its wealth of banks, it stock market, and availability of capital. Chapter four is a positive analysis of these advanced systems within Hong Kong's economy, emphasising its sound government foundation. Leading on from this, chapter five shows how these systems serve China. The argument explores the extent to which Hong Kong generates capital for the Mainland and how the city is used by foreign investors to access the Chinese economy. Hong Kong facilitates transactions which would otherwise prove prohibitive because of the lack of a legal and financial network on the Mainland. As a result of its advantages, Hong Kong functions as a base for the Chinese overseas community and as the nexus for the Greater Chinese economy.

Because of the capital that is managed by Hong Kong, it is natural that Chinese companies would come to Hong Kong to access these funds. Chapter six examines China's use of the Hong Kong economy by focusing on Chinese companies in Hong Kong. An analysis of Chinese business activity will demonstrate the progress of China's economic expansion into Hong Kong. Chinese companies have made substantial inroads into vital industries in Hong Kong, and state-owned corporations have become major players in the territory's economy. This poses a threat to the integrity of Hong Kong's economy because the special ties these companies have to the Chinese government are vulnerable to exploitation. Various Chinese ministries and municipal governments have corporate representation in Hong Kong, and thus there is an element of Chinese participation in the territory which is neither accounted for in the Basic Law nor answerable to any diplomatic channel between Hong Kong and China. These issues receive full examination in chapter seven, where implications of extensive Chinese involvement in the Hong Kong economy are investigated. The conclusion looks to the future of Hong Kong's role in the world economy and the increasing integration of the Chinese and Hong Kong economies.

II. China's plan for Hong Kong

China wanted to regain control of Hong Kong in 1997 for three interconnected reasons: pride, its one-China policy, and Hong Kong's economic significance. China resented colonial takeover of portions of its territory in the late 1800s, and it was anxious to right the wrongs of past 'unequal' treaties. The one-China policy of the Mainland is related to the issue of pride in that China wants all territory that once belonged to the Mainland to be united once again. This policy typically refers to Hong Kong, Taiwan and Macao, a small colony which is currently controlled by the Portuguese under the terms of a nineteenth century treaty and is due to be handed back to China in 1999. Finally, but most importantly, China wanted to reunite Hong Kong with the Mainland because of its economic value in terms of acting as China's financial centre and facilitating its trade with the rest of the world. It was primarily an economic motive that drove China to seek sovereignty of Hong Kong when it did, and it was with the understanding of Hong Kong's importance in servicing the Mainland economy that China set about acquiring Hong Kong with a single-minded determination. China's leaders were anxious to reach a negotiated settlement with Britain in order to secure investor confidence in the future of the territory; however, throughout the negotiations they stuck to the principle of sovereignty of Hong Kong which would allow China to create a business government in the territory that would be conducive to contributing to Chinese economic growth.

This chapter begins with a summation of the trade disputes which resulted in Hong Kong being ceded to Britain. Britain's acquisition of Hong Kong last century is important in understanding why Hong Kong was returned to China in 1997. Through a series of treaties in the second half of the nineteenth century Britain came to be in possession of Hong Kong island and the peninsular area of Kowloon and the

New Territories to the north. Although the various governments of China never recognised the validity of these treaties (it was consistently claimed that the treaties were the result of colonial aggression and were unfairly imposed upon the Manchu dynasty), it was politically and economically convenient to continue to allow Britain to rule Hong Kong throughout the twentieth century. When Britain began to worry over the future of Hong Kong with regard to the 1997 deadline for its lease of the New Territories stipulated by one of these treaties, China came to the conclusion that the time was ripe for preparing for the repossession of Hong Kong. From the outset of China's own economic reforms in the late 1970s, China envisioned a role that Hong Kong could play to facilitate the Mainland's growth. Hong Kong's utility was noted in a statement in the mid-1980s in which the head of Hong Kong operations for the Bank of China suggested that the excess liquidity in the enclave could be well-used on the Mainland. (Rafferty, 1989, 326) A financial centre would be instrumental in bolstering the reforms, and it was with this in mind that China framed the conditions under which Hong Kong was to be returned.

Early History

Conflicts over trade with China were the reason Britain sought to occupy Hong Kong in the second half of the last century. A strong British presence in Asia was established with the formation of the East India Company. Initially trade between Britain and China was conducted through the East India Company, which had a virtual monopoly on the tea trade. British trading houses set up compounds where employees lived and worked in Guangzhou, the southern Chinese city on the Pearl River. Foreigners were not allowed to leave the compounds and were only allowed to conduct trading three months out of the year. The most profitable trade with China was the opium trade: throughout the nineteenth century opium trade was the source of one-third of the total revenue for British India. (Crisswell, 1981, 4) The Chinese emperor had banned opium; however, as this trade was particularly profitable, merchants such as William Jardine and James Matheson found this a convenient way to build up personal fortunes. In the 1830s Jardine and Matheson controlled about one-third of foreign trade with China, which largely consisted of the illegal running of opium from India to Chinese coastal ports. (Crisswell, 1981, 4)

The so-called 'Opium Wars' erupted due to the tensions between British merchants, who wanted their trading with China guaranteed, and the Chinese regime, which rejected the corrupting influence of western forces and sought to limit trading with foreigners. European merchants had frequently run into conflict with Chinese forces in Guangzhou over the illegal trade in opium. In an attempt to crack down on the illicit trade, an advisor to the Chinese emperor was sent to Guangzhou where he established a committee of Chinese merchants, the Co-Hong, which unilaterally set up the rules for trade. Foreigners could only conduct trade in Guangzhou and were only allowed to trade with China through merchants who had been appointed by the Co-Hong. British resistance to these constraints was the cause of military skirmishes between Britain and China, as Britain sought to trade with China on its own terms. As part of the campaign to evade the restrictions, Britain sought a trading base off the Chinese coast where it could put constant pressure on the Chinese authorities to negotiate with a representative of Britain to open trade with China and eliminate the restrictions set by the Co-Hong. (Crisswell, 1981, 43)

The independent merchants, who believed that a military presence would mean better trading terms, advocated the acquisition of a British trading base. In March 1839, as a show of resistance by the Chinese who were trying to end the opium trade, the foreigners were blockaded in their compounds, and were given an ultimatum to hand over their stocks of opium, or trade would be closed at Guangzhou. The British Royal Navy engaged in skirmishes with Chinese boats, which they easily overcame, and in the resultant treaty Hong Kong was claimed by Britain. Hong Kong became a permanent colony of the United Kingdom in 1842 under the Treaty of Nanking. With the treaty which ended the second Opium War in 1860, the British were granted part of the Kowloon Peninsula to the north of Hong Kong island. The Manchu dynasty, already weak from war with Japan, ceded or leased lands to other western powers in the 1890s. In this context Britain became anxious to strengthen its own position in East Asia, and in June 1898 British acquired a lease of 99 years of the New Territories, 355 square miles of rural land directly north of Kowloon. Britain agreed to a lease as opposed to an outright cession because other foreign countries at that time established the precedent to lease the Chinese lands they had annexed.

British control of the territory which constituted Hong Kong for the next 99 years (excluding a period of Japanese occupation during WWII) was to provide an oasis of relative stability and modernisation on China's coast. Because of the turmoil in China during much of this century, it was expedient to continue to allow Britain to run Hong Kong, and as a consequence, Hong Kong forged a radically different development path from that of the Mainland. Throughout this period Hong Kong found its niche in service to China, and China undoubtedly benefited from Hong Kong's status being separate from that of China.

Negotiations

Thus British control of Hong Kong remained unchallenged for much of the twentieth century, as it was economically and politically convenient for China to have

Britain maintain control of the territory. Hong Kong was a place of stability and financial success on China's doorstep during a tumultuous period in the Mainland's history. Throughout this time Hong Kong served as an entrepot for China's trade and facilitated economic transactions between China and the rest of the world. Because this relationship worked well, it was not until 1979 that Hong Kong's sovereignty became an issue between Britain and China. In the late 1970s the British governor in Hong Kong, Sir Murray MacLehose, appreciated he had a unique problem on his hands. New terms for the leases for government lands and properties in the New Territories that were due up for renewal in the next few years would extend beyond 1997. However, with the British lease of the New Territories ending in 1997, the British government in Hong Kong potentially would not have the authority to approve new leases. Britain, concerned for the extension of leases and the question of whether or not banks would lend for mortgages overlapping the 1997 deadline, felt it was necessary to be certain of Hong Kong's post-1997 future in order to assure investors.[1] Britain was anxious to clarify the issue of sovereignty with China and was wary of continuing to govern the colony on the assumption that they would be able to do so *ad infinitum*.

The late 1970s presented the opportune moment from Britain's point of view for raising the issue with China. China had literally begun to open its markets at the end of 1978 when the Central Committee of the Communist Party endorsed Deng Xiaoping's (China's de facto leader at the time) reforms for the Chinese economy, and Britain viewed this as a sign that China was at a point where they would be most receptive to discussing a beneficial resolution to the Hong Kong question. Sir Murray

[1] As the New Territories are over 90% of the land area of the territory of Hong Kong and the various regions of the whole territory are well integrated, it would be virtually impossible for Britain to call into question the sovereignty of the New Territories without causing serious logistical problems for the remainder of the colony.

consequently brought up the issue of the leases with Deng Xiaoping in a visit to Beijing in 1979, at which time he was told that China intended to take back Hong Kong, but would not do so before the 1997 deadline. Britain unwittingly conceded much of its bargaining position when it alluded to China that it was willing to discuss the future of Hong Kong at this time. With the opening of its economy, China was looking for support for its initiatives, and Hong Kong was a natural target for China's outward look. China began to co-opt Hong Kong before talks with Britain had even begun: in 1978 China resumed direct flights with Hong Kong after thirty years, and the creation of the Shenzhen special economic zone (SEZ)[2] directly across the border from Hong Kong meant that Shenzhen would be poised to take advantage of investment from its neighbour. China's intentions at the time were reflected by a statement in 1978 by Li Qiang, China's foreign trade minister, in which he claimed that China would 'require tens of billions of dollars in foreign credits to support its modernisation programme, in which Hong Kong will play a part'. (Cottrell, 1993, 39) China's position on Hong Kong was clear: China wanted to use Hong Kong to strengthen its own economy, and once it knew Britain was willing to negotiate, obtaining sovereignty became part of its plan.

Negotiations were initiated when the British understood that China was intent on taking back the territory. China and Britain both had vested interests in seeing the territory returned to China with all confidence and stability intact. China, although it had always regarded the treaties of the respective Opium Wars as one-sided and unequal, had never made overtures to reclaim the territory by force. It could have easily have done so, especially in the decade after World War II, or by simply cutting

[2] Four coastal areas were designated as open economic zones in which foreign investment was encouraged by means of special incentives and tax breaks. The creation of these zones is outlined further in the next chapter.

off Hong Kong's water or food resources at any point. China realised the value in negotiating for a diplomatic settlement of Hong Kong, as it wanted to gain back Hong Kong in the same state as it currently operated in terms of its economic value to China. China was also 'saving face' by participating in a negotiated settlement and hoped to inspire investor confidence in China and Hong Kong. Britain was also motivated by a moral obligation to the people of Hong Kong: this was the first instance in which a British colony would not be given independence, but instead handed over to another authority, and a communist and autocratic one at that. Britain desired certainty for the benefit of future loans and investment in the territory. Britain's main proposal was for continued British governance of the territory while sovereignty would be resumed by China, as the British perceived that this would be the best settlement for continued confidence in the territory's economy. Britain had hoped that by raising the Hong Kong issue when it did, China's own economic development and consequential need for Hong Kong's economic status quo would reinforce the need for continuity in the form of British presence in the territory. Even before the opening of negotiations in 1983, China dismissed this proposal outright, and it wasn't until Britain was willing to concede this point that China would come to the negotiating table. China not only wanted sovereignty, but political control as well. China wanted Hong Kong, in its future growth as a financial centre, to serve the Chinese economy, and Chinese control of the territory would help to ensure this:

> Whereas the British have tended to treat Hong Kong in a separate niche from the rest of its foreign policy, the Chinese have tended to treat it a part of a much broader domestic and international canvass. ...Britain's interests are focused entirely on managing a smooth transfer of sovereignty that will preserve Hong Kong's way of life and that will be acceptable to its people. The Chinese authorities are not only determined to re-establish sovereignty, they seek to do so in ways that will not lead to the subversion of their politics, that will help them in the reunification with Taiwan, and that will serve their broad foreign policy goals in the Asia-Pacific, as well as in ways that will serve the economy. (Yahuda, 1996, 94)

Britain put much stock in a negotiated settlement, fearful that China would act unilaterally on various issues of the repossession, and thus China had the upper hand throughout the negotiations. China formulated its plans for Hong Kong early on and indeed took many one-sided decisions about the territory: in late 1982, before serious negotiations had even begun, the head of the Hong Kong and Macao Affairs Office in China announced that Hong Kong's system would not be changed after the handover. The next month China's NPC created a clause in the Chinese constitution that would allow for the creation of special administrative regions. Even during the course of negotiations China made public announcements as to their intentions for Hong Kong, although the negotiations were supposed to be confidential. In July 1983 China revealed that its plans for future governance would allow Hong Kong to keep its capitalist system and that local people would participate in helping to form a new constitution for the territory. (Rafferty, 1989, 405) China espoused the theory of 'one country, two systems', a concept which had earlier been developed by Deng Xiaoping in relation to Taiwan. China has continually sought since the Communist Revolution to integrate Taiwan into the PRC, and proposed 'one country, two systems' to the Taiwanese government as a way of furthering this goal. When Hong Kong became an issue, this concept was used as the bargaining linchpin of China, as their proposed mechanism to maintain confidence and business strength in Hong Kong. While resuming sovereignty of Hong Kong, China would allow the territory to operate as a Special Administrative Region, meaning Hong Kong could maintain its economic and political systems separate from those of the Mainland.

Despite its plans for the territory, China refused to allow Hong Kong to be a third party in the negotiations, claiming that the matter was purely between the Chinese and British governments. It was part of China's policy of 'maximising its freedom of action over Hong Kong and seeking to consolidate support against the UK' and of its 'desire to capitalise on the power which China holds over the future of Hong Kong'. (Bowers, 1995, 5) China exercised this power and underlined its interests in the future path of Hong Kong's economy through the arrangements for Hong Kong's new airport. In 1983 discussions had begun in Hong Kong for the need of a new airport to replace Kai Tak, which was overburdened with increasing levels of air traffic to Hong Kong. The project was accelerated in 1988, but the airport would necessarily need the approval of China before banks would finance the project. The need for approval allowed China to gain greater consultation over pre-1997 economic affairs: China objected when Jardine Matheson was awarded a contract to build container terminals for the new airport and subsequently delayed the project. (Yahuda, 1996, 67, and Bowers, 1995, 3) China was displeased that Jardines had de-listed from the Stock Exchange of Hong Kong in March 1984 and moved its financial domicile to Bermuda. Through its consultations on the airport project, China took advantage of its role as future master to influence the development of Hong Kong's economic affairs.

Revenue from land leases were another issue in which China sought to secure the prosperity of Hong Kong's post-1997 economy. Motivated by a concern that Britain would dry up Hong Kong government funds before 1997, China insisted upon an agreement by which a Land Fund was established in 1985. Half of the proceeds from the lease of land before July 1997 would be placed in the Fund, which would revert to the Hong Kong government's coffers after the handover.

China was assertive in the negotiations; from its point of view, it was to be the future sovereign and had the right to establish political parameters for the territory in accordance with its own national laws. While China wanted Hong Kong to remain a successful financial centre, at the same time it wanted Hong Kong back on its own terms and was willing to sacrifice some stability to achieve this end. Reacting to tensions between Britain and China in the negotiations, the Hong Kong dollar fell to a record low in September 1983, but despite this China announced at the end of that September that they would take unilateral action on Hong Kong if a settlement was not reached by September 1984. Britain was confronted with either reaching an agreement with China on China's terms or having no agreement at all; thus Britain agreed to have no official role in Hong Kong after the handover, the main sticking point in negotiations at that time. (Chiu, 1987, 9) After the twenty-second round of formal talks, Britain and China initialled the Sino-British Joint Declaration in September 1984: this was the guiding treaty by which Hong Kong was handed back to China and which allowed for British governance of the territory until midnight 30 June 1997.

In accordance with the terms of the Joint Declaration, which is recognised as an international treaty, China formed a constitution which establishes Hong Kong as a Special Administrative Region (HKSAR) of the PRC. The Basic Law, as it is known, was approved by the NPC on 4 April 1990. Under the Basic Law, the HKSAR is guaranteed 'a high degree of autonomy' and that the 'previous capitalist system and way of life shall remain unchanged' for fifty years after the handover. (Basic Law, Articles 5 and 2) Article 109 of the Basic Law is most revealing, however, in explaining the terms under which China expects Hong Kong to operate, requiring that the HKSAR government 'provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre'. The Basic Law was constructed partially with a view to securing investor confidence in the future of Hong Kong by providing assurances and therefore removing some uncertainty about the territory's future under Chinese rule. With the written guarantees of a separate government and financial system and the maintenance of the status quo, investors would tend to feel more confident in continuing their market activities in the territory as opposed to if there were no such guarantees at all. While in Hong Kong many members of the business community whom I interviewed pointed to the Basic Law as a reason for retaining confidence in the territory. China therefore seems set to continue to reap the benefits of investor activity in the territory.

Hong Kong's business government

In the pre-handover deliberations China made a number of decisions which established the precedent of China's right as sovereign to influence the makeup of the Hong Kong government. China wants Hong Kong to remain a business-orientated territory, where politics come a distant second. A government with a powerful executive, the type of government Hong Kong has had for most of its modern existence, is conducive to placing business over politics. Therefore, China would like to see this type of government maintained in the territory, in order to reduce the threat of political subversion to the Communist regime and to emphasize the economic role the territory plays. In pursuit of a strong top-down, executive-led government, the Communist regime in Beijing aligned itself with business interests in Hong Kong to consolidate its position within the territory. Although contradictory on the surface, for the Communist government to work in conjunction with capitalists is a means to an end. The 'end' is forming a business-minded government in Hong Kong sympathetic (or at least, non-subversive) to China. China has a long-standing policy of creating alliances with groups it is ideologically at odds with, in order to 'build popular support' or further a common goal. (Allen, 1997, 68) Later, it may sever these ties when they cease to serve any useful purpose. This policy of 'seeking to co-opt as wide a range of interests as possible' is referred to as forming a united front. (Bowers, 1995, 4) For example, the communists formed a united front with the nationalist forces of Chiang Kai-chek to fight the invading Japanese forces in the 1930s. The Communist government in Beijing has worked for an executive-led government in Hong Kong which will accentuate Hong Kong's economic role and minimise its political nature. This is also what certain business interests would like, as they see an executive-led government conducive to stability, which provides for an environment in which business can flourish. It is because of this common objective of the primacy of economics over politics that Beijing has aligned itself with capitalist business interests to gain support within the territory for this initiative. Hence, in order to bring businesspeople into its camp, China gave a number of important official positions to businesspeople, naming them Hong Kong Affairs Advisers in which capacity they would be responsible for advising China on local issues. China also appointed businesspeople to the various committees created to handle issues of the handover, specifically the Preparatory Committee which had the responsibility, amongst others, to review Hong Kong's laws and make recommendations to bring them in line with the Basic Law. In the beginning of 1997, the Committee proposed that 25 Hong Kong laws be rewritten or eliminated, including some relating to the territory's Bill of Rights, the territory's outline of certain fundamental rights guaranteed to its citizens.

Observations have been made as to the unlikely partnership that has been created between the capitalist businesspeople, many who had family that fled communist China, and the present Communist regime in Beijing: 'there seems to be an unholy alliance among the Communists, the capitalists, and the high-ranking bureaucrats who are likely to insist on an executive-centered and performance-oriented constitution.' (Kuan and Lau, 1987, 112) Successful capitalists have done well in Hong Kong in the past fifty years partially due to little or no government influence in economic affairs, and like Beijing, they believe a stable environment for business takes precedence over political concerns. Furthermore, they see that it makes good business sense to form alliances with China, the new master of the territory and Hong Kong's economic hinterland.

The Preparatory Committee, the body which was to attend to the logistics of the handover, consisted of Chinese and Hong Kong residents appointed by the Beijing government. The Preparatory Committee was in charge of appointing a Selection Committee that was responsible for electing the Provisional Legislature and the new Chief Executive of Hong Kong. The Selection Committee consisted of 400 members, all of whom were from Hong Kong, 70 of whom were members of the Chinese Chamber of Commerce. In December 1996 this committee voted Tung Chee Hwa, a business executive with links to the West and ties with Beijing, as the new Chief Executive.[3] Of the final three candidates, Tung had the strongest business credentials and had prior business dealings with China through a shipping company he used to own. Under his ownership the business suffered bankruptcy and was bailed out by a consortium of investors backed by China. As a businessman, Tung has consistently emphasised the need for stability during his tenure as Chief Executive and has underlined that economic strength is paramount to political reform in the territory. Tung appointed many businesspeople to the Executive Council (ExecCo), his body of advisors. Five of these advisors served on the Preparatory

[3] The new title, replacing that of Governor, of the head of the Hong Kong SAR government, is indicative of the manner in which the territory is to be run.

Committee, and three are also members of the Provisional Legislature. (Ridding, *Financial Times*, 25 January 1997)

The Provisional Legislature took over from the existing, partially elected legislature following the handover. Democratically elected seats were first introduced into the Legislative Council (LegCo), Hong Kong's law-making body, in 1991, but under the arrangements only 20% of the seats were directly elected by the general population. The British and the Chinese were to agree on a 'through-train' legislature with a portion of directly elected seats that was to be elected in 1995 and sit through the transition to the end of its term. However, China was surprised and displeased with the announcements of Chris Patten in 1992 that he planned to push through reforms which would extend the franchise of LegCo. He guided his proposals through LegCo, without consultation or negotiations with the Chinese, as had been the case with all other proposed government changes since negotiations had begun. This was a unilateral move by the British, and consequently the Chinese reacted by claiming that they would dissolve the 1995 legislature with the changes as Chris Patten had implemented, and form their own legislature for Hong Kong which would take its place immediately after the handover. Hong Kong's post-1997 form of government was decided by China and not Hong Kong itself: '(w)hile the British appear to have succeeded in decolonizing some aspects of Hong Kong's polity, Mainland Chinese officials seem to be determined to recolonize it.' (Hing, 1995, 266) In December 1996 the Selection Committee elected the Provisional Legislature, in which strong business and pro-China interests received a large number of seats. More than half of the members of the pre-handover legislature were appointed to be members of the Provisional Legislature, and this was the cause of some considerable discussion as to conflict of interest. Furthermore, only nine members of the

Provisional Legislature were not members of the Selection Committee. The makeup of the legislature is further proof of China's intentions to frame the government to be sympathetic to business concerns: the largest groups in the Provisional Legislature are the pro-China Democratic Alliance for the Betterment of Hong Kong and the pro-business Liberal Party. At the time Beijing claimed the Provisional Legislature was a temporary measure until the mechanism for elections could be set up for a new legislature that would be formed in the year or two after the handover. These arrangements were made in early 1998 and elections were conducted in May 1998, but only 20 out of 60 seats were elected by the population at large in a proportional representation system. The Provisional Legislature will stay in power until the new legislature takes up proceedings in May 1999.

Conclusion

This chapter explored the terms under which China regained sovereignty of Hong Kong. Much as the reasons were economic for China losing the territory in the 1800s, China's interest in having Hong Kong returned was economically motivated. China had definite ideas of the form in which it wanted Hong Kong to be handed back and the subsequent role it should play in China's own development. It adhered to these principles throughout the negotiations and as a result it is currently benefiting from having a financial centre under its auspices. China's intentions for Hong Kong ascertained via announcements made prior to and during the negotiations were made manifest with the signing of the Joint Declaration, and China seems to have acquired everything it set out to gain. Hong Kong was handed back to China midnight 30 June 1997 in a ceremony which emphasised the pride China felt at regaining the territory. In a visit a few months later, it was clear that Hong Kong was continuing with the status quo, and many people were quick to point out how well the policy of 'one country, two systems' was working. The policy underlines that China would like to be able to use the capitalist financial and trading centre while keeping it separate from its own socialist ideology. Hong Kong is first and foremost a business centre, and China will work to ensure that this remains the case. Hong Kong is crucial for encouraging China's growth, and this 'economic mission of Hong Kong… require[s] the Chinese government to retain the ultimate control over the direction Hong Kong is taking in terms of "one country, two systems"'. (Kuan and Lau, 1987, 105-106) China is heavily dependent upon Hong Kong as the window to the global economy, and Hong Kong's service in this capacity is explored in the following chapters. Because Hong Kong is an important part of China's economy, China wanted to internalise the territory in order to create and formalise a closer working relationship with the Hong Kong decision-makers as well as the territory as a whole. The dichotomy of reuniting Hong Kong with the Mainland but simultaneously keeping it separate, semi-autonomous entity allows China to use the enclave's economy in its current, successful incarnation, that of an international capitalist market while sidestepping the issue of reconciling the vastly different systems.

In this chapter I have explained the manner in which China gained control of Hong Kong, and in the process I have touched on the reasons why China would want ultimate authority of the territory. As a developing country, China requires large amounts of foreign capital to fund its growth, and Hong Kong is the arena in which to obtain the majority of this needed investment. Control of the territory means that China is able to guarantee, through certain powers of the state such as approving the selection of Chief Executive, that Hong Kong continues to operate as a financial city. China desired the closer relationship which sovereignty accords because then China felt it could exercise some legitimate element of control in Hong Kong. This control was brought to bear in the formation of Hong Kong's post-1997 government. China, of course, would not take any actions toward Hong Kong that it felt it could not justify through the Basic Law for fear of scaring off investors; China will always be conscious of the level of power it is able to exercise without jeopardising foreign investment in the territory. China wanted to utilise Hong Kong for its development through a more integrated relationship of sovereignty over the territory. It is important, therefore, to examine why China is dependent upon Hong Kong to contribute to its growth before we undertake an analysis of how Hong Kong serves the Chinese economy. Particular development problems within China mean that China itself is unable to develop an international financial centre in the near future so that consequently it will continue to rely upon Hong Kong for financing and investment. China's economy is outlined in the next chapter in order to evidence China's development needs as well as to show the direction in which the nation's leaders are guiding China's growth.

III. China's economy and the need for capital

China embarked on a series of economic reforms in 1978, as a result of which the economy was opened to outside investment. As a developing country with the largest population in the world, China needs large amounts of capital to drive the engine of economic growth. The economic reforms have hurtled along at a breakneck pace in the past twenty years, often without the benefit of official authority or legal backing but resulting in double-digit national growth rates in the early half of the 1990s. The modernisation of China's economy will ultimately require the overhaul of state-owned enterprises (SOEs), which are at the centre of China's development problems. The Communist government relies on massive growth in the economy to maintain stability and to justify its power. Subsequently, China is dependent to a large extent on foreign investment and trade to sustain expansion and modernisation of the national economy.

The chapter begins with a brief look at the initial reforms which set China on its path of phenomenal growth. The reforms that have consequently formed the basis of China's development are explained thereafter; these have included devolution of power from the centre to the provinces. China modernisation agenda is far from being completed, however. China's currency, the renminbi, is not yet fully convertible, and its three stock markets are ill equipped to serve the funding needs of the nation's companies. As a result, China will continue to require the experience and assistance of Hong Kong's financial markets to contribute to the nation's development for the foreseeable future. To set the groundwork for an analysis of the way in which Hong Kong is expected to aid China's growth, the following will detail the particular needs of the Chinese economy.

Background

Deng Xiaoping, China's de facto leader up until his death in February 1997, instituted a process of market reforms which opened up the Mainland economy beginning in 1978. The Communist Party leaders realised that in order to become a major player in the global economy, China would need to open its economy to foreign trade and investment. Before 1978, China relied heavily on a policy of self-sufficiency, in which the nation sought to provide for its needs and to become industrialised through its own means. This policy became harder to maintain, however, as China realised it required external capital to finance industrial projects and foreign trade to expand its economy:

> The Chinese ruling elite appreciated that a command economy, based on state owned industrial enterprises and collective communes, was incapable of providing satisfactory growth, e.g. *to become a leading international power*. Deng's justification for pushing reforms in the late 1970's was to enable China to catch up with the other major powers. The problem was perceived as how to move towards a more vibrant and decentralised (market) economy without weakening the political supremacy of the Party. (Goodhart and Xu, 1996, 59, emphasis added)

The reforms included the establishment of four Special Economic Zones (SEZs), export-processing areas created to encourage foreign investment in China's manufacturing sector. The SEZs were meant to be an experiment isolated from the rest of the Mainland, which tested the principles of interacting with the international economy. Because of their contained nature, SEZs allowed the government to control the activities of foreign investors. Various incentives were offered to businesses to locate in the SEZs: these included the relative independence to hire and fire workers and the setting of wages; a lower profit tax rate of 15% compared with about 33% in the rest of the country at the time; exemption from profit tax on profits reinvested in the SEZs for five years or longer; reduced prices for China-made products and raw materials; and the ability to repatriate any profits. Beijing recently announced that it would reinstate the incentives which had been rescinded by the central government in 1997 which allowed foreign firms to import raw materials and equipment without paying customs duties. From the beginning it was investors from Hong Kong and Taiwan who primarily took advantage of the opportunities in these areas and transferred their manufacturing industries to the SEZs. The creation of the four SEZs along the Mainland coast followed patterns of investment already established by Taiwan and Hong Kong which had been channelling funds to businesses or family members on the Mainland before the implementation of reforms: Shenzhen, Zhuhai, and Shantou are all in Guangdong Province which borders Hong Kong, and the fourth, Xiamen in Fujian Province, was set up across the strait from Taiwan. China was obviously attempting to exploit the excess investment capital in Hong Kong and Taiwan. The Shenzhen SEZ alone had US$2.42 billion in foreign investment in 1996, up 40% from 1995. (*Wall Street Journal*, 14 January 1997) Guangdong Province accounted for about one-third of China's total foreign investment in 1996. (*Wall Street Journal*, 14 January 1997) Major investment and infrastructure projects in the areas around the SEZs have meant that the economic investment has expanded beyond the SEZ borders. In fact, many of the special privileges associated with investment in SEZs have slowly been phased out by the central government so that investment is encouraged to develop beyond these areas. One of the modern dilemmas of China, however, is to open its economy while trying to contain the influence of ideas and capitalist mechanisms it deems subversive to its central control.

Chinese federalism

The development of a loose form of federalism in China has guaranteed economic reforms to some extent. Chinese federalism has developed as power has devolved from the central government to the provinces as a result of trade and investment patterns, not through any directive of the central government. This 'market-preserving federalism' provides some insurance as to the irreversibility of the economic reforms thus far: the current growth pattern has proved too important to keep the current government in power and is necessary for internal and regional stability. The coastal regions have an important leverage over the central government in that their economic success is essential for legitimising Communist Party power. The natural economic zone that encompasses Hong Kong is the most important of these regions.[4] Hong Kong's unique status as a Special Administrative Region encourages this federalism, and in turn the devolution of power from the centre will benefit Hong Kong in its every day conduct as a separate entity from the Mainland. However, Chinese federalism has its down side in that it jeopardises China's unity. International trade promises made by the central government may not hold much weight considering that its power is undermined by the devolution of authority and that it has difficulty commanding the trading and manufacturing industries within some of the provinces. Many of the provinces have their own regulations for trade and investment and some have set up trade barriers amongst themselves, resulting in inter-China protectionism. A huge segment of government revenue and business activity is controlled at the provincial level, and therefore foreign companies often bargain with the provincial governments directly regarding investment opportunities. Provinces controlled 68% of foreign direct investment in 1992. (Montinola, 1995,

62) Despite the fact that power could be concentrated in the hands Beijing's policy makers, it would perhaps be in the world trading regime's interest for China to have a strong central government, so that regulations agreed in international forums would be substantiated with the understanding that they would be able to be effectively enforced throughout China.

Economic growth

China's growth since reform began in 1978 has been nothing short of spectacular. In 1992 GNP growth, which includes the product of Chinese companies abroad, was 13.6%, in 1993 it was 13.4%, in 1994 it was 11.8%. (Faison, *New York Times*, 2 January 1996) In 1995 GDP growth was 10.2%, and in 1996 it grew by 9.7%, reaching a level of almost US$508 billion, although it was the first time since 1991 that the economy grew less than 10% annually according to China's State Statistics Bureau. (*New York Times*, 31 December 1996) However, this slower growth also helped to slow inflation in the national economy, which is one of the priorities of the central government. Inflation in 1996 was 6%, down from 14.8% in 1995 and 21.7% in 1994. (*New York Times*, 31 December 1996)

In order to improve the quality of life for the 1.2 billion population and therefore validate its own rule, China continually seeks to attract foreign investment, improve its infrastructure, and secure the supply of vital resources. To acquire raw materials China has asserted itself in contested areas that are expected to contain natural resources. A massive coal-mining project is planned for Inner Mongolia, which is estimated to cost US$5 billion. China is also participating in oil drilling

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[4] The natural economic zone known as Greater China comprises Hong Kong, Guangdong Province in southern China, and Taiwan. The attributes of the economic relationship of this area are disclosed in Chapter 5.

projects in the western interior and in the South China Sea. If China is unable to increase its own supply of oil and therefore pushes up demand in foreign markets, especially the Middle East, then there is a real possibility for an oil shock if these producers are not prepared to meet the demand. When China's NPC approved the Ninth Five-Year Economic Plan in March 1996, it approved a number of infrastructure projects. A number of these projects are extremely ambitious, and the World Bank estimates that the total investment requirements will be between US$280 billion and US$370 billion. (*Financial Times*, 19 March 1996) While most of this investment will come internally from China, 15-20% of the funds will need to be drawn from foreign resources. (*Financial Times*, 19 March 1996) Yet China's own spending on infrastructure is constrained by the government's efforts to keep inflation under control. Of the largest projects, the Three Gorges Dam is probably the most controversial. Plans are to build the largest dam in the world on the Yangtze River below the scenic Three Gorges. Besides ruining many sites of significant historical interest, the plan will also force thousands of people to relocate and will cause numerous ecological problems. Other infrastructure projects include a north-south coastal rail and highway system, telecommunications systems which are earmarked to receive US$60 billion, and ports, which will require US$10 billion. (*Financial Times*, 19 March 1996)

Foreign investment

What will confirm China as an economic superpower is ultimately what will serve as a leverage on other countries. China's huge population is a lucrative market to be exploited in the eyes of foreign companies. So eager are companies to access this market that Beijing holds a powerful bargaining tool. The Chinese government's power vis-à-vis other countries derives from its role as gatekeeper to the massive, evolving market of middle-class consumers. Several countries compete for investment opportunities in China, thus if one country imposes restrictions on trade with China, China can turn elsewhere to supply its trading and capital needs. China's market pull enables it to play countries off of one another; this has led to the conclusion that 'the West will not be able to maintain a common front' in their eagerness to enter the Chinese market. (Cable and Ferdinand, 1994, 256) This leverage, however, is checked by the interdependence of the East Asia region and the global economy as a whole. Because of the large amounts of trade in the region and the reliance China has on foreign investment, it is important not to jeopardise these relationships. Over the past four years foreign companies have invested more than US$340 billion in China, more than 70% of which came from Asian companies. (Sugawara, *Washington Post*, 18 March 1996) In 1995 China received the most foreign direct investment (FDI) of any developing country with US$38 billion. (*The Economist*, 16 March 1996) This figure increased to US$40 billion in 1996. (Brauchli, *Wall Street Journal*, 14 January 1997) Foreign investment is allowed in virtually every sector now, excepting a few key sectors such as energy.

China, as well as presenting market opportunities, is also a source of competition to trading partners. China has developed a large manufacturing base as many manufacturing operations locate in China seeking low-cost labour; nearly 80% of overseas investment was in the manufacturing sector. (*Wall Street Journal*, 14 January 1997) Of China's exports in 1992, 80% were labour-intensive manufactures. (Cable and Ferdinand, 1994, 246) These manufacturing industries, as they produce higher quality goods and operate more efficiently, are already competitors to manufacturing bases in other East Asian nations, as well as those located in industrialised nations. However, China has many issues with which to contend before it reaches its full potential in manufacturing capabilities. China's industrial plant infrastructure is antiquated, yet major renovations will be a huge undertaking. It is estimated that only 20 to 25% of equipment in industrial enterprises are as recent as the 1970's and 80's. (Simon, 1991, 23) Furthermore, at the crux of global competition today is the ability to respond swiftly to customers' needs, and this oftentimes means forming strategy and organising production on a global basis. At the present time, there are no state-owned Chinese companies, perhaps with the exception of CITIC,[5] which are in the position to operate at a truly global level: most state-owned companies are not able to take advantage of new market opportunities because they are burdened with debt and superfluous employees.

China presently lags behind in the development of modern, higher value-added manufacturing and high-technology industries such as software and information technology. Significantly, 'China has yet to achieve the required type and level of strategic assets to play a significant role in the competition among key national and corporate actors in the international marketplace. China remains aloof from the mainstream of global competition in most industries, particularly in information intensive fields...' (Simon, 1991, 12) Included amongst these information intensive industries is the banking sector, and until the mechanisms are developed to support this industry, China continues to be dependent upon Hong Kong for advanced financial services. While it will be able initially to base its growth on the large-scale, low-cost manufacturing sector, China will undoubtedly seek to develop technologically advanced enterprises in order to increase its competitiveness in the world economic scene. It is certainly attempting to develop this industry

[5] This Chinese company, amongst others, is discussed in detail in Chapter 6.

through its own indigenous companies, some of which have expanded into Hong Kong for the purpose of acquiring the latest technology. The U.S. maintains export controls on advanced technology to China, primarily to prevent the technology from being applied to weapons systems, and thus Chinese companies have set up in Hong Kong in order to bypass these restrictions. (Fung, 1997, 93) The U.S., Japan, and EU nations will, for the long-term, continue to be the leaders in advanced technology, especially because these countries have the legal environment as well as the research and development budgets to maintain leadership position in this industry.

Chinese economic development is undermined by the fact that many of the reforms have not been cemented with the rule of law, which leaves an uncertain future for the direction and pace of Chinese economic reform. Investments are not protected by standardised, legal investment regulations, and therefore investment in China is often a risky venture: 'there have been few attempts to provide the central feature of private markets, a system of secure private-property rights. Nor has an attempt been made to develop a commercial law...or an independent court system for adjudication.' (Montinola, 1995, 50) However, Chinese development continues at a rapid pace despite the lack of support of a legal framework. Hong Kong and Taiwan investors are the driving forces behind much of this growth, as they see tremendous investment opportunities in their economic hinterland. Whether or not they are better equipped than western investors to do business 'Chinese style' is explored in the next chapter.

The dearth of technical and legal infrastructure will hold China back for awhile: a major point of contention in the international trading community is China's inadequate legal provisions and enforcement of regulations for copyrighting and intellectual property. Foreign businesses are reluctant to locate base operations in

China because of the poor infrastructure as well as the lack of a clear, fair legal framework. When coupled with the uncertainties of Chinese political future and bureaucratic red tape, 'it will clearly be some time before major MNCs [multi-national corporations] call on significant portions of the Chinese economy to assist with their effort to enhance competitiveness.' (Simon, 1991, 24) Other factors hindering foreign investment in China include lack of currency convertibility on the capital account, the length of time it takes to realise profits after initially investing in China, and the problems of enforcing contracts due to the lack of legal backing.[6]

Trade

Until 1990, because foreign exchange holdings and the capital account balance were small, the government kept imports roughly even with exports. However, foreign exchange reserves went from US$19.4 billion at the end of 1992 to US$69.8 billion in October 1995. (Goodhart and Xu, 1996, 74) Exports and imports have grown at more or less the same rate throughout the reform period, and so there has been no persistent trend in the balance of trade. About 80% of the country's total foreign trade is with the Asia-Pacific region. (Taylor, 1994, 266) China's exports totalled US$151 billion in 1996, increasing thirty times in twenty years. (Faison, *New York Times*, 4 March 1997)

Through the Asia-Pacific Economic Council (APEC), the only such trade forum of which China is a member, China has announced further plans to liberalise trade. Some of its planned reforms include a 30% cut in tariffs, elimination of a number of import quotas and controls, and easing of restrictions on operations of joint ventures. (Goodhart and Xu, 1996, 76) With the implementation of these reforms

[6] For discussions on the problems of bureaucracy hindering business and the difficulty in realising profits in China, see the automobile industry example in Kristof and WuDunn, 1994.

China aims to become a member of the World Trade Organisation (WTO), the successor to the General Agreement on Tariffs and Trade (GATT). It is contended by member countries of the WTO, the U.S. in particular, that China must make more concessions before it is granted membership. Hong Kong, on the other hand, is a full member of APEC and the WTO and is permitted by China to maintain separate relations with these organisations. China still engages in a wide variety of protectionist measures, in part to shield state-owned enterprises (SOEs). China believes it should be allowed more time to meet WTO criteria, as it asserts it is a developing country and therefore must address domestic growth before completely liberalising trade. Import tariffs average 30%, thus to access China's market, companies are virtually compelled to build factories on the Mainland. The government demands that foreign companies share their technological expertise as a requirement for locating operations in China. Foreign-owned companies are also required to export a certain percentage of their output and are only allowed to ship goods overseas through Chinese trading companies. The U.S. believes China has shown little commitment to improving on some of the more basic of the concerns the U.S. has regarding free trade with China, including personal property rights and copyrighting and piracy laws. This is seen in the ongoing debates between the U.S. and China over pirating of compact discs and software. U.S. compact disc manufacturers have estimated their loss to China over pirated CD's and software to be over US$866 million. (Mufson, *Washington Post*, 18 February 1996)

Reform of State-Owned Enterprises

State-owned enterprises (SOEs) in China cover a broad range, from the cumbersome and bankrupt to the successful conglomerates. Chinese companies listed on the Stock Exchange of Hong Kong (SEHK), H-shares and red chips, are the more viable and prosperous of the SOEs, although they share certain traits with the stagnant and debt-ridden state industries which are propped up by the central government. Many state industries are heavily subsidised and receive unlimited 'loans' from the state banks. Because of the lack of incentive and lack of a hard budget constraint, many SOEs record losses year after year. The government, however, continues to feed the SOEs direct subsidies: in 1994 subsidies to loss-making enterprises totalled 36.62 billion yuan, which was 7.02% of government fiscal revenue. (Goodhart and Xu, 1996, 69) In 1996 45% of SOEs recorded losses, which totalled US$8.3 billion, an amount 45% greater than in 1995. (*New York Times*, 31 December 1996) China continues to fund these industries because of the social safety net they provide. Under the old Communist system, the work unit, or danwei, was responsible for providing employees' housing, health care, family's education, and retirement benefit. SOEs are still responsible for providing for many of these needs, thus the central government is reluctant to allow these companies to fail for fear of the mass unemployment and welfare black hole it would create. If the SOEs are allowed to go out of business, mass unemployment would predictably lead to labour unrest, threatening the power of the central government. Of the more than 100 million employees of SOEs, it is estimated that a quarter of these are surplus workers. (Mufson, *Washington Post*, 13 September 1997) However, the government also realises that it is necessary to reform SOEs in order to modernise the economy, to control inflation, to reform the banking system, and to perpetuate growth at a level which would maintain stability. The Communist Party realises that the raising of living standards and perpetuation of economic growth lends legitimacy to the government. Thus during the 15th National Party Conference, in October 1997, President Jiang Zemin announced that reform of the SOEs would be a priority over the next few years. The reform plan allows for the selling of the medium and small SOEs, and the 'privatisation' (although that term is not used) of SOEs through the selling of shares to employees. More large enterprises will be allowed to issue stocks and bonds to raise funds, and the debt of certain SOEs will become special holdings owned by the state. In addition, mergers are to be made easier, and some bankrupt SOEs will be allowed to fail. This announcement was given more credence with the appointment of Zhu Rongji as the new Premier. As the former finance minister, Zhu is seen by many as a moderate and a pragmatist, and he has proven in the past that he is able to take the necessary steps to prudently manage the Chinese economy. He has kept inflation low despite high growth rates. Realistically, however, many doubt that the government will be able to 'privatise' these industries without causing mass unemployment.

What has saved China, though, from being completely undermined by the inefficient SOEs is the diminishing role they are playing in the national economy. The state-owned sector of the economy is half as large as it was in 1980. (Mufson, *Washington Post*, 13 September 1997) Jobs created by foreign direct investment will be instrumental in moving people out of the state sector, which means that private investment will continue to need to be encouraged from places such as Hong Kong. Foreign companies as well as indigenous entrepreneurs who are starting and running successful businesses are helping to fill the economic gap left by SOEs. Increasingly, it is private companies which are taking over from township village enterprises (TVEs), rural enterprises run and managed by community collectives, as the sector fuelling growth in the economy. According to Figure 1, private enterprises now account for 25% of the product of enterprises on the Mainland (private businesses +

share holding enterprises). Although SOEs still account for 41% of output, collective enterprises (TVEs) and domestic share-holding enterprises together account for almost as much output (39%). Hong Kong's crucial role in investing on the Mainland, especially by facilitating economic relations between Taiwan and the Mainland, is also illustrated by Figure 1, which reveals that enterprises funded by Hong Kong, Macao, and Taiwan contribute 10% of the output of companies operating on the Mainland, equally as much as that produced by all other foreign-funded enterprises together.

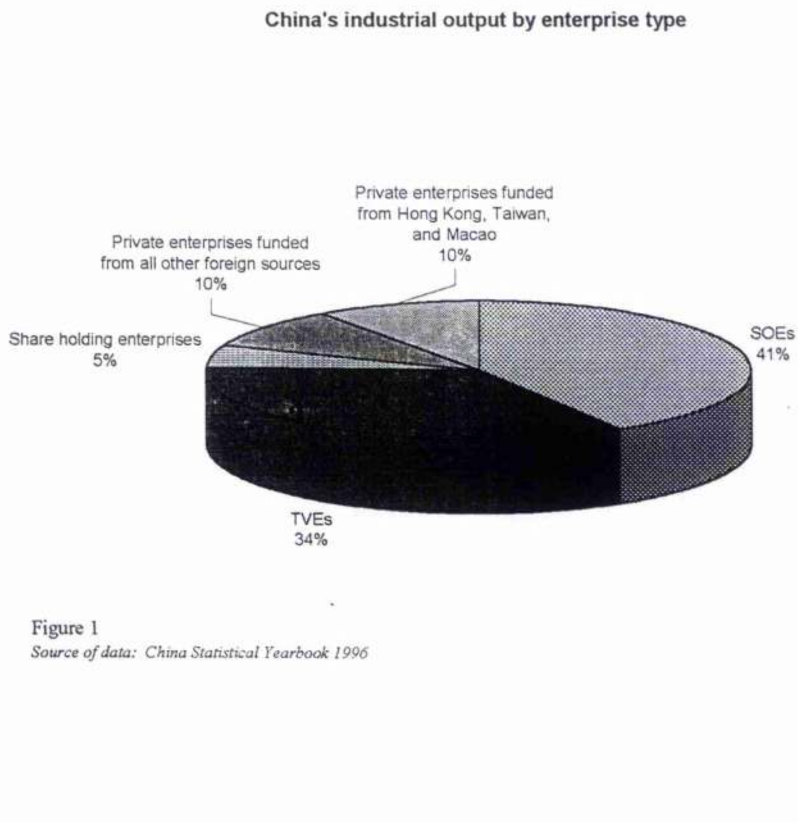

Figure 1
Source of data: China Statistical Yearbook 1996

By the end of 1997, registered private companies numbered 960,000 and employed 39 million people, about a third as many as the SOEs. (Mufson, *Washington Post*, 12 April 1998) Companies with foreign investment produced 40% of exports in 1996, up from just 1% in 1985. (Faison, *New York Times*, 4 March

1997) TVEs initially began to supplant SOEs in the national economy in the early 1980s. In 1980 state enterprises produced 76.1% of China's industrial output, while the collectives produced 23.5%. In 1994, however, the state enterprises only produced 34.1% of China's industrial output, and the TVEs produced 40.9%. (Goodhart and Xu, 1996, 60) The breakdown of types of enterprises operating in China is given in Table 1; TVEs outnumber SOEs almost 14 to 1, although SOEs tend to be massive enterprises, many times the size of TVEs in terms of number of employees.

Table 1

Industrial enterprises, 1996	
State-owned enterprises	114,000
Collectives	1,592,000
'Individual' enterprises	6,200,000
Others (includes joint ventures)	70,000
TOTAL	**7,976,000**

Source: Presentation by Jamie Allen, AMCHAM Forum, Hong Kong, October 1997.

Local management of business in the form of TVEs help to soak up surplus rural labour, and because these companies are locally controlled, the owners have more incentive to improve productivity and thus increase profits. Local governments via TVEs are encouraged to compete with one another as well as try their own approaches to speed up growth. (Goodhart and Xu, 1996, 65) Local control also allows experimentation to the area economy without widespread effects on the national economy.

The competition and commerce between the TVEs and private enterprises have continued to boost market forces. Why has the government allowed privately owned companies and TVEs to proliferate without central government control? Simply, they have become so important for the growth of China that the state could not close these firms with out suffering economic disaster and undermining its political power by alienating those who run and are employed by these businesses. Furthermore, local officials will work to protect the TVEs because of the money which they make from them. These companies also provide a valuable source of employment for surplus agricultural workers, although they have not been able to create employment for all of the redundant rural labourers; approximately 130 million people have immigrated to urban areas seeking employment. (Cable and Ferdinand, 1994, 251) Huge instability can be caused with such surplus labour movements, and the central government seeks to discourage urban migration, increasingly turning to the TVEs and private businesses to provide jobs. This migration is problematic for the provincial governments as well, who have even gone so far as to restrict the movements of people across provincial borders.

China's stock markets

China's stock markets are an experiment in market economy. Beginning in 1985 some companies began issuing their own bonds to the public. Because of the stringent requirements for listing on China's stock exchanges, most companies raise money through bonds rather than stocks. (Overholt, 1993, 108) In 1984 seven state enterprises in Shanghai were permitted by the authorities to issue shares to the public, and in 1986 the Industrial and Commercial Bank of China set up a share-trading counter. (Overholt, 1993, 107) In December 1990 share trading unofficially opened in Shenzhen, while Shanghai officially began trading at the same time. Shenzhen later received official recognition July 1991. (Overholt, 1993, 107) Today China has three formal stock markets, one each in Shanghai, Shenzhen, and Beijing.[7] The

[7] A detailed history of the Shenzhen and Shanghai stock markets is expounded in Mookerjee and Yu, 1995.

Beijing stock market began listing companies in July 1992. These stock markets are regulated by China's Securities Regulatory Commission, which itself is overseen by the securities committee of the Cabinet. Beijing tends to trade 'legal person' shares (shares owned by government bodies and SOEs), whereas Shanghai and Shenzhen trade 'natural person' shares (shares owned by individuals). (Overholt, 1993, 110) Although the markets were intended to be fairly similar, Shanghai has become the market for China's large state enterprises, and Shenzhen is the exchange for smaller, entrepreneurial companies. (Overholt, 1993, 107) New share issues are typically oversubscribed many times, although the central government continues to limit the number of companies that are eligible to offer shares. Officials have also raised a tax on stock trading in an effort to control trading activity. The central government wants to move with caution in developing stock markets for ideological as well as practical reasons such as keeping inflation at a reasonable level.

Foreigners are limited in their permitted investment in the Chinese stock markets. There is a special group of shares which only foreigners are allowed to own, called B shares, and these shares are limited to a minority stake in the listed company. Because of the excessive demand in China for company stock, however, domestic buyers illegally purchase B shares, activity which the central government cracks down on every now and again, when inflation pressures on the economy are particularly acute. The first B shares were listed in Shanghai and Shenzhen in February 1992. B share issues require special approval from the Chinese central bank, and no investor is allowed to acquire more than 5% of a company without approval. Prices are quoted and purchases are settled in US$ in Shanghai or in HK$ in Shenzhen. (Overholt, 1993, 111)

Although the restrictions on China's stock market are aimed to help the government keep a tight reign on the nation's capital markets, they also serve to hinder Chinese company expansion by limiting their fundraising capabilities. Besides government restrictions, trading activity on the stock markets is also limited by the lack of full currency convertibility. The Chinese government is wary of allowing its nascent markets to grow unfettered for fear that inflation could spiral out of control. The Communist regime's *raison d'etre* is also undermined by allowing a capitalist market mechanism such as share trading by the owners of capital lead the way to reform of the nation's enterprises. For these reasons, Hong Kong's financial markets are an important tool for Chinese company development because they are set apart, structurally and ideologically, from the Mainland's own economic system.

China's currency

As part of its economic reform, China began to revamp its foreign exchange systems in 1979. In 1992 Beijing opened the National Foreign Exchange Swap Centre, a computerised 60-seat market created with the ultimate aim of gaining a unified national renminbi market rate. (Overholt, 1993, 103) At the start of 1994 China unified its official exchange rate with its swap market exchange rate. When the dual exchange rates were unified in 1994, China's currency, the yuan (also known as the renminbi, or 'people's money'), was devalued by 33% against the dollar. As the official rate had been seen as too high, this unification meant that the official rate was depreciated to more closely resemble the swap rate. The unification to one floating exchange was a step towards full currency convertibility. The yuan was made convertible at the end of November 1996 for current account transactions, covering trade-related activities, but it continues to be inconvertible in the capital account, which covers equity transactions and direct investment activities. This is one of the reasons why China remained somewhat isolated from the East Asian economic crisis of 1997-1998, and consequently officials are in no hurry to make the yuan fully convertible. The yuan's integrity has been maintained by large amounts of foreign investment and the fact that Chinese companies must remit their foreign currency earnings to the central bank. China had foreign exchange reserves totalling US$85 billion in 1996. (*Financial Times*, 21 June 1996) Reserves now total US$131.6 billion, one of the highest levels in the world. (Sanger, *New York Times*, 23 September 1997) China needs to maintain high levels of foreign exchange reserves so that it can continue to import and pay off foreign debt. China has pledged to modernise its financial system, and according to Premier Zhu Rongji, who spearheads China's economic reforms, this involves strengthening currency regulation by the central bank and promoting commercialisation of state-owned banks.

It wasn't until the beginning of 1997 that foreign banks in China were allowed to deal in yuans. At the end of December 1996 four foreign banks were authorised to make loans, accept deposits, and carry out other transactions in the Chinese currency. These four banks, Citibank, the Hongkong and Shanghai Bank, the Bank of Tokyo-Mitsubishi, and the Industrial Bank of Japan, are limited to yuan loans no greater than 35% of their foreign-currency loans. The restrictions on dealing in yuans and the lack of full currency convertibility mean that Mainland Chinese cities are inhibited from developing the advanced financial markets which would pose any competition to Hong Kong.

China's experience with the East Asian economic crisis

China was relatively insulated from the economic crisis that originated in East Asia in 1997. Two factors have protected China from the fate of some of its neighbours: one is the fact that a large portion of its exports is destined for non-Asian countries in which the demand remains strong. Secondly, the yuan is not fully convertible and thus not subject to the rollercoaster rides of currency markets. This is not to say that China has not exhibited some of the symptoms of the crisis. This includes excess capacity in the form of a tremendous number of new construction projects for buildings which may lie empty for lack of demand; according to one report, almost one quarter of the world's building cranes is being utilised in Shanghai alone. (North, *Washington Post*, 3 August 1997) China is also fighting inflation and overheating of the economy, due in part to large amounts of foreign investment which flow in to the country. Bad loans to SOEs also undermine the strength of the economy and push up inflation, as explained above, and it is not quite clear if the government plans to restructure these loans or allow default; but in the process the government must be careful that the banks themselves do not fail. With the appointment of Zhu Rongji as Premier, the government is signalling its understanding that austere measures will need to be taken to restrict liquidity. Zhu has worked to reign in inflation through tighter credit measures and has managed to keep inflation impressively low for the rapidly expanding economy. Throughout the depression in Asia, China has resisted pressure to devalue its currency. Were China to devalue the yuan, this would certainly put maximum pressure on Hong Kong to devalue the HK$, which China would be loathe to let happen.

Conclusion

The reforms that China has undertaken has meant that China expanded its trade and investment links with the rest of the world, most notably through the creation of the SEZs. The open door policy also has allowed Chinese investors to send capital to other parts of the world. China's capital outflow was as large as US$30.5 billion in 1992. (Hornik, 1994, 34) China still has many development issues to address, primarily the reorganisation of the SOEs, before its economy can truly modernise. In the process it continues to require outside investment to fund business growth and create new jobs, and Hong Kong plays a crucial part in organising this investment. Hong Kong is China's international financial centre, providing investment and project financing, and acting as an outlet for Mainland companies to interact with the global market. Chapter four will be an overview of the Hong Kong economy, emphasising its strong foundations and those aspects which are of particular relevance to China. Now that the weaknesses in China's economy have been discussed, the argument proceeds to examine Hong Kong's systems and their capacity to help the Mainland.

IV. Hong Kong, China's financial centre

With the return of Hong Kong to China, China has internalised a powerful international economic entity. China needs Hong Kong to fill a role for the Mainland which it is unprepared to fill itself, and thus Hong Kong's economy is pre-eminent in China's development plans. But it is a reciprocal economic relationship: as shall be evidenced, Hong Kong itself has exploited China's needs for its own growth. Hong Kong itself profits from the attraction of foreign capital.

Hong Kong's economic utility to China is possible because of the advanced economic systems that exist in the territory. This chapter stresses the firm foundations of the territory's economy which underpin these systems and in the process establishes that Hong Kong is useful to China precisely because of its capitalist market mechanisms. Hong Kong forged a close relationship with the Chinese economy when the Mainland began opening up to foreign investment in the late 1970s. To benefit from China's reforms, Hong Kong shaped its economy to provide the trade and financial services which China would require. In the 1980s Hong Kong made moves to strengthen the Hong Kong dollar and the local bourse in order to consolidate its position as one of the premier global financial centres. Today its economy has been shaken somewhat by the East Asian crisis, but because of the strength of the underlying fundamentals (which are outlined below), Hong Kong has been able to weather the storm.

Background

Hong Kong is one of the original 'tiger economies', the group of four East Asian nations which radically transformed their developing economies into modern economic powerhouses. The group, comprising Taiwan, South Korea, Singapore, and Hong Kong, focused on developing their export industries and expanding their economies during the 1960s and 70s. Hong Kong has inherent advantages which it has exploited over the past four decades, including its geographical location and the best deep-water port on the Chinese coast. It has built on these advantages, developing an efficient administrative regime and the rule of law, a modern infrastructure, sound finances and low taxes, a free port and the unrestricted flow of capital. China is Hong Kong's economic hinterland, and therefore Hong Kong's own growth has been tied up with that of China. Hong Kong depended upon Chinese exports for goods, especially raw materials and food, which it was unable to provide for itself. Hong Kong's success in achieving spectacular growth in the 60s and 70s was partly due to the supply of foodstuffs, consumer goods, and raw materials from China at prices much lower than at world levels. (Chau, 1983, 184) By helping to keep prices down, these inexpensive provisions helped to keep wages low, and thus inflation was minimised. As a major source of hard currencies, the Hong Kong market was apparently allotted a high priority by China with regard to selling food. (Chau, 1983, 196)

Hong Kong was not economically prominent for the earlier part of the century, acting as a useful port but taking a back seat to the thriving East Asian banking centre of Shanghai. During this time Hong Kong's primary role was as an entrepot for the Chinese economy, providing trading services for goods flowing in and out of China. The Communist Revolution catalysed Hong Kong's economic modernisation and forced the territory to make many of the changes that led it to become an financially significant entity. During the Communist Revolution in the late 1940s, many bankers, merchants, and entrepreneurs fled Mainland China and reestablished their businesses in Hong Kong. Manufacturing truly developed on a large scale in the 1950s and continued in strong force through the 1970s; during this period Hong Kong was abundant in cheap labour in the form of immigrants from the Mainland. Another crucial turning point in Hong Kong's development was the U.S. embargo on goods imported from China during the Korean War in the 1950s and an UN embargo on the export of strategic goods to China. The embargoes subsequently muffled much of Hong Kong's trade flows with China, and in order to maintain its trade activity with the rest of the world, Hong Kong nurtured its own manufacturing base. Its manufacturing industry thrived through the 1960s and 70s, excepting a recession in 1974-75 when labour costs rose and as other Asian countries moved into manufacturing. (Scott, 1990, xix)

A breakthrough for the Hong Kong economy came at the end of 1978, when Deng Xiaoping recommended that the Chinese economy open up to foreign trade and investment. Reforms which were implemented in 1979 included the creation of SEZs, coastal areas intended to be open manufacturing and trading enclaves. Shenzhen, formerly a rural agricultural town directly across the border from Hong Kong, was designated as a SEZ. Chinese leaders recognised the importance of investment and export know-how from Hong Kong, and the economic incentives provided by the PRC government encouraged Hong Kong industrialists to move their labour-intensive operations across the border. Many thought that in 1978 when China began its course of economic reforms, Hong Kong's significance would decline as China would no longer use it as its main point of access to the rest of the world. However, Hong Kong adapted to these new conditions in China to become even more relevant to the Chinese economy as its primary link with the international economy. (Yahuda, 1996, 23)

Trade

Hong Kong's economy relies heavily upon two sectors: services and trade. The natural harbour and the territory's strategic location on the South China Sea give it two important advantages over any other city in the Pacific, and it has exploited these advantages to become a premier trading centre. Approximately one-fourth of the world's shipping moves through the South China Sea, and Hong Kong is advantageously situated to facilitate the trade in the region. (Weidenbaum and Hughes, 1996, 17) Hong Kong's trade volume is two and a half times its GDP, and its port is the busiest in the world in terms of container throughput. (Interview with director of China Trade, HKGTD, October 1997) Hong Kong's economic growth is solid: GDP grew by 3.9% in 1995, and by 4.9% in 1996. Services account for the majority of GDP, with manufactures taking a decreasing role in Hong Kong's economy. The service sector accounted for 84% of Hong Kong's GDP in 1995, while manufacturing only contributed 9.3% of the 1994 GDP. About 80% of Hong Kong's manufactured goods are for export, and its major export markets were China (35%), the U.S. (21%), and the European Union (15%). (HKTDC Web Page, updated 7 November 1997)

Hong Kong's port, situated on the territory's augmented natural harbour, is promoted by government policy of no import or export tariffs, contributing to Hong Kong's status as the world's seventh largest trading economy in 1996. (Hong Kong Government Information Services, 1997, 1) China currently relies upon Hong Kong to ship most of its exports from southern China to the rest of the world. According to Mr. Ba Sang Yeung, director of China Trade at the Hong Kong Government Trade Department, it is more efficient for China to transport goods to Hong Kong via railway, and use Hong Kong's port to ship to other parts of the world, than to use northern China ports. Re-exports are an increasingly important part of Hong Kong's trade, confirming Hong Kong's role as an entrepot economy. Re-exports account for more than half of Hong Kong's total trade, and in the first nine months of 1997, 85% of Hong Kong exports were re-exports. (HKTDC Web Page, updated 7 November 1997) Hong Kong's re-export trade from 1992 to 1996 is shown in Figure 2, clearly revealing the vital role Hong Kong has played recently in handling China's trade. For each of the years shown, trade with China has accounted consistently for more than 89% of Hong Kong's total re-export trade, and has grown by about a percent year on year. Thus in 1992 Hong Kong's re-exports involving China trade were 89%, but in 1996 the re-export trade with China had increased to 93%. In the decade between 1984 and 1994, China became the largest market for Hong Kong's exports and the biggest supplier of its imports. (Yahuda, 1996, 25)

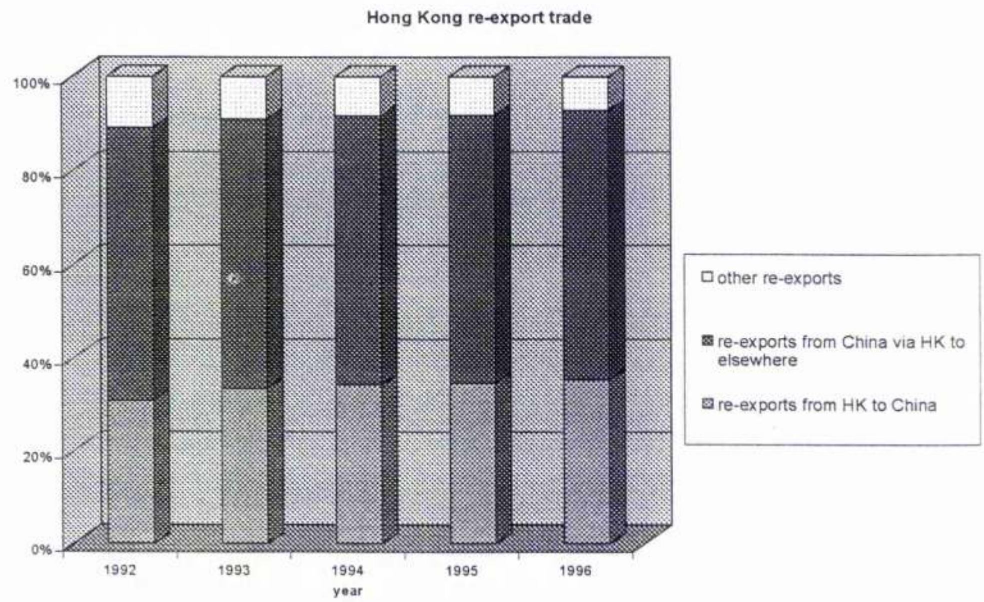

Figure 2
Source of data: Hong Kong Government Trade Department

Another way to look at Hong Kong-China trade is through the stages of production model. Almost 55% of Hong Kong's exports to China are for outward processing; these exports are used as inputs for a final good produced in China, and the final product is often re-exported to Hong Kong for onward shipping. Thus Hong Kong-China trade is very often not trade in final goods for consumption but inputs for stages of production. This exemplifies the highly integrated business relationship between Hong Kong and the Mainland, as the various phases of manufacture, trade and finance are located on both sides of the border. The Hong Kong Trade Industry and Customs Department introduced in February 1981 an 'Outward Processing Arrangement' under which 'a certificate of Hong Kong origin may be issued in respect of a product if it can be established that despite certain intermediate processes of manufacture having been subcontracted out of Hong Kong, the terminal- or origin-conferring process has been carried out by a factory in Hong Kong registered with the Department for certification purposes.' (Chai, 1983, 144)

Hong Kong's role as a financial centre

As its manufacturing industries increasingly moved to China, Hong Kong turned to its service sector to generate economic growth in the territory. China requires a massive amount of capital to fund its growth, and with the opening of the Chinese economy to foreign investment, Hong Kong modified its own industrial makeup to take on the role of financier to the Mainland. This important role has defined Hong Kong ever since, and it has become one of the largest financial centres in the world. Hong Kong is the fifth largest financial centre in terms of volume of external banking transactions and fifth largest in terms of foreign exchange transactions. (Hong Kong Government Information Services, 1) As Hong Kong has improved its capacity to manage financial transactions, it has increasingly exported capital. In 1996 Hong Kong was the fourth largest source of outward foreign direct investment in the world behind the US, the UK, and Germany, investing a total of US$27 billion. (HKTDC Web Page, 7 November 1997) As Hong Kong has financed China's development, its banking, investment, and trade industries have expanded correspondingly. While Hong Kong can be classified as an international financial centre, its strength is in servicing the Chinese economy; international investors use Hong Kong as a base from which to conduct trade and investment in China and the East Asian region.

Hong Kong's Stock Market

Hong Kong's stock market takes advantage of its position between other major markets such as London and New York to provide continuous trading around the clock. The Stock Exchange of Hong Kong (SEHK) was officially created in April 1986 when the government urged four smaller existing stock exchanges to merge. Today there are 650 companies listed on the SEHK. To be list on the SEHK, firms must have been operating for three years, have a profit level of HK$20 million in the year prior to listing, and have a combined profit level of HK$30 million for the two years prior to that. At least 25% of the firm must be offered. (Berger and Lester, 1997, 312) The SEHK is monitored by the Hong Kong Securities and Futures Commission (SFC) which was created in 1989.

Data on stock market movements and exchange rate stability during crises shows that Hong Kong is sensitive to political shocks from China. The Hong Kong stock market and the exchange rate of the HK$ were sensitive to the state of relations between Britain and China during negotiations of Hong Kong's sovereignty. [8] The SEHK is subject to severe shocks partly because there is a lack of diversity among the type of companies listed on the SEHK. In the 1980s, the Hong Kong stock exchange topography was dominated by property sector stocks, which had the second largest market capitalisation and the greatest number of listings on the market of any sector. In mid-1997 the property sector continued to be the largest player in the SEHK, contributing about one-third of the value of stock market listings. (Ridding, *Financial Times*, 3 May 1997) This leaves the SEHK particularly vulnerable to certain types of shocks, specifically interest rate movements which are unfavourable to the real estate industry. The stock market is further concentrated by interlinked share holdings (listed companies holding shares in other listed ventures) and companies which are owned by the same parent group but traded separately. (Freris, 1991, 100) Trading in Hong Kong's stock market is confined to a small number of shares which account for a large percentage of the overall value and volume of the market's activity--these shares also account for most of the market's capitalisation. In the first 18 months of the operations of the unified stock exchange (April 1986 to August 1987) the top twenty most active shares accounted consistently for more than 60% of the value of turnover and for over 65% of the market capitalisation. (Freris, 1991, 102) With the health of the exchange so reliant upon the fortunes of a concentrated number of companies, it is perhaps not surprising that the SEHK is subject to extreme swings in fortune. In a study over 1971-1985, the Hong Kong stock market topped the list of exchanges in terms of the highest volatility and returns. (Freris, 1991, 169)

[8] For the most thorough discussion on the effects of the negotiations on the Hong Kong stock exchange and exchange rate of the HK$, refer to Rafferty, 1991, pages 387-420.

The most commonly quoted index of the SEHK is the Hang Seng Index (HSI), compiled by the Hang Seng Bank. The index comprises thirty-three leading stocks, with the base year as 1964. The composition of the HSI is changed frequently, with certain criteria employed to determine the constituent stocks: companies must have Hong Kong as their primary operational centre, they must have a minimum average monthly market value for a specified period, and they also must have a minimum aggregate monthly turnover value for a certain period. Furthermore, a company's past and current earnings and growth and the nature of the business sector are taken into account. (Freris, 1991, 106)

Monetary regime

Hong Kong's monetary system is overseen by the Hong Kong Monetary Authority (HKMA), the territory's quasi-central bank created in 1993. The Hong Kong dollar (HK$) reached its lowest point in September-October 1983, when there was a large amount of uncertainty surrounding the Sino-British negotiations. This confidence crisis spread to the property sector, which in turn had an impact on the stock market. As investors shifted currencies, the pressure on the Hong Kong government mounted, and they felt it essential to intervene to restore confidence in the currency. The HK$ was pegged to the US$ at a parity of US$1 = HK$ 7.80 through the medium of the note issue and the exchange fund. The HK$ is run according to a currency board, which means that every unit of local currency is backed by a unit of foreign currency held in reserve.

Because of the dependence on the link, there is no independent monetary policy in Hong Kong: Hong Kong has relinquished control of the money supply and the interest rate mechanism. With the pegging of the HK$ to the US$, the Hong

Kong economy became inextricably linked with the U.S. economy and the movement there of exchange and interest rates. Interest rates in Hong Kong are tied to those set by the Federal Reserve Board in the U.S. The government must maintain whatever money supply will support the pegged rate. The authorities can either fix the money supply or the exchange rate, but not both. According to the Mundell-Fleming approach developed in the 1960s, a country can have at most two of the following conditions: a fixed exchange rate, monetary policy autonomy, or capital mobility. Hong Kong of course has capital mobility and a fixed exchange rate, therefore it has relinquished monetary policy autonomy. Fixing the exchange rate in a world of mobile capital gives priority to a stable exchange rate over the ability of national policy to affect domestic prices. (Frieden, 446) Thus Hong Kong's choice of a pegged rate reflects the importance of trade and the industries related to trade in the Hong Kong economy. Furthermore, non-tradable goods, such as land and housing, are more expensive in Hong Kong relative to other national economies. Between 1959 and 1970 the average price per square foot of industrial land in the metropolitan areas (excluding the new Territories) went up from HK$9.70 to HK$102.90. (Chau, 1983, 217) Instead of the exchange rate, the interest rates shoulder the impact of changes in liquidity and the money supply, and as a consequence Hong Kong has faced large fluctuations in the interest rate, especially during the recent Asian economic crisis.

The peg relies on investors' conviction that the parity is set at a realistic level supported by economic fundamentals. Crucially, the 'necessary condition for the maintenance of a parity for a currency is that investors believe that the authorities are committed to the parity, and will incur the necessary costs in terms of their domestic employment and price level objectives so that the parity can be maintained.' (Aliber, 1990, 202) During the recent economic downturn in East Asia, Hong Kong has shown that it is indeed prepared to stand by the currency at a large cost to the domestic economy. Hong Kong has a strong mechanism in place to maintain this parity, which is controlled through the HKMA. This parity works through the Exchange Fund, which was originally established in the 1920s to support the HK$ by keeping reserves ready to defend it. The Exchange Fund was later incorporated into the HKMA. The HKMA's main responsibility and the main issue of monetary policy is to support this peg. There are three note-issuing banks (NIBs), the Hongkong and Shanghai Banking Corporation, the Standard Chartered, and the Bank of China. In order to maintain the peg, these banks deposit U.S. dollars with the Exchange Fund, and in return receive Certificates of Indebtedness (CIs) from the Exchange Fund. The CIs allow the NIBs to print HK$. The peg guarantees a fixed price of HK$7.80 worth of CIs for every US$ surrendered, and conversely the fund will buy back CIs for US$ at the same rate. Hong Kong has a unique peg in that the HK$ still floats freely on the foreign exchange market. The government relies on arbitrage to bring the open market price in line with the parity maintained for monetary purposes. Since every additional HK$ issued is backed by U.S. dollars, any inflow or outflow of HK$ has a direct effect on the money supply and on interest rates. (Freris, 1991, 188) However, the Hong Kong government seems well prepared to defend the parity, as it is required to deposit its budget surplus into the Exchange Fund. When the Financial Secretary revealed the last budget, he predicted a huge surplus for the 1997 fiscal year of HK$15.1 billion.

Until the recent Asian economic crisis, Hong Kong had the third largest foreign exchange reserves in the world. The HKMA is able to back the HK$ eight times over, as the Exchange Reserve Fund holds over US$80 billion, while there is approximately US$10 billion HK$ in circulation. (Interview with Mr. Chad Leechor, HKMA, October 1997) According to Mr. Chad Leechor, head of Economic Research at the HKMA, there are no plans whatsoever to drop the peg or devalue the HK$, and the government will only consider doing so when it perceives there are no risks to investor confidence and the stigma of being a part of China no longer exists for Hong Kong. When questioned as to whether the HK$ was overvalued at the level of the peg, Mr. Leechor conceded that it could be, but that this was different from the HK$ being sustainable. He believes that the HK$ is not overvalued in the tradable goods sector, but that non-tradable goods prices are somewhat inflated. The peg has been successful, especially for the export-oriented economy which relies on a stable currency: there has been relative price stability, and the monetary system has been able to cope with confidence shocks. (Freris, 1991, 236) Thus, Hong Kong intends to keep the exchange rate peg and sees no signs of dropping it in the near future, not only for the fact that it has worked well in the past, but also because of the role it serves in securing investor confidence for the new Hong Kong regime under Chinese authority.

Hong Kong's experience with the recent East Asian economic crisis

Beginning in July 1997, Thailand's currency, the baht, came under increasing pressure to devalue as the government found the country's economy faltering. With increased investments and big money projects going full speed ahead, but without the demand to match, Thailand was creating a bubble economy. Speculators were quick to move in and force the Thai currency lower. Unfortunately this scenario was being repeated throughout the region, and Indonesia, Malaysia, and the Philippines found their currencies the subject of attack. Poor economic policies in these countries were often the culprit; these countries had found themselves on the receiving end of large inflows of capital, not only from private investors but also loans from foreign banks. This capital was not effectively managed and spent on projects that had poor returns. As things began to go wrong, investors pulled out and the loans dried up, compounding the crisis. As one country in East Asia fell, then inevitably interdependent neighbouring countries felt the effect. Speculators turned on the HK$ in October 1997, betting that Hong Kong could not stand its ground as (1) the HK$ would be much more expensive relative to the neighbouring depreciating currencies, and (2) Hong Kong would be unable or unwilling to defend the currency over a prolonged period. The speculative attack has caused Hong Kong some strain as the government has taken strong measures to defend the HK$. In order to defend the currency, HK$ interbank rates were raised as much as 300% at one point to tighten liquidity. By raising interest rates, Hong Kong jeopardised the property market, which dominates the stock market and has borrowed heavily from the banks. Property stocks were also hard hit as investors fled the market. The stock market took a dive, losing 38% through September and October 1997. Hong Kong's case differs from that of the other Southeast Asian nations in that its economic fundamentals are sound and it has the reserves to back its currency. Estimates range from US$3 billion to US$8 billion as to the amount the Hong Kong government has spent to defend the currency, and these outlays are well covered by the over US$80 billion Hong Kong has in foreign exchange reserves.

Public finance

Sound government finance is an enduring fundamental which inspires investor confidence in Hong Kong. The government has had a budget surplus for nine of the past ten years, and it was estimated that Hong Kong would have a budget surplus again for financial year 1997/98. It is written into the Basic Law that Hong Kong must attempt to maintain a balanced budget (Article 107), and due to its restricted fiscal spending, Hong Kong has been able to keep substantial reserves and also lower taxes for certain brackets of the population. There is no capital gains tax, and for the 1997/98 budget, the standard salary tax rate remained unchanged. Although there are demands on the government to spend its surplus, the Treasury Deputy Secretary explained that it is vital to have these reserves on hand for years of budget deficit, such as fiscal year 1995/96 when spending on the new airport reached it peak. (Interview, October 1997) If the Hong Kong government loses revenue, then these reserves will be necessary not only to maintain a balanced budget but also to support public spending as well as backing exchange rate of the HK$. There is no established government definition of what constitutes adequate fiscal reserves. Hong Kong has fared better than most other East Asian economies in the recent economic turndown, and this can be credited to sound management of the government's finances. According to government estimates, Hong Kong will have fiscal reserves of HK$377 billion at the end of the fiscal year 1998. This includes the reserves in the Land Fund, which is discussed below. (HKTDC Web Page, 7 November 1997)

All land, minus that which the Anglican church near the government offices is built upon, is owned by the government and is managed by the Planning, Environment, and Lands Bureau. The government regularly holds land auctions to lease the right to parcels of land. These are typically 75-year leases, and due to the scarcity of land, bidding often runs high. Thus substantial income is derived from the sale of these leases, but because land sales from year to year are variable, land revenue is not a stable source of revenue for the government. As the property sector was particularly hard hit in the Asian crisis, demand for property has weakened and land prices have fallen in the past year. Because the property sector is a dominant part of the Hong Kong economy and the SEHK, the property crisis has had a major impact on the whole of the territory's economic health, which suffered but did not collapse.

Proceeds from land auctions in the twelve years before the handover were put in the Land Fund, which was set up in 1985 to assuage Beijing's fears that the money made from government land auctions would be usurped by the British Hong Kong government. The revenue from land auctions was divided 50-50 between the post-1997 Hong Kong government and the pre-handover British Hong Kong government. After the handover, the Land Fund was merged again, with a windfall of a one-time payment of bankrolled revenues in the Land Fund from the previous twelve years going to the Hong Kong government.

Hong Kong government spending is quite low relative to other nations with similar per capita GDPs. It is this concept of minimal government intervention which has earned it the accolades of economists who view it as an example of true laissez faire capitalism at work. Public expenditure is only 18.3% of GDP, one of the lowest percentages of an industrial nation. The establishment of the budget begins with a Resource Allocation Exercise, in which the secretaries of the various government departments submit bids. Bids often outnumber resources five to ten times. (Interview with the Deputy Secretary of the Treasury, October 1997) Resources are allocated according to the priority areas established in the Chief Executive policy address, the first of which was given by the new Chief Executive, Tung Chee Hwa, in October 1997. The budget also is allocated amongst 'bread and butter' items in the economy, such as government salaries. Once the expenses are determined, the revenue is estimated. It is at this point that the government decides if a tax raise is necessary or if, in fact, tax cuts are viable. Impressively, the government has not raised taxes in the past decade. There is a 15% tax ceiling, and in fact, only around 80,000 individuals actually pay at the 15% level. It is a progressive tax system, and out of approximately 3.2 million working people, approximately half do not pay tax. The other half typically pays at a level of 5%. (Interview with the Deputy Secretary for the Treasury, October 1997) The Legislative Council must pass the government budget, and Beijing has no say in its determination.

The Hong Kong government is not a virtual hands-off government, as it is often perceived to be; on the contrary, as the government is actively involved in many sectors of the economy. For example, Hong Kong supports the post-secondary education system, social security measures for the elderly, and housing for the majority of the populace. It is this last item which is one of the biggest areas of public expenditure. Because land is scarce, housing is affordable only for the wealthy. Thus the government subsidises mortgages for the middle classes so as to make owning a flat possible for the population at large. The Hong Kong Housing Authority is responsible for public housing, which it plans, builds, and manages. The Authority is required to cover its expenditure from its income, which it derives mainly from rent, although it can borrow free of interest from the official Development Loan Fund. The government provides land free of charge to the Authority. The government has created numerous New Towns in the New Territories which are purpose built condominiums: tower blocks of hundreds of apartments, usually including shopping areas, recreation areas, and entertainment facilities. Through its involvement in the housing market and its numerous land reclamation projects the government has been accused of contributing to the overheating the property market and of raising inflation by increasing the housing and land supply.

Conclusion

Hong Kong's economy has evolved over the last century, from low-value added trading entrepot to manufacturing powerhouse to a service-based economy. These stages in Hong Kong's development have reflected the circumstances of China's own political and economic evolution. China sent Hong Kong economic 'prompts', such as the creation of the Shenzhen SEZ, which allowed Hong Kong to exploit the trade and investment opportunities on the Mainland. The result of Hong Kong working closely with the Chinese economy has been that Hong Kong has become the main source of investment for the Mainland. Hong Kong's service to and support of the Chinese economy is corroborated in the next chapter with a look at the investment flows which Hong Kong manages for China.

V. Capital movements

Since China opened to outside trade and investment at the end of 1978, capital flows between the China and Hong Kong have increased dramatically. Hong Kong has become inextricably linked with the economy of China due to trade and investment flows, and the following chapter explores the reasons behind this integration. China's remarkable growth record has meant that there are potentially lucrative investment opportunities on the Mainland. However, there is no financial centre within China of Hong Kong's calibre which has the necessary mechanisms to manage large inflows of foreign capital. Thus foreign companies wishing to invest on the Mainland often use Hong Kong as a stepping stone. As China's premiere financial centre, Hong Kong has become an integral part of the Chinese economy; China depends heavily on Hong Kong's economy, and vice versa. Correspondingly, the multitude of Chinese companies are not raising the necessary capital within the Mainland to fund their operations and have increasingly looked to Hong Kong to help them attract investment. Thus both foreign and Chinese companies use Hong Kong for their investment activities because of its advanced mechanisms for servicing investment capital and the particular business atmosphere which allows these mechanisms to thrive.

Hong Kong serves the Chinese economy in three ways. Firstly, Hong Kong handles much of China's trade, which was discussed in the previous chapter. Secondly, Hong Kong businesses invest an enormous amount on the Mainland, encouraging Chinese growth. Thirdly, Hong Kong links China with the rest of the world by acting as a base for foreign investors as well as hosting Chinese companies who are looking to expand and raise capital beyond the Mainland. Because of the complexity of Chinese company activity in Hong Kong and the issues it raises, the succeeding chapter is devoted to this last point. To set the scene for an investigation into China's expansion into the Hong Kong economy, it is important to evidence the foreign capital that Hong Kong attracts and manages for China. It is partially because of the presence of foreign funds in Hong Kong that Mainland companies are drawn to the enclave. As foreign companies increasingly use Hong Kong to access China and Chinese companies conversely use Hong Kong to access foreign capital for their operations, Hong Kong has become inseparable from the Chinese economy. Both China and Hong Kong benefit enormously from this relationship; there are no other developing countries with such a financial centre at their door to help acquire the necessary capital for growth. Hong Kong has remained its largest foreign direct investor ever since China began its economic reforms, and in each of China's thirty provinces and municipalities except for five, Hong Kong ranked either first or second in both foreign trade and direct foreign investment. (Yahuda, 1996, 24) At the end of 1996 Hong Kong investors were linked to 57% of foreign-funded projects in China. (HKTDC Web Page, 7 November 1997)

The next two chapters focus specifically on investment between China and Hong Kong: one side of the relationship, Hong Kong's investment in China and foreign investors' engagement of Hong Kong to ultimately invest in China is explained herein. The analysis then proceeds to explore the reverse relationship, China's expansion in the Hong Kong economy. The ties between the two economies are part of the larger phenomena of the growth of the Greater China economic region and the immense economic activity of the Chinese overseas. Hong Kong serves as the doorway to China for Taiwan and the Chinese overseas, and as such, its own economy is bolstered by the capital which is serviced in the territory en route to

China. Hong Kong is well positioned to take advantage of China's economic dealings not only with Taiwan and the Chinese overseas but with virtually all other foreign investors as well.

Greater China

Hong Kong forms part of Greater China, the economic network of Southern China, Taiwan and Hong Kong. Greater China is a natural economic zone which has arisen out of economic transactions despite lack of political direction or involvement. Because of the close economic relationships between these areas, the economic network is a dynamic growth area that supersedes national boundaries and political ideology. In 1994 Hong Kong by far invested the most in China at US$20.2 billion than any other entity, and Taiwan was second with US$3.29 billion. (Goodhart and Xu, 1996, 75) More than two-thirds of the foreign money that has already flowed into China has come from Hong Kong or Taiwan. (Brauchli, *Wall Street Journal*, 14 January 1997) This economic activity bodes very well for Hong Kong, which serves as a crucial link for Mainland China and Taiwan. The exploitation of the competitive advantages of each region has meant that each economy has focused on specialised areas of activity. As land and labour costs increased in Hong Kong and Taiwan in the 1980s, companies moved their low-end manufacturing production sites to southern China, primarily into the SEZs. The Hong Kong economy has mainly become service-oriented, dealing with shipping and banking activities, and the Taiwanese economy has moved into more high-tech, less-labour intensive industries. The synergy created between these economies has created an economic giant that is a world force: taken as one entity, this economic area has the third largest GNP in the world, the largest foreign exchange reserves and the third largest foreign trade turnover. (Shambaugh, 1995, 3)

Taiwan does not have formal trade or diplomatic ties with China, nor does it maintain direct shipping links, and thus Hong Kong serves as the nexus for the Taiwanese and Chinese economies. Taiwan trades with China through Hong Kong, and Taiwan uses Hong Kong as a base for its investment to the Mainland, currently at a level of about US$20 billion. (Richburg, *Washington Post*, 2 February 1997) China claims Taiwan as a breakaway republic, while increasingly Taiwan is leaning toward independence, evidenced with the first direct election of its president in 1996. It is not likely that Taiwan and China will resolve their differences in the near future, and thus Hong Kong will continue to be important in serving as the link between the two.

The Chinese overseas network

A well-documented economic force in the global economy is the 'bamboo network', the community of Chinese overseas businesspeople. Chinese overseas play an important part in the development of Hong Kong, not only in its growth as a financial centre but also in strengthening its ties with Mainland China.[9] Chinese overseas refer to the collective population, estimated to be around 55 million, of Chinese people who have emigrated from China and settled in other countries in Southeast Asia, North America, and Europe. (This definition includes the ethnic Chinese populations in Hong Kong and Taiwan.) Chinese people in many of these places have become successful entrepreneurs, and over the years have developed

[9] Following the example set in *Greater China: The Next Superpower?* (Shambaugh, 1995), I refer to populations of ethnic Chinese people living in non-native countries as Chinese overseas, distinguishing them from overseas Chinese, those Chinese who are temporarily living abroad.

large business empires. As estimated by the World Bank, the combined economic output of Chinese overseas was nearly US$400 billion in 1991. (Weidenbaum and Hughes, 1996, 25) In Singapore, Malaysia, Thailand, Indonesia, and the Philippines, companies owned by ethnic Chinese make up about 70% of the private business sector. (Weidenbaum and Hughes, 1996, 8) The Charoen Pokphand Group is a good example of the success of Chinese overseas. Based in Bangkok, Thailand, the CP Group is run by Sumet Jiaravanon, a Chinese overseas who is the grandson of the company's founder, Chia Ek Chor. Chia Ek Chor fled Communist China in 1949 and moved the seed company he had started in Shantou, China, to Bangkok. The company, which began in the chicken feed business, grew and diversified into interests such as motorcycles and petrochemicals, and is now allegedly the single largest investor in Mainland China, each one of its divisions having established a joint venture. (Weidenbaum and Hughes, 1996, 32) Their after-tax profit in China in 1994 was US$50.4 million. (Gargan, *New York Times*) Today CP Group controls more than 200 affiliated companies, only 14 of which are publicly listed.

As many of the Chinese overseas traveled through Hong Kong emigrating from China, Hong Kong has long been perceived as the headquarters of this overseas network, and thus the great majority of funds that come from Chinese overseas destined for China flow through Hong Kong. Hong Kong has well developed this role through the development of its financial industry. Since 1978, more than 75% of the direct foreign investment in China (estimated by the end of 1994 as a cumulative total of US$100 billion) has come from or through Hong Kong. (Yahuda, 1996, 7) The overseas Chinese typically have extensive business and government connections in China, which give them an edge for investment into projects in Mainland China. It can also be argued that the overseas Chinese are obviously more familiar with

Chinese way of doing business, and can manipulate these knowledge advantages. Chinese overseas investors do not mind putting money into China for long-term investments which may not pay off for a long time because they view their investments as aiding their homeland; furthermore, they are willing to take risks other foreign investors might not take due to their experience with the Chinese economy and their connections which allows them to secure informal contracts. Chinese overseas have succeeded in China because of guanxi (connections) and networks to deal with the Chinese bureaucracy. Not only are they familiar with the country and the language, and therefore do not have to go through middlemen, they are familiar with and are willing to participate in certain Chinese business practices, such as paying bribes in order to push the project through various levels. As the rule of law, business law in particular, is still a fairly underdeveloped concept in China, the acquiescence of the cadres at various levels must be secured before business can be conducted. Local government officials control the economy in their area, and the necessary guanxi makes these business deals go smoothly.

The Chinese business community often does not rely on formal contracts but on handshake agreements. Siu-lun Wong, in his article on business trust among Chinese, hypothesises that trust is the glue which binds Chinese overseas businesspeople and their counterparts in China. (Wong, 1991) This is also directly related to the notion of 'face' among Chinese. Maintaining face is crucial to the Chinese, and this notion is made manifest in their business dealings. If a business deal goes sour, the person responsible loses face, and subsequently is less likely to secure future business deals in the future. Trust is important in reducing transaction costs for the Chinese overseas: formal contracts are replaced by an implicit understanding between parties that the deal will be adhered to in the spirit of saving face. Chinese overseas conglomerates are typically privately owned, family-run, and conduct a large amount of their business activity in trading, holding, and shipping interests. These conglomerates hold interests in other, perhaps family-connected, conglomerates, which in turn have holdings in the parent corporation, creating a complex, inter-connected ownership network between divisions or different companies owned by the same family or parent company. Some of the interests in these corporations are publicly listed, but often ownership is a tangled network of family ownership. Family ownership serves two purposes. As the family is the basic unit of trust in traditional Chinese society, Chinese overseas are more willing to conduct business with family members. Because business deals are often verbal agreements based on this highly binding and forceful concept of keeping face, transaction costs are minimised. Secondly, because wealth is privately held, these corporations may do with their profits as they please.

Chinese overseas have increasingly selected to invest their fortunes in China as its economy has opened up to outside investment. Taken as an economic entity, Chinese overseas are the largest investors in Mainland China, and have formed more that 100,000 joint ventures in China. (Weidenbaum and Hughes, 1996, 5 and 27) Many of these Chinese are discriminated against as a racial minority in their adopted homelands, and thus they have made attempts to redistribute their wealth to Mainland China. Many of the overseas Chinese left behind family when they emigrated from China, and some of the money sent back to China is in the form of gifts to relatives. Chinese overseas often tend to prefer investing in the particular regions in China in which they may have familial ties. The overseas population who have left China are typically from the eastern and coastal provinces and consequently have invested largely in this area. Thus these fast-growth areas have been able to take advantage of the establishment of the SEZ free trade areas with the investment of Chinese overseas.

The extent of Chinese overseas investment in China and the particular development of the Hong Kong economy would not be possible in the first place had there not been reforms on the Mainland. If China had not opened its borders, there could not have been the formation of Greater China or the opportunity for Chinese overseas to develop trade and investment relations via Hong Kong with Mainland China. Having said that, China's amazing double digit growth for much of the past 15 years and the development of its industries and economy was dependent upon foreign investment and trade, of which the Chinese overseas has provided a majority. In 1992 it was estimated that about 75 percent of investment in China came from Chinese overseas. (Cable and Ferdinand, 1994, 246) Four years later, in 1996, the percentage of investment from Chinese overseas was roughly the same, with 70% of the US$490 billion in foreign investments in China originating from Chinese overseas. (Richburg, *Washington Post,* 26 January 1997) For continued investment in China, Chinese overseas will be looking for China to maintain policies which will further a Greater China and will look for signs of stability within China and its adjustment to international relationships. (Yahuda, 32-33)

Hong Kong has benefited from the growing network and successes of expatriate Chinese. With Hong Kong serving as the link between Chinese overseas and China, the city is at the centre of a network of Chinese overseas companies from all over the world. In this sense, Hong Kong is well placed for the next few decades as these Chinese overseas companies continue to expand, which will further serve to expose Hong Kong to international business activity. Hong Kong's role to the Chinese overseas goes hand in hand with its role as the epicentre for Greater China.

As Hong Kong continues to mediate between China's economy and these economic entities, it will be better placed to service investment between all foreign investors and the Mainland.

Foreign investors and Hong Kong

By using Hong Kong to enter the Chinese market as opposed to entering China directly, foreign investors are choosing to reduce their transaction costs. The concentration of a wide variety of companies and the open and fair system of conducting business imply that a corporation is able to explore and secure business relationships relatively easily. Hong Kong's advanced financial systems, including the fact that its currency is fully convertible, mean that it is better prepared to manage capital than the Mainland. Of the US$150 billion foreign direct investment in China from 1980-95, three-fifths came from or through Hong Kong. (*The Economist*, 12 October 1996, 109)

The American Chamber of Commerce in Hong Kong conducts an annual survey of its members to gauge business confidence and activity in the territory, and the results of the 1996 survey revealed that a majority of those surveyed had operations in China. It is evident from Figure 3 that an increasing number of companies are investing in the Mainland from Hong Kong. The survey found that 71% of members that had responded had operations in China, up from 53% in 1992. Of the companies with existing operations in China, 86% plan to make additional investments in the Mainland. Furthermore, 49% of the companies that did not have a presence in China planned to make an initial investment in China over the next three years, a statistic which confirms that it is popular practice to use Hong Kong as a base from which to invest in China. (AMCHAM Survey, November 1996, 3)

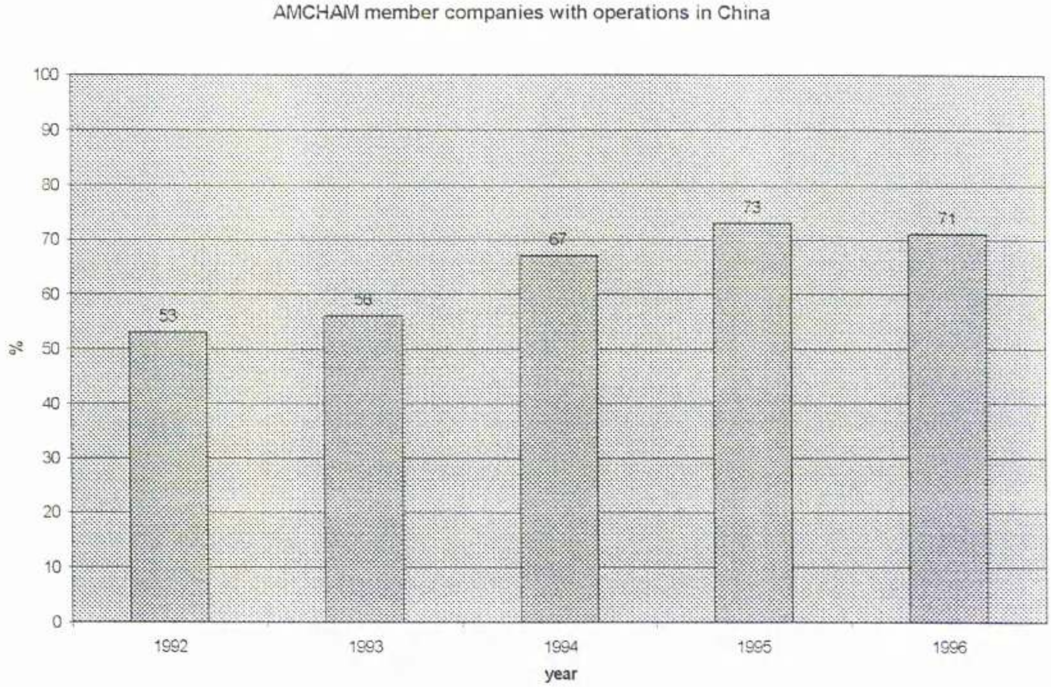

Figure 3
Graph reproduced from AMCHAM 1996 Business Confidence Survey

One of the reasons why Hong Kong is an ideal place in which to organise investment schemes or joint ventures in China is the established set of laws governing contracts and agreements. Quite often it is the legal expertise of Hong Kong firms who know the Chinese system and often have Chinese contacts who arrange business contracts between westerners and Chinese. The legal system in China is lacking in many ways, but most notably in the area of business law; contracts in China have often lacked legal weight behind them. The legal system in China has been slow to reform, and Hong Kong will most definitely have an important role to play in providing legal expertise when organising business and investment deals.

Hong Kong's thoroughly modern network of financial institutions has also meant that the city is in a prime position to facilitate investment in Mainland businesses. There are over 185 banks in the territory, thus project finance and foreign exchange are readily available. China's banking system, on the other hand, is far from being liberalised. The Bank of China is still the Mainland's primary bank and the only one until recently allowed to deal in yuan, the Chinese currency. The Bank of China is centrally controlled and is under obligation to provide a constant source of 'loans' to the SOEs. The SOEs are in desperate need of reform, although reform would mean a massive overhaul of the Chinese economic system. Were the SOEs to shut down, this would cause mass unemployment in China and be a major impetus for political destabilisation. Thus they continue to fund the redundant state industries, which has repercussions on the banking industry. Because the Bank of China must prop up the SOEs, its own goals are divided: it must try to control inflation while at the same time continually providing funds to the SOEs. It wants to promote growth and a tight monetary economy, but finds it must balance these goals against its obligations to the state sector. Thus the banking system in China remains contrary to reform, (1) structurally, as the banking system is tightly regulated; (2) intrinsically, with the lack of full currency convertibility; and (3) relationally, as it must support the state industries. The underlying problem of the state sector must be addressed before the banking sector can undergo true reform, but the reform of the SOEs will be a long and arduous process.

Hong Kong serving China

Since it opened its economy, China's understanding of Hong Kong has not deviated from the central premise that Hong Kong is useful for China's growth and modernisation. Hong Kong has fulfilled its unofficial mandate thus far set by the Chinese government to aid the Mainland in its economic development. The issue of Hong Kong's return to China has done nothing to diminish its ability to attract capital from foreign sources and derive funds internally to send on to China. Direct investment in Hong Kong totalled US$99.7 billion at the end of 1995, an increase of 11% from 1994. (HKTDC Web Page, 7 November 1997) Knowing that Hong Kong is a source and conduit for capital, China has established plans to use Hong Kong to further develop China's economy, industry, and infrastructure. China's Ninth Five Year Plan, which is the Chinese economic blueprint for 1996 through the year 2000, as well as the economic plans for 1996-2010, address the issue of getting Hong Kong to serve the country as a whole. According to the Ninth Five Year Plan, the HKSAR is expected to continue to help the Mainland raise funds and attract investments. Beijing hopes that Hong Kong will respond to its signals and that it will be able to lead international investors in the direction of China's planned economic development, such as increased growth in the interior. (Yahuda, 1996, 137) Hong Kong is indeed responsive to these desires on the part of the Mainland to provide funds for development projects. According to the HKTDC, at the end of 1994 venture capital funds totalling US$6 billion were managed out of Hong Kong, the bulk of which was invested in China. (HKTDC, 1996, 19)

To attract the necessary capital, Hong Kong continues to strive to sustain an environment which is conducive to the modern, innovative operations of foreign businesses and financial institutions. Moves to strengthen Hong Kong's legal system, the HK$, and the city's financial regulations are all a part of the effort to consolidate Hong Kong's position as an international financial centre. According to a survey conducted by the Hong Kong Investment Funds Association, approximately 70% of funds managed in Hong Kong come from outside of the territory. (HKTDC, 1996, 19) Xu Jiatun, head of the Xinhua news agency, which was China's de facto representation in the territory while it was under British rule, was quoted in 1987 as saying, 'Hong Kong plays a unique role in assisting the motherland in publicising and pursuing its policy of openness. It can serve the motherland in obtaining the economic information of the world and absorbing the experiences of management, capital, technology and professionals.' (Rafferty, 1991, 326-327) China wants Hong Kong to be open and attractive to foreign investment, but also to suppress subversive elements, so that outside influences are kept at arms length and are not directly corrupting.

Hong Kong's economic hinterland

As Mainland China is Hong Kong's economic hinterland, Hong Kong realises with its investments in China it is facilitating China's growth and by extension the strengthening of its own economy. Not only has Hong Kong become the largest investor in China, but China is the second largest investor in Hong Kong. Chinese investment in Hong Kong is estimated to be between US$25 billion and US$45 billion. (Richburg, *Washington Post*) China's investment in Hong Kong may be underreported due to the large capital outflows from the Mainland which are unaccounted for. Because Hong Kong does not have any restrictions or reporting requirements on capital flows, the territory is a useful offshore centre for Mainland capital outflows which are not sanctioned by the government. Unofficial capital outflows from a country are often represented in the errors and omissions category in the balance of payments statistics. The errors and omissions figure for China in 1996, in which the capital outflow was recorded at US$16 billion, was greater than its trade surplus. (Deutsche Morgan Grenfell, October 1997, 7) According to Chinese officials, Hong Kong is the recipient of about 80% of this outflow which goes to fund Chinese business expansion and the purchase of property and financial assets.

(Deutsche Morgan Grenfell, 1997, 8) Because Hong Kong has a currency board (and thus the currency value does not fluctuate), an inflow of foreign funds will be accounted for by a rise in the territory's foreign exchange reserves, and in fact a rise in Hong Kong's reserves have virtually mirrored an increase in the value of China's errors and omissions statistic. (Deutsche Morgan Grenfell, 1997, 8) This statistic also denotes that there is an enormous amount of excess liquidity in China from the new wealth that is being created which does not have adequate investment opportunities on the Mainland, and much of this liquidity is channelled to Hong Kong illicitly. If the unofficial capital outflows from China to Hong Kong (80% of US$16 billion = US$12.8 billion) are added to the official investment, then China's investment in the territory could possibly exceed an amazing US$57.8 billion.

China's growth means that its indigenous companies will be looking for opportunities to expand, and Hong Kong is the logical stepping stone for these companies to move into the global economy. The Hong Kong Chinese Enterprises Association (HKCEA), incorporated in 1991, acts as a chamber of commerce for Mainland Chinese enterprises registered in Hong Kong. The HKCEA emphasises that its reasons for expanding in Hong Kong are, logically, those of familiarity and the existence already of a large amount of capital flows between the two economies: '(t)he reason why we selected the Hong Kong market is that, Hong Kong, being one of the international centres, is economically connected with the Mainland most closely. ...Therefore, we feel sure of success if our enterprises are listed in the Hong Kong stock market.' (HKCEA, 1995, 18) Hong Kong embodies a certain amount of security for Chinese companies because the territory ultimately is part of China. Because of the past successes of Chinese companies listed on the SEHK, other Chinese companies are optimistic in their ability to tap these funds. Chinese investors are also anxious for the opportunity to meet the plethora of western business contacts in the territory. As Chinese companies raise money for their Mainland operations in Hong Kong, these funds are repatriated, contributing to the sum of capital which Hong Kong manages for China. It has been estimated that about 40% of Hong Kong's investment in China are from companies with Chinese ties in Hong Kong, including Mainland banks which account for much of this investment. (Fung, 1997, 81)

Chinese companies had new expectations for their growth and development with the promise of Chinese control of Hong Kong when the Sino-British Joint Declaration was signed in 1984. In 1985 the HKTDC gave a figure of HK$30 billion for China's investment in Hong Kong. (Rafferty, 1991, 331) By 1988 Chinese investment in Hong Kong was estimated at US$10 billion, higher than the US$6 billion invested by U.S. companies. (Rafferty, 1991, 333) Five years later, in 1993, investment was estimated at US$20 billion, a 100% increase from 1988, making China the largest investor in Hong Kong. (Chan, 1995, 941) Chinese investments in Hong Kong in recent years are calculated to be growing at more than 25% annually. (Chen, *Wall Street Journal*, 29 November 1996) With the expectation of Chinese sovereignty of Hong Kong came increased economic activity in the territory by Mainland interests, perhaps with an implicit assumption that ultimate sovereignty would make Chinese investments more 'at home' in the territory. Apart from any impact they may have due to sheer size, Chinese investments should be subject to scrutiny because they are unique from any other type of foreign investment in Hong Kong and pose particular problems to the integrity of the Hong Kong economy.

This chapter has shown the extent to which Hong Kong facilitates investment in Mainland China. This is precisely role that China had hoped Hong Kong would play with the inception of Chinese economic reforms. China sought to gain control of Hong Kong in order to have a closer relationship with the territory and greater influence in terms of being able to shape the political makeup of the territory's government, which it wanted to be sympathetic to business interests. The political environment would then be conducive to attracting foreign companies and supporting investment activity, which could be channelled to the Mainland. The foreign capital which is managed in the territory is a powerful reason for Chinese companies to have a presence in Hong Kong, so that they can take advantage of the availability of funds. Chinese conglomerates are also interested in the opportunities for expansion and the prospects for investing in various sectors and businesses that the territory presents. The argument that China's relationship with Hong Kong is best understood when analysed from China's economic motivations now proceeds to an account of Chinese companies operating in the territory. A description of the activities of the companies evidences the ways in which China participates in the Hong Kong economy in order to access capital as well as investment opportunities.

VI. Chinese companies in Hong Kong

The previous chapters have established that Hong Kong is the most important trading partner, investment source, and economic development tool for Mainland China. Hong Kong is also the most important channel for investment to the Mainland, as well as the Mainland's window to the global economy, acting as a platform for the Mainland to raise money and invest overseas. China expects Hong Kong to be a bridge to the outside world, and in this role Hong Kong facilitates economic and legal transactions for Chinese companies that do not have access to certain market mechanisms in China. Chinese companies have moved into Hong Kong in greater numbers in the past decade, and now account for a large portion of the Hong Kong economy. China's Ministry of Foreign Trade and Economic Relations estimates that 80% of Chinese companies' international investment is in Hong Kong. (Kim Eng Securities, 1996, 8) Mainland enterprises are categorised by their structure and ownership: those that are listed on the Stock Exchange of Hong Kong (SEHK) are divided into two groups, red chips and H shares. Government-owned red chip companies, the listed vehicles of China's most successful conglomerates, are given special consideration later in the chapter because of the important role they play in the Hong Kong economy.

Chinese company involvement in the territory is highly influential; China is the second largest investor in the territory after Britain, and as such it contributes a great deal to the Hong Kong economy. With this in mind, it is important to explore the nature of business conducted by Chinese companies in Hong Kong. Thousands of Chinese companies are involved in the Hong Kong economy. Just of those companies that are members of the HKCEA, (for there are many smaller Chinese enterprises that are not members or those which are operating in the territory without Chinese government permission), there are approximately 1090. (HKCEA Membership Directory, 1995) Chinese companies are moving into Hong Kong in great numbers, and, in fact, have greatly increased their presence in the past decade. A conservative estimate states that Hong Kong Chinese companies conduct 20% of business activity in Hong Kong. (HKCEA Annual Report, 1995, 41)

There are vital differences between Chinese businesses and other 'foreign' businesses operating in Hong Kong, and it is because of the unique nature of Chinese investments in the territory that Chinese business activity warrants investigation. First of all, Chinese companies, although given foreign status in Hong Kong, originate from Hong Kong's parent country. Significantly, the largest and most powerful Chinese companies are government owned. While some TVEs and private enterprises are involved in the Hong Kong economy, they do not operate on the same scale as government-owned companies in terms of the scope and size of their investments in the territory. As China is Hong Kong's master, Mainland company activity in the territory, especially in vital industries, has interesting implications. Namely, bureaucrats who form government policy who also have business interests can utilise government information to the benefit of their corporate interests in Hong Kong. In addition, government-owned company involvement in Hong Kong also provides a form of representation in the territory for the various levels of Chinese government (city, province, and national), which gives the Chinese government another, unofficial avenue of power. The Chinese government, through its companies operating in the territory, is free to lobby the Hong Kong government for policy formation or reform, expand its representation among the business elite in the territory, and increase its presence on the boards of other companies as well as its membership in trade and commerce groups. Hong Kong's open, free economic system means that it would allow this representation to operate without a sufficient counter-balance to maintain its economic independence.

Secondly, China is a developing country and consequently must deal with problems of adopting market mechanisms while still holding onto socialist mores. There are a host of issues such as inflation, currency convertibility, and banking reform that China must confront, and in the process it could be a rocky road for China's indigenous companies. Hong Kong is therefore susceptible to imported risk, especially via Chinese business activity in the territory. Chinese companies are dealing with a less-than-stable home country economic environment, which has consequences for exchange rates, capital repatriation, and business growth and stability. Chinese companies compete for government resources and are vulnerable to power plays between government agencies. Decisions taken by the Chinese government about the national economy, especially those regarding the reform of SOEs and managing inflation, directly affect government-owned enterprises.

Thirdly, government officials control access to the Chinese economy, and it is these same officials who run Chinese companies, many of which have representation in Hong Kong. Furthermore, certain Chinese companies in Hong Kong have monopoly rights to certain sectors or areas in China, and thus they are the point of contact for any business interested in entering those markets. It makes logical business sense to form relationships with the people and companies that are the gatekeepers to investment on the Mainland. Thus Chinese companies that are controlled by or have connections to the bureaucrats who regulate access to China's economy exercise hold certain trump cards in Hong Kong. Their leverage arises because Hong Kong is the principal gateway to China for investment flows, and Hong

Kong and foreign companies which are interested in investing in China will seek relationships with the companies which provide access to the markets. In seeking these relationships, Chinese companies are often the benefactor of privileged deals, for example purchasing shares in companies at a reduced rate (a fact which was confirmed in an interview with Ms. Jeannie Cheung, director of China research at Paribas Asia Equity, a fund management firm in Hong Kong). This has the obvious implication for Hong Kong in that while it was once lauded for its open and fair economic system, Chinese company involvement could negatively affect this reputation.

It is with these considerations that the following analysis has been undertaken to examine the extent to which Chinese companies have the power to affect the Hong Kong economy. It is important to examine Chinese company investment in the territory, more so than other 'foreign' investment, as Chinese companies have the potential to influence the territory much more so than any other type of foreign business activity.

Chinese company representation in Hong Kong

Supposedly Chinese companies must request permission from the government before they can open a subsidiary in Hong Kong, but many Chinese companies, especially smaller enterprises, find ways of moving into the Hong Kong economy by bypassing this restriction. It is difficult to estimate the number of Chinese companies that are established in Hong Kong for the very reason that some companies are anxious to keep their profits and business activity from the auspices of Chinese authorities. Balance sheets for Chinese non-financial firms in Hong Kong are not readily available; the problem of transparency is compounded by the practice of using

Hong Kong residents as 'fronts' to disguise real ownership. (Jao, 1983, 45) The Chinese government estimates that there are about 1800 Mainland companies registered in Hong Kong, with assets totalling at least US$43.5 billion dollars. Another estimate posits that there are over 10,000 companies operating with Chinese capital. (Richburg, *Washington Post*, 26 January 1997) The later estimate includes those businesses that are operating in Hong Kong without official permission, although the actual number could be much higher than this.

Chinese businesses can be categorised into three groups: the officially registered firms that are regulated by Beijing, the subsidiary firms that have approval to operate from their parent company or from their provincial authorities, and the unofficial or illegal firms. Almost every Chinese provincial government has corporate representation in Hong Kong, and the People's Liberation Army (PLA) is thought to be the largest investor in the territory with a large number of the estimated 20,000 companies under its control believed to be in Hong Kong. (Richburg, *Washington Post*, 26 January 1997) The PLA is also believed to be one of the major participants in smuggling and black market operations between China and Hong Kong, especially as their vehicles are exempt from searches on the Mainland. Supposedly, Chinese naval units account for 50% of the piracy in the South China Sea. (Bueno de Mesquita, 1996, 93) Many Chinese business interests aren't large, but are looking for market information and investments to channel back to China. (Chen, *Wall Street Journal*, 29 November 1996) A lack of access to funds in Mainland China is a considerable reason why Chinese companies want to expand into Hong Kong. As mentioned in Chapter 3, the total number of enterprises on the Mainland is close to eight million, and yet there are only 388 companies listed on the Shanghai stock exchange, and roughly the same number each listed on the Beijing and Shenzhen bourses. (Allen, AMCHAM presentation, October 1997) As explained in Chapter 3, the Chinese authorities work to keep the exchanges within their control, and although the demand to list on the exchange is high, only a small number of companies is allowed to list. Therefore, although only 39 or so Chinese companies are listed on the SEHK, other Mainland firms are able to access funds from foreign sources in Hong Kong in various other ways such as loans, direct foreign investment, and forming partnerships with foreign companies.

Data taken from the HKCEA notes that in 1994-95 Mainland companies had the following market share in Hong Kong: banking (24%), insurance (20%), tourism to China (60%), transportation (20%). Further figures provided from a separate study include market share for foreign trade (22%) and construction (12%). (Allen, 1997, 206) Chinese businesses, in a relatively short span of time, have gained an impressive market share in major business areas in Hong Kong. Two striking examples of Chinese expansion in the territory are China Overseas Holdings Ltd., owned by the Chinese Ministry of Construction, and China National Aviation Corporation (CNAC). China Overseas began to invest actively in 1984 after Britain and China signed the Joint Declaration, and most recently had the massive responsibility of constructing the terminal for the new Hong Kong airport.

The case of CNAC is a bit more disconcerting regarding its expansion into Hong Kong. Swire Pacific Limited, a British blue ship company, sold a major stake of its regional airline, Dragonair, to CNAC, the commercial arm of China's aviation regulator in April 1996. This was after a determined attempt by CNAC to gain access to the Hong Kong airline market. CNAC first announced its intentions in 1995, signalling that it planned to launch its own short-haul airline to compete with Dragonair, short distance carrier for Cathay Pacific, on Mainland China routes and routes to Taiwan. Shares in Dragonair were offered by Swire to CNAC to prevent the creation of a new airline that would directly compete with the regional carrier. After a year of negotiations, CNAC acquired a 35.86% stake in Dragonair. CNAC bought these shares at as 20-30% discount to the value of the Dragonair shares had they been offered on the stock market. (Allen, 1997, 226) At the time, slightly more than half of Dragonair was owned by CITIC, the most successful Chinese conglomerate, which was apparently directed by Beijing to sell off the majority of its shares to CNAC, thus reducing its stake from 25% to 10%. This is an interesting example of two Mainland companies with competing interests, and how government politics plays an important role determining the business strategy of these companies. As foreign companies seek Mainland companies with which to do business so as to ease passage into the Chinese economy, they will find that this isn't always a sure-fire bet for their joint operations to succeed: '...the episode showed that even well-connected Mainland partners can never fully protect the interests of foreign companies in Hong Kong, since there are bound to be people or groups in China more powerful than that partner.' (Allen, 1997, 233) This is also an example of how Beijing is not too keen for Mainland companies to compete against one another (e.g., CNAC did not start its own airline but bought CITIC's shares in the established Dragonair airline) and will intervene to ensure the interests of its well-connected companies. Swire also agreed to sell more of its own share in Cathay to CITIC, in effect compensating CITIC to some extent for its loss in Dragonair. Now that CNAC controls Dragonair, there is the potential for it to expand its operations to compete directly with Cathay, which Swire still controls, on its routes. Swire would then have an interesting dilemma, either to willingly bow out and let Dragonair into these routes, or to directly compete. Were Swire to compete, it could come under pressure from Beijing, which would negatively affect its business. Were it to try and appease Beijing through concessions to CNAC and Dragonair, it might gain some quid pro quo from Beijing for other business opportunities on the Mainland.

Other red chips also have a presence in essential industries in Hong Kong. The Hong Kong business activities of eleven major Chinese conglomerates are explained in detail in the appendix, which was created to show the vast extent to which Chinese companies have become involved in vital sectors and important companies in the territory's economy. As is evidenced in the appendix, both China Telecom and China Everbright have minority shares in Hong Kong Telecom, CITIC Pacific owns 20% of China Light & Power, and China Resources, China Merchants, and COSCO all have interests in different container terminals. CITIC Pacific, when it purchased their stake in China Light and Power, bought the shares at a 3.1% discount on the open market price. (Ridding, *Financial Times*, 29 January 1997) Furthermore, CITIC owns 35% of the West Harbour tunnel, and China Merchants owns stakes in another tunnel system and an interstate in Hong Kong. As a separate take on the concept of 'one country, two systems', Chinese companies operating in Hong Kong are to abide by 'one centre, two flanking sectors'. (HKCEA, 1995, 41) One centre refers to Hong Kong acting as the lifeblood of the growth of these Chinese companies, and two flanking sectors refers to the fact that these companies will continue to expand in both the Mainland and overseas economies, including Hong Kong.

In his significant work which applied a resource dependence explanation to transaction cost theory, Gilbert Wong emphasised, as in the transactions costs model, that firms will internalise those systems which provide a necessary product for the running of the company so as to reduce uncertainty in the supply of that product.

'The resource dependence perspective postulates that organisations generally cannot generate all the resources the need internally and are dependent to varying degrees on resources supplied [externally]. Very often there are great uncertainties in the supply of those resources (e.g. financial capital, raw materials) that are critical for the survival of the company.' (G. Wong, 1991, 126) One could expand this model and apply it at the level of the corporation, specifically as a compelling explanation for the desire of Chinese companies to 'internalise' certain Hong Kong businesses, such as shipping and finance, which are critical to their operations. Thus in order to secure the supply of a necessary resource or component of their businesses, Chinese companies seek to control, or to some extent become involved in, relevant sectors of the Hong Kong economy.

Red Chips and H shares

Mainland companies must request permission from the relevant authorities in Beijing before setting up operations in Hong Kong. The government wants to limit the number of Chinese companies in Hong Kong, not only to keep a watchful eye over Chinese corporate expansion, but also to artificially reduce competition amongst Chinese companies. Beijing is reluctant to have its Mainland companies compete, when they might be inadequately prepared to do so, and perhaps fail as a result. Accordingly, only a small proportion of the 500,000 large and medium SOEs has received permission from Beijing to operate in Hong Kong because the Chinese government wants to prevent crowding of the market. (Allen, 1997, 277)

Red chip is the term given to a Chinese-owned company (Chinese ownership is defined as a primary stake of at least 35%) which is listed on the SEHK and has operations in Hong Kong. The primary shareholders of these companies are either

Chinese government ministries, provincial governments, or municipalities. So while both red chips and traditional SOEs are government controlled, red chips are large conglomerates which are listed on the SEHK and have business operations in Hong Kong. Red chip companies are at the forefront of the international orientation of China-based companies and are leading the way to Chinese economic expansion beyond Hong Kong. The aim of many Chinese companies is to become global, implementing modern operations and structure, and conducting business in Hong Kong or listing on the SEHK are steps in this process. Chinese companies doing business in Hong Kong are helping to promote China's economic development as they acquire economic information, capital, and managerial experience to channel back to the Mainland.

In July 1992 the Joint Group of Securities Affairs for Hong Kong and the Mainland was formed to study the possibilities of Mainland companies listing on the SEHK. The SEHK and the Chinese government have worked together to make it possible for Chinese companies to list on the SEHK, and as a result of this cooperation they have established regulations to which Chinese companies must adhere if they are to list on the Exchange. These regulations stipulate that companies listing in Hong Kong must conform to international and/or Hong Kong accounting standards. Some Mainland companies also list in London, New York, and Singapore, but the SEHK is their primary bourse and their most important source of funding: the value of red chips and H shares share floatations on the SEHK in the first eight months of 1997 totaled more than US$4.2 billion. (Ridding, *Financial Times*, 27 October 1997)

Chinese companies also must meet the requirements set forth by the Securities Commission in Hong Kong and the China Securities Regulatory Commission in

China before they are allowed to list on the SEHK. If a Mainland company wishes to raise capital on the stock exchange, they must list via an IPO, because backdoor listings, in which shares in a shell company are swapped for assets from the Mainland company, have been banned theoretically by China. Red chips cannot diversify from their main business or raise new capital within six months of listing.

The first two Mainland companies to be listed on the SEHK were Guangdong Investment and Min Xin Holdings in 1987. Early on, backdoor listings were a popular way for Chinese companies to list on the SEHK. By acquiring a shell company already listed on the SEHK, and then transferring assets to this 'front' company, Chinese enterprises were able to circumvent many of the regulations that an IPO might have meant. Backdoor listings were favoured by Mainland companies because they were generally faster than the IPO process. Chinese enterprises purchased 19 shell companies in 1992 and 1993. (Fung, 1997, 94) In May 1993 the SEHK and the Securities and Futures Commission of Hong Kong issued guidelines on backdoor listings which were intended to crack down on these listings. If the listed company changes the nature of its business as a result of acquisition, then it could be considered in violation of these guidelines and the issuer of the shares may be treated as a new applicant for listing. These guidelines also require companies who purchase shell companies must provide written notification of the present and future proposed activities of the listed company and outlining plans for asset injections or sales.

In the second half of 1992, there was a large increase in the number of red chip IPOs. These were mostly companies already operating in Hong Kong which hoped a public listing would boost their funding. Guangzhou Investment, China Travel, and China Merchants were the first Mainland companies to go public via an

IPO. Because of the success of the listing of these red chips, other Mainland companies sought to raise money through the SEHK as well. According to statistics published by Goldman Sachs, red chips account for 9.65% of the SEHK market capitalisation. (Goldman Sachs, 1997)

Red chip companies, because of the nature of their ownership, are targeted by investors because they have access to Mainland assets at lower-than-market value, and/or because they may be granted special franchises by the Chinese government. The valuation of SOEs is very much dependent upon the quality of the assets under its control. In order to improve the viability of SOEs as well as to lure investors, state-owned assets, such as power plants and toll roads, are turned over to the business arm of the government agency who controls these assets. These assets are then supposed to provide a revenue base as well as attract investment. Because foreign investors are not permitted to invest directly in certain sectors in China, it is necessary for foreigners who would like to take advantage of growth in strategic industries in China such as infrastructure and energy to invest in the red chips which are involved in these sectors. The value of their shares derives principally from the significance of their connections on the Mainland and 'their potential to exploit China earnings'. (Goldman Sachs, 1997, 7) Thus their share price is largely speculative driven: as an example, Goldman Sachs notes the case of CITIC Pacific, the largest red chip, whose share price declined when CITIC Beijing reduced its stake in the company. It was thought that this move would reduce CITIC Pacific's more important connections on the Mainland. Many analysts believe that the increasing interest in red chips and H shares is driven by liquidity from the Mainland, although there are no official statistics to support this. They believe that the increase in investment from retail investors is driven by Chinese investors who may have access to information about political or economic situations of Chinese companies. The fluctuating share prices of red chips have been attributed to the extent to which news and rumours affect these stocks. Because these companies are politically backed, any government actions or political plays in China will more directly affect these companies than companies with no ties to their national government. The dramatic increase in market share of red chips and H shares, from 10% in November 1996 to 28% in July 1997 shows the strong demand for China-related stocks as well as the strong desire of Mainland companies to gain access to capital markets. The share price of Beijing Enterprises, the corporate representative of the Beijing municipal government, tripled in value in one month after its initial offering was 1,276 times oversubscribed. (Martin, *Financial Times*, 16 June 1997) Were Chinese companies to lose value, perhaps due to a reduction of the value of Mainland assets, this would have a substantial negative effect on the entire stock exchange. Red chips indeed have suffered in the recent East Asian economic crisis. In October 1997, when the crisis hit Hong Kong, the red chip index fell by 40%, contributing to the overall crisis in the SEHK, which fell to a six-month low that same month. (Ridding, *Financial Times*, 22 October 1997)

H shares are also Chinese-owned companies listed on the SEHK, but H share companies' operations exist solely on the Mainland. H shares are more closely associated with traditional SOEs which are still very much dependent upon the state. H shares are typically smaller and a weaker management, and they tend to focus on only one sector, while red chips have diversified interests and are looking to expand beyond the Chinese market. As of September 1997 there were 32 H shares. Because their businesses are entirely within China, they have been hit hard by high inflation and China's attempts to reign in the economy. As a result of these factors and the weaker management, H shares have not performed as well as red chips and are consequently considered to be not as good an investment as the red chips. The H shares are thus valued lower on the exchange and are considered larger risks. Despite these negatives, H shares are anxious to raise money through the Hong Kong market, and there are at least 40 new H share companies wanting to list.

Red chips are considered better investments than other Chinese-investment stocks open to foreigners, including those listed on the Chinese stock exchanges, for a number of reasons. While they receive quality asset injections from their controlling owners, their business outlook encompasses opportunities beyond the mainland, specifically in Hong Kong, which reduces risk and makes for strong growth potential. Very often their owners are primary state agencies, which have more clout in China's political system than secondary agencies or municipal governments. The red chips also do not share many of the characteristics of SOEs in that they have relatively more freedom in their operational policies and are more transparent in terms of their accounting and legal practices.

The Red Chip companies

The following red chip companies have been highlighted to illustrate the expansion of official Chinese investment in Hong Kong, with the implication that more Chinese investment in the territory over the coming years should be expected. The appendix provides a more in depth survey of the activity of Chinese companies. The Bank of China, China Resources Holdings, China Merchants International, and China Travel Services (HK) were the first Chinese companies to locate branches in Hong Kong, and were the four largest investors until the late 1980s. Mainland conglomerates are moving into virtually every sector of the Hong Kong economy, and the red chips act as their listing vehicles, windows to the capitalist market for these Mainland enterprises. The largest red chip is CITIC Pacific, which has a market capitalisation of over HK$90 billion. It is the ninth-largest listed company in Hong Kong. It is majority owned by CITIC (Hong Kong), and management owns another 21%, exemplifying a western ownership strategy. CITIC owns a 20% stake in China Light & Power, the main electricity provider for the territory. It also owns a 25% stake in Cathay Pacific and a 28.5% stake in Dragonair, the two Hong Kong-based airlines. CITIC Pacific also has extensive interests in property and infrastructure, including terminals in Hong Kong's underground. Larry Yung, son of China's Vice President, Rong Yiren, runs CITIC Pacific. CITIC Pacific first listed in August 1991, and its shares rose 67% in 1996, outpacing the 33% rise in the Hang Seng index of leading Hong Kong stocks. ('HK Executives…', *The New York Times*, 1996)

China Merchants Holdings is a large conglomerate, with investments primarily in infrastructure and shipping. It was first listed in 1992 and is under the auspices of the Ministry of Communications. China Merchants now has over 530 subsidiaries, including Union Bank in Hong Kong, as well as operating the largest barge fleet in Hong Kong and one of China's largest ocean fleets.

China Resources Enterprise (CRE) is the flagship company of China Resources Holdings which is controlled by Ministry of Foreign Trade and Economic Cooperation (MOFTEC). CRE is the second largest red chip behind CITIC Pacific. Its interests include property, a Chinese brewery, and warehouse and storage facilities. China Resources Holdings was established in Hong Kong in 1949 by MOFTEC, and now has more than 500 subsidiaries.

China Travel International Investment (Hong Kong) (CTII) has interests in, but not exclusive to, tourism, hotels, and infrastructure. CTII is 60% owned by China

Travel Service (CTS), which reports to the Overseas Chinese Affairs Office, a ministry–level department reporting directly to the State Council. CTII is the largest of China Travel's listed ventures. China Travel has a virtual monopoly on tourism in China, and is also the largest travel operator in Hong Kong. It has the sole right to handle tourist visas to China. CTII is also one of two agents authorised to handle railroad cargo between China and Hong Kong.

Virtually all provinces, as well as numerous cities and the SEZs, have corporate representation which have listed vehicles on the SEHK. Fujian province's window company, Fujian Investment and Enterprise Corporation, controls the listed vehicle Min Xin. Guangdong's listed vehicle is Guangdong Investments, which has interests in various manufacturing enterprises. Shum Yip Investment Ltd. is the window company for Shenzhen Economic Zone, and its primary interests are in infrastructure and property investments in China. Shanghai Industrial Holdings is the window company of the Shanghai municipal government; it was first listed in 1996 but already is the third largest red chip as its share price has risen over 450%. The company has investments in infrastructure, manufacturing, and retailing.

Many of these red chips are acting as the sole representative of China in dealing with Hong Kong and foreign companies in certain areas of business. Increasingly, however, as more and more Chinese companies move into Hong Kong, the traditional red chips will find native competition for their businesses areas and access to China. As the original Chinese companies in Hong Kong enjoyed a virtual monopoly on their business in China, stock listing was not a priority, but for new Chinese businesses that must find a way of competing, issuing shares has become vital to raise funds to expand their operations.

Not only are Chinese companies going to inevitably affect the market in Hong Kong, but Mainland businesses have adopted certain capitalist methods to operate in the international market. The HKCEA itself realises the necessity of attracting funds by emphasising efficiency and competitiveness in its member companies through the medium of issuing shares, by which 'the enterprise can be remolded (sic) after a share company, and this is benefitial (sic) to the change-over of the operational mechanism, to the structural readjustment and to the strengthening of the market over the enterprise.' (HKCEA Annual Report, 1995, 18) By choosing to do business in Hong Kong, Mainland businesses will be forced to compete against global capitalist corporations. Thus by doing so they themselves will evolve, and in the process encourage the evolution of business practices within China.

China's relationship with red chips

The HKCEA is enthusiastic about transforming enterprises into shareholding corporations, for they realise the benefits of making the company more responsive to the market, not only for the strengthening of the Chinese economy but to also attract funds from discerning investors. They advocate stock market listing to encourage 'structural readjustment' and 'strengthening of the market over the enterprise'. (HKCEA Annual Report, 1995, 18) Red chips enjoy support from China in that they bring in needed funds, which B shares and H shares, nor for that matter A shares and other internal investments, cannot do alone. Red chips also offer another alternative for the excess liquidity in China which is destined for the stock markets. Investment in red chips can alleviate some of the pressure on the domestic A shares in China.

However, although red chip companies enjoy the support of the Chinese government, China has actually worked to slow the expansion of the red chips, as the red chips control state assets which the government does not want squandered. Exorbitant share prices and more funds at the disposal of these companies overheat China's economy through increased liquidity and inflation. As stated before, one of China's main goals is to keep inflation under control. With the aim of controlling speculative investment in red chips, the Mainland government introduced rules on 20 June 1997 which are designed to regulate more stringently the listing of red chip companies and to make sure those companies that do list are structurally sound. By hopefully limiting the number of companies that list, China is exerting some control over the market exposure of Chinese companies. Regulations set forth by China aim to monitor the red chip phenomenon to make sure listed companies continue to serve the purposes of the Chinese government regarding the economy. Transfers of domestic assets to red chips must have the approval from the relevant government authorities and the China Securities Regulation Committee (CSRC), and red chips may only spin off subsidiaries with a solid three-year record.

As red chips are the corporate arms of government agencies, they are money-making vehicles for the government as well, and it is important to the government to see these companies succeed. These powerful branches of the government will want to ensure that their corporate extensions perform well. Connections are all-important in China, so those companies which have impeccable government ties will be well placed to receive favourable government treatment, lucrative government business contracts, important state asset injections, and considerable investor interest. By viewing Hong Kong as a way for Mainland companies to raise capital, Beijing very clearly sees the Hong Kong economy as an environment in which Mainland companies can and should be successful.

Issues of Chinese company activity in Hong Kong

Chinese companies continue to treat Hong Kong as the capitalist window to their own Mainland market, a role which Hong Kong itself has cultivated. Hong Kong has become a highly important base for the operations of many Chinese conglomerates, and the Chinese government, which backs Chinese companies, have a vested interest in attracting international capital to Hong Kong. Jamie Allen puts it bluntly when he says, '(h)urting Hong Kong would directly harm the interests of China's largest and most successful state-owned enterprises.' (Allen, 1997, 200) However, China is experiencing growing pains due to a move to a more market-oriented economy, and Chinese companies themselves will inevitably be affected, which would have knock-on effects to their operations in Hong Kong. This is particularly critical for the Hong Kong economy as Chinese businesses move into vital industries in Hong Kong. As China is a developing country with a government preoccupied with maintaining control, there is the danger that China could impose capital controls in an attempt to restrict unofficial outflows. Because China faces some of the biggest development challenges in the world as its socialist economy implements market reforms, its companies face more dangers in terms of stability and economic constraints than companies from countries with long-established market traditions. Furthermore, these companies are state-owned, which means they lack the independence of decision-making, and business strategy is often synonymous with government interest. The dynamic of state-backed Chinese investment will compromise Hong Kong's economic autonomy. Chinese officials, both businessmen and politicians, have the 'dual identities of policy-makers in China and profit-seekers in Hong Kong'. (Chan, 1995, 949) As the hongs (the big British banks and trading companies) are leaving and British companies are being taken over by Chinese interests, the Beijing-backed Hong Kong government is left without a serious countervailing power. (Hicks, 1987, 34)

Many analysts have concluded that well-connected Chinese companies have an advantage and will be vital partners for any foreign company with designs on moving into the Mainland market: '(t)he assumption is already widespread that companies with close political ties in China will flourish (in Hong Kong).' (Chen, *Wall Street Journal*, 29 November 1996) Both foreign and Hong Kong companies are anxious to cultivate ties with Chinese companies in the territory in order to open up business opportunities on the Mainland. This is illustrated through the example of the New China Hong Kong Group company, set up by a Hong Kong businessman, whose shareholders included 13 Chinese government firms, eleven of which were connected to the national government. (Chan, 1995, 950) With such powerful allies on his side, such a well-connected businessman would be advantageously situated to procure business in China. Companies in Hong Kong with good Chinese connections are considered good investments; conversely, a company's shares could suffer if a Chinese partner withdrew. This was the case when CITIC Pacific reduced its holding in Hongkong Telecom from 10% to 8% in 1996. Hongkong Telecom shares fell by 3.1% after the sale, and analysts believed that Cable and Wireless, which then owned 58% of the company, would attempt to find another Mainland investor. (Lucas, *Financial Times*)

Directors of Mainland companies operating in Hong Kong must avoid the temptation to abuse the power they wield over access to the Mainland economy. For a foreign company to open up operations on the Mainland, it is necessary to form a joint venture with a Mainland company, and the corporate arms of the Chinese government monopolize access to certain geographical regions, at the provincial level, or particular sectors, at the ministry level. Because foreign companies use Hong Kong to enter the Chinese market, Chinese companies have enormous influence in the 'semi-autonomous region' which is supposed to be separate from China. How Chinese influence in the territory will affect Hong Kong's integrity and consequently investor confidence is the subject of the succeeding chapter. China has invariably used Hong Kong to augment its own economy, especially with increasing concentration after the signing of the Joint Declaration. China's use of the city is not without consequences for the independence of the territory's economy.

VII. Implications of China's involvement in the Hong Kong economy

Subtly, China is changing the economic environment in Hong Kong. According to statements by Chinese officials and the activity of Chinese companies, Hong Kong's utility is defined as its ability to raise capital for China. The unique circumstances of Hong Kong's status as a Special Administrative Region within China poses certain problems for the territory that could ultimately jeopardise its standing as the paragon of a free market economy. There are a number issues which have the potential to disturb investor confidence and consequently undermine Hong Kong's role as a financial centre. These issues stem from the tensions that exist for a capitalist enclave operating under the auspices of a socialist government.

The case of China's government-owned companies in Hong Kong embodies these tensions between state-directed planning and free-market economics. Because of the vital differences Chinese companies have from other foreign companies operating in Hong Kong (which were explained in the previous chapter), there exists the potential for corruption, conflict of interest, self-censorship, and the abuse of guanxi in the attempt to secure relationships with Chinese companies. These dangers are particularly acute because Chinese government-owned companies are heavily involved in important industries in Hong Kong, industries upon which the Hong Kong economy is based such as banking and shipping.

The opportunities for exploitation of the power wielded by the Chinese government and their businesses is the subject of this chapter. Hong Kong needs not necessarily lose its level playing field, but it will take some deft handling of its relationship with the Mainland to maintain its economic autonomy. If China's policy is to use the Hong Kong economy, both China and Hong Kong have a responsibility to make sure it is used conscientiously so that its autonomy is not compromised, because it is Hong Kong's economic independence from the Mainland which inspires investor confidence.

Conflict of interest

As we have seen from the previous chapter, Chinese companies are moving into Hong Kong in ever increasing numbers and are active in important industries in the territory. As these companies are government owned, they are either directed by or have significant connections with officials who form government policy. A conflict of interest arises as Chinese government officials who are responsible for formulating Chinese government policy which affects Hong Kong are also concerned with making money out of the territory. Certain Mainland policy actions could have a direct impact upon the Hong Kong economy, such as taxing certain transactions or liberalising the banking sector in China, and officials privy to such information might have insider knowledge for their private business activity and investments in the stock market in Hong Kong. There is also a moral hazard issue in which directors of Chinese enterprises, because the companies are backed by the government, take greater investment risks, which can lead to 'property market and stock market speculations that are not consistent with market risks' as well as excessive volatility. (Fung, 1997, 95) Perhaps, too, foreigners who have invested in Mainland companies may feel that if the government is willing to cover the losses of government-owned enterprises through funding and 'soft' loans, then their investments are somewhat insured. (Fung, 1997, 95-96)

Guanxi

Guanxi, the Chinese term for connections, is the driving force behind Chinese business deals. Because of these connections, either with other business people or with government officials, businesses more easily acquire materials needed for their operations, secure lucrative contracts, or participate in business activities that for all other intents and purposes are classified as illegal by Beijing. It is crucial for foreign companies to have the right connections in order to get through the bureaucratic red tape of doing business in China. Companies seeking to do business in provinces or cities must go through lower-level cadres to gain the necessary permission, and thus lesser government officials are in a position to demand concessions.

There is the concern that Chinese businesses will be granted special deals and contracts in Hong Kong as the territory's companies bid to secure the right guanxi. In a quid pro quo relationship, it is then hoped that these Chinese companies can then give Hong Kong businesses an 'in' to the China market. Investors are concerned about the permeation of corruption in the territory as Chinese contacts are sought. It is not an uncommon business practice for payments or gifts to be given to Chinese companies to woo potential business partners. The Independent Commission Against Corruption (ICAC) estimated in 1991 that the cash and gifts paid to Mainland firms to facilitate business transactions in China added between three and five percent to business operating costs. (Yahuda, 1996, 129) As Hong Kong and foreign companies move to make deals with Chinese businesses, Hong Kong can get dragged into these business practices. Many worry that the courts will be inhibited from deciding against politically well-connected Chinese. (Yahuda, 1996, 130) These fears were confirmed when in March 1998 Hong Kong's top legal official decided not to prosecute a newspaper publisher who was a member of one of China's political bodies for fraud, and in a separate case the government did not prosecute Xinhua for violating Hong Kong's privacy statute. (Landler, *New York Times*, 31 March 1998)

As discussed in Chapter 2 with regard to China' policy of forming a united front, China is courting Hong Kong businesspeople to maintain powerful allies in the territory. The Better Hong Kong Foundation (BHKF) is a non-profit group set up in 1996 by several Hong Kong businesspeople, many of them billionaires, who 'have a huge stake in protecting their fortunes by getting along with their future rulers.' (Greenberger and Stein, *Wall Street Journal*, 3 March 1997) All of the trustees of the BHKF have been appointed by China to be Hong Kong Affairs Advisors, an informal role in which they are expected to advise China on Hong Kong issues. The BHKF is spending millions on public relations and lobbying to project a positive image of China and Hong Kong around the world, very simply because its members' fortunes are heavily invested in these two economies. The 21 trustees of the BHKF are some of the most important actors in the Hong Kong economy; they also have partnerships with Chinese industries and have developed extensive business interests in China. Together the 21 trustees have investments in Hong Kong valued at about US$80 billion. (Greenberger and Stein, *Wall Street Journal*, 3 March 1997) However, it is interesting to note that a member of the BHKF, Li Ka-shing, who owns Cheung Kong Holdings, the third largest land company in the territory, has put his family's trust in the Caribbean.

The members of the BHKF and other businesspeople are anxious to curry favour with Beijing. They realise that if Hong Kong were seen as a threat to the Chinese government, a clampdown would mean a huge threat to their businesses and the freedom they currently enjoy. This acquiescence is troubling, however, as formerly, business could be conducted in Hong Kong with guaranteed freedom and virtually no interference from the government. This reality of no government involvement meant that the market was the sole means of competition. We already see a trend in the other direction, where Chinese government influence in Hong Kong is pervasive to an extent not delineated in the Basic Law nor reflected in Hong Kong's claims to be 'independent' in their operations from China. When this influence is manipulated for economic gain, the level playing field is undermined.

Corruption

Corruption as a result of seeking contacts with Chinese companies in an illegal manner and black-market activities is a threat to the Hong Kong economy, but ICAC, which was established in 1972 by the governor, has been instrumental in minimising this threat. Its mandate is to help maintain a clear, level playing field in Hong Kong. Chinese firms operating in Hong Kong come under the scrutiny of ICAC, although ICAC has never published its detailed findings regarding China-related firms. (Yahuda, 1996, 129) As an offshore centre for Chinese capital, there are undoubtedly illegal funds passing through Hong Kong financial institutions which are attempting to evade the jurisdiction of Chinese officials. Corruption is the result of the exploitation of the gap between socialist and capitalist economies, such as the smuggling and black-market transactions which take place in the waters surrounding Hong Kong.

Fair, open trade practices are at the core of Hong Kong's reputation as a member of the WTO. Re-exports from China through Hong Kong have already fallen afoul of fair trading practices as established by the WTO as seen in the trade disputes the U.S. has had with the territory. Both Hong Kong and China have quotas on their imports of clothing into the U.S. However, Hong Kong's quotas are underused; this creates a loophole which enterprising Chinese and Hong Kong businesspeople have taken advantage of. China ships clothing to Hong Kong factories, which then sew 'Made in Hong Kong' labels into the clothing, which are then shipped to the U.S. Interestingly, Hong Kong's textile work force has declined by two-thirds in the last decade, while its exports are up by almost 50%, according to Hong Kong government data. The government of Hong Kong is not impervious to skirting the law--one of the members of the Executive Council has been fined by Britain for the illegal exporting of goods originating elsewhere, and has been investigated for similar charges by the U.S. authorities. (Bonner, *New York Times*, 1 April 1997)

Censorship

Acquiescence by the business community is directly related to the issue of self-censorship in Hong Kong's media. Investor confidence is an intangible quantity which could make or break the territory's reputation as an international financial centre. This confidence is partly based on open communications and a free press with the free-flow of information. Lu Ping, head of the Chinese government Hong Kong and Macao Affairs Office, claimed before the handover that the press had to be patriotic, otherwise it would be regulated by laws. Tung Chee Hwa has announced that some reports on Tibet and Taiwan as well as personal criticisms of Chinese officials are off-limits. Although China has promised through the Basic Law to continue freedoms such as free speech in Hong Kong, the established journalistic parameters are infringed by a pervasive form of self-censorship in the territory. Hong Kong journalist, academics, and businesspeople are steering clear of any criticisms of China, partially because it is rumoured that China keeps a list of 'troublemakers' in the territory, and very few individuals or organisations wish to be labelled as subversive by the Chinese government. Only a few select individuals outspoken in their demand for democratic reforms, whereas business groups and the media are participating in a form of self-censorship that is very rarely critical of Chinese policies. Overall Hong Kongers wish to smooth the way for good relations with China and subsequently good business deals with Chinese companies. Star TV, which is controlled by the Rupert Murdoch empire and is actively pursuing the Chinese television market, dropped BBC news from its programming when Beijing became offended by a BBC documentary on Mao Tse Tung. (Ching, 1997, 64) The worry is that as the free-flow of information is restricted, there are dangers for the transparency and freedom of commerce. A stake in Giordano Intl. Ltd., a Hong Kong clothing store, was sold to five Chinese companies in order to overcome official resistance to its expansion on the Mainland. Giordano has been thwarted from opening new shops in China for three years ever since an article critical of the then Chinese premier was published in Next magazine, which is owned by Giordano's founder, Jimmy Lai. To help Giordano's expansion, Jimmy Lai resigned from the board of Giordano. (*International Herald Tribune*, 15-16 March 1997)

Leaving the territory

Loss of confidence in Hong Kong manifests itself in different ways, all of which are harmful to the future dynamism of the territory. The emigration phenomenon has been documented,[10] but also as devastating is the exit of capital and companies from the territory. This exodus is due to companies opting for reduction of exposure to risk, primarily attributable to the uncertainty over the future of the territory.

[10] Evidence of emigration from Hong Kong and a possible 'brain drain' is detailed in Skeldon, 1994, pages 3-18, 21-51, and 325-332.

Repatriation of capital is done for a variety of reasons, including to avoid direct taxation of these assets, to avoid types of 'taxation' on these assets in the form of high domestic inflation, and to avoid political and social unrest in a territory, which may undermine the value of their assets vis-à-vis other currencies due to an unstable exchange rate or again, high inflation. Capital flight is also attributed to low real interest rates (due to hyperinflation), repressive tax systems, and large fiscal deficits. John Cuddington, in his seminal work on capital flight in the early 1980s, defined it as short-term speculative capital outflows responding to political or financial crises. (Cuddington, 1983, 2) The concern over the future of the territory was revealed in a recent opinion poll in the Far Eastern Economic Review that showed that 23% of those surveyed claimed that more than half their savings had already been removed to foreign investments. (Royle, *Scotland on Sunday*, 16 February 1997) Hong Kong, while conditions as defined above for capital flight are virtually non-existent, is controlled by a developing country that does fill many of the prerequisites for capital flight. Thus, capital flight may be relevant to Hong Kong in terms of imported risk.

Half of Hong Kong's top 200 corporations have their company registration outside of the territory, and more than half of the companies listed on the SEHK have their headquarters outside of Hong Kong. (Weidenbaum and Hughes, 1996, 68) A poll conducted before the handover revealed that 59% of all the colony's companies are already listed overseas. (Royle, *Scotland on Sunday*, 16 February 1997) Businesspeople know that under current conditions in Hong Kong, where there are no controls on capital flows in and out of the territory, they could easily transfer their capital out of Hong Kong, and if favourable conditions remained, they could transfer their money back as easily and quickly:

> Most multinational corporations have been careful to limit their investments in Hong Kong to a small proportion of their overall international investments and could readily transfer the investment elsewhere if the risk seemed prohibitive or the profits

> unattractive. The overwhelming majority of Hong Kong's business people have foreign passports and a large number of the important local firms have established a right to foreign domicile. (Yahuda, 1996, 123-124)

The local and foreign business community in Hong Kong is already protected against uncertainty concerning the future of the territory, as they have calculated the risks and have hedged their bets accordingly. Those that are risk-averse will prefer to send their capital to more stable environments, as opposed to being exposed to volatility caused by posturing by China. By moving their company headquarters elsewhere, companies are prepared should China jeopardise Hong Kong's economic system.

An interesting example of capital repatriation is Jardine Matheson and Co., the original hong, which moved its financial domicile from Hong Kong to Bermuda in 1984 and re-incorporated itself there. It is also no longer listed on the Hong Kong stock exchange. Another such example is the Hong Kong Shanghai Banking Corporation (HSBC), which moved its headquarters to London in the past few years. It was done, it was claimed, because the HSBC took over Midland Bank, a British-based bank, and the Bank of England required a transfer of headquarters. However, some analysts pointed out that this was a convenient way for the company to move its financial domicile from Hong Kong before the handover. The only British merchant house to retain its financial base in Hong Kong is Swire Pacific Ltd., which is, nevertheless, decreasing its presence in Hong Kong, most notably through the sale of a major stake of the flagship airline for Hong Kong, Cathay Pacific, to China in April 1996. Chinese investment seems to be increasing in Hong Kong, and indeed, taking the place of 'foreign' investment in the territory. The implication is that Chinese businesses bring with them Chinese businesspeople, and the atmosphere in the territory will become more and more pro-China as they assume positions of power in the Hong Kong economy.

Maintaining power

The primary argument for continued confidence in Hong Kong is the idea that China will not kill the goose that lays the golden egg. That is to say, China benefits greatly from the economic success of Hong Kong in terms of the investment that is channelled through the territory, the increasing market for Chinese goods as Hong Kong peoples' incomes increase, and the entrepot role Hong Kong plays for Chinese goods. If China were to jeopardise Hong Kong's success by heavy-handedness or through political and thus economic suppression, then China in turn might jeopardise its own economic growth by threatening investment funds and markets for its exports. Hong Kong is the main source of foreign exchange for China as a result of the trade that is conducted with China in a wide variety of goods from all over the world. China would be doing itself a disservice were it to cut off the market and economic viability of the territory.

These considerations govern China's policy toward Hong Kong, although China has shown that it is not reluctant to take actions to affirm its authority. The cliched argument that China will not harm the goose that lays the gold egg has little relevance for a Chinese government which will try and maintain its own power at all costs. As the ruling power, China has reserved for itself final say on all matters in Hong Kong. China emphasises control first and foremost, which is echoed in the statements of Chinese leaders and in the actions of the Chinese government not only with Hong Kong, but also with situations such as Taiwan. China conducted military exercises in the Taiwan Strait when Taiwan went ahead with democratic presidential elections. This manoeuvre emphasises that China still maintains a very strong one China policy and is anxious to make both Taiwan and Hong Kong an integral part of

China once again. This is also exemplified in China's decision to replace Hong Kong's elected legislature with one indirectly appointed by Beijing once the handover had occurred:

> (T)o the extent that China is more concerned with social stability and economic prosperity than political innovation, democratization in the form of mass volatility, group activism, and partisan and adversarial politics would render China's ultimate control much more difficult than a situation in which the bureaucratic government is stronger than the society. Otherwise, the Chinese government might be tempted into a visible and preemptive role in Hong Kong's political struggle, thereby threatening stability and prosperity. (Kuan and Lau, 1987, 106)

China considers stability and sovereignty paramount to economic concerns. Thus China is willing to take risks which may unsettle the economy in order to preserve stability and its sovereignty; but crucially, it will be always be conscious of the affect its actions will have on its own, and therefore by inference Hong Kong's, markets and will be sure not to irrevocably damage investor confidence or the strengthening of its economy. Paradoxically, it is a strong economy which undergirds stability and goodwill toward the government; thus China has an awareness of the limits to which it can test economic resilience.

China in transition

As a developing country, China is subject to internal strains which will undoubtedly affect Hong Kong. China is changing from a socialist, centrally led economic system to a market economy and is rapidly modernising as well. Countries and companies are competing to supply the enormous Chinese market and the growing middle class of consumers the market reforms are producing. This competition for investment seems to be very forgiving, in that businesspeople will not let political tensions interfere with the economic opportunities for investment in China.

Maintaining Hong Kong as a semi-autonomous region will take some adept political handling on the part of Beijing. As China transforms its state-owned enterprises and its banking and financial sector, it will rely heavily on investment support and expertise from Hong Kong. At the same time, China seeks to contain Hong Kong: '...as an agent of modernity and marketisation Hong Kong also constitutes a challenge to the traditional command economy and to the centres of administrative and ideological authority of the communist-led state.' (Yahuda, 1996, 22) If people in China recognise that those in Hong Kong enjoy freedoms that they themselves do not enjoy, it will be hard to justify China's toleration of the enclave amongst its own restrictive Mainland policies. There are already income disparity tensions between the wealthy coastal areas and the poor inland rural areas which have yet to feel the full effects of investment and market reform. These tensions can only be accentuated by a rich Hong Kong, and will force more reforms in the rural areas to encourage investment there.

Conclusion

China seeks to use Hong Kong as a tool for its own growth and development and to influence to some extent the direction of growth of Hong Kong, so that China can channel international investment funds through Hong Kong into much needed development projects in China. Chinese companies, especially, are keen to use the territory as an outlet for the expansion of their operations. On the other hand, Hong Kong and other foreign interests have felt less sure about their future in Hong Kong, and have been realigning their investments to hedge their bets against a future downturn in the territory caused by imported risk from China, an increase in corruption, or a mishandling of the territory by China. Hong Kong may be affected in the future by turmoil in China, and it is difficult to say whether or not connections in China will protect businesspeople. The future of Hong Kong is tied with the future prosperity of China's economy, and the two economies will only further integrate as more Chinese investors move into the territory and as Hong Kong businesses invest in China. Because of the benefits China derives from having an international financial centre on its doorstep, China has a vested interest in maintaining the capitalist mechanisms in the territory which attract foreign businesses. However, China's very involvement in Hong Kong threatens to undermine the market which it depends upon to further the growth of the national economy. Difficulties arise because of the extensive integration of the two economies: China's development problems have the potential to affect the Hong Kong economy via cross-border investments and trade. Furthermore, government-owned Chinese companies have special connections on the Mainland which confer on them a disproportionate amount of power relative to other businesses or interest groups in Hong Kong. Because of Hong Kong's relationship dynamic with China as business outlet and protectorate, there is the potential for the loss of Hong Kong's reputation as a free, open market. The Chinese government ministries have huge corporate representation in Hong Kong, which automatically gives the Chinese government an exposure and an influence in Hong Kong on which the Basic Law remains conspicuously silent.

The short-term economic stability in Hong Kong is undermined by the political uncertainty. Not only has Hong Kong changed regimes, but it is under the control of a socialist-orientated and authoritarian government. China's policy toward the territory will continue to be governed by the economic relationship between the two entities as well as Hong Kong's rapport with foreign investors. In order to inspire confidence in Hong Kong, it will need to be perceived by the international community as having autonomy from Beijing. Investors want to see that Hong Kong's efficient system where transactions are governed by the market is in direct contrast to China's cumbersome bureaucracy which is informed by guanxi. Strengthening of Hong Kong's own government and the maintaining the integrity of the rule of law will go a long way toward giving Hong Kong its own international identity separate from that of just another southern Chinese city.

VIII. Conclusion

There are immense economic implications of political change, and Hong Kong's new ruling power adds a new dimension to the territory's economic operations. Although the Hong Kong and Chinese economies have been integrating for the past twenty years, the 1997 handover marked a new beginning for Hong Kong in which it would be directly responsible to China. Hong Kong has not remained unchanged from China's use of its economy, and now serves as the arena for Chinese companies to raise capital for their operations and to expand their businesses. Hong Kong's economy will continue to evolve as China continues to use the capitalist enclave to service the Mainland's growth requirements. It must be pointed out that Hong Kong has itself encouraged this role, for Hong Kong benefits from its relationship with the Mainland. Its role in managing capital for China's growth reaps big rewards for Hong Kong in terms of attracting foreign investment and strengthening its financial systems in the global economy, and because of this Hong Kong will continue to serve in this capacity by fostering an environment which will be conducive to attracting foreign investors.

Chinese state-owned companies operate in Hong Kong's major industries while receiving state subsidies, and thus the directors of these businesses face different constraints from those of other companies. This is certainly in violation of Hong Kong's writ to maintain a level playing field for businesses, which will almost certainly affect Hong Kong's reputation as a competitive international economic centre. If foreign companies see Chinese companies gaining special privileges such as stakes in Hong Kong companies at reduced share prices, they will quickly come to the conclusion that connections are what drive economic relationships in contemporary Hong Kong. Hong Kong companies and foreign companies operating in Hong Kong will cultivate relationships with Chinese businesses and Chinese government officials at all levels, who control the economy in China, and in doing so will hope that these relationships will help their own prospects for investment opportunities in China.

China has used Hong Kong as a tool to further its own economic goals. Knowing that this has been the model for their relationship in the past, there should be no reason why this should not be the case in the future as China continues to seek a place on the world economic stage. China still has a long way to go to become a modern industrialised nation, and for the next few decades China will still require large amounts of foreign capital to finance its growth. China's leadership realises it needs the hope of economic prosperity and the maintenance of stability to justify its power and control of the nation. The leadership can only continue to do this with the contribution of foreign investment to maintain the required level of growth and employment. Hong Kong is the venue through and from which the majority of this investment comes. Chinese companies have used Hong Kong as a stepping stone for investment to the wider world and as a testing ground to expand their own operations. Some, by listing on the stock market, have had to make their operations more competitive and modern and have successfully used the stock market to raise funds for expansion. So not only has Hong Kong channelled foreign funds to China, but it has acted as a host for Chinese companies moving beyond the Chinese market. The dilemma for Hong Kong lies in the fact that Chinese interests will increasingly play a part in the Hong Kong economy, which could have negative consequences for the independence of the economy. Yet Hong Kong must work to maintain a separate identity from other Chinese cities in order to have a competitive advantage in the global economy. Because most of the foreign investment destined for China goes through the territory, 'Hong Kong's role as an international city is vital to sustaining its present economic position and indeed to its capacity to be of such significance in the economic development of China itself'. (Yahuda, 1995, 54) There is an essential dichotomy as Hong Kong must remain an international city to attract investments for the Mainland, yet China, by using the Hong Kong economy, will compromise those very features of Hong Kong which attract foreign investors.

China may not want Hong Kong to become too international because it still wants to maintain some element of control. Thus it is courting Hong Kong businesspeople, or perhaps, in effect indirectly bribing them, and it is also encouraging investment and expansion in Hong Kong by Chinese interests. Through this it hopes to influence to some extent the direction of growth of Hong Kong, such that China can channel international investment funds through Hong Kong into much needed development projects in China. The economies of China and Hong Kong have been integrating for the past few decades, but it was in 1984 with the signing of the Joint Declaration that Chinese investment in the territory really took off as China interests felt confident about their own presence in Hong Kong. Once Chinese companies were certain that Hong Kong would become part of China, they made inroads in investing in Hong Kong industries, knowing that their status would help give them validity or a justification for operating in vital sectors in the territory. The problem with this investment is that, as state-owned companies from a developing country, Chinese companies are more vulnerable to economic turmoil on the Mainland, with the consequence that this turmoil could easily spill over into the Hong Kong industries through the Chinese companies; furthermore, they are more susceptible to turmoil in China in the form of fighting among the various levels and departments of the government. Chinese companies because of their government connections also present problems for conflict of interest or the exploitation of guanxi, perhaps with the consequence of an increase in corruption. Some foreign interests have felt less sure about their future in Hong Kong, and have been realigning their investments to hedge their bets against future turmoil in China which would undoubtedly affect Hong Kong, or a possible breakdown in the competitiveness or integrity of the economy. Hong Kong's economy could be compromised in the future if China pursues its territorial claims and makes military postures in the Pacific with the consequence that foreign investment to China decreases. Hong Kong is invariably tied up with how China goes about pursuing its international goals (i.e. superpower, acquisition of land and oil resources in the Pacific) and inevitably will be affected by China's military and international strategy: '...Hong Kong, while benefiting from its links with the People's Republic of China, must contend with the fact that its long-term political risks put constraints on the type and stability of financial flows that the city is likely to attract.' (Lee and Vertinsky, 1990, 246) Part of this political risk can be attributed to uncertainty over the future of the territory. Hong Kong is not the master of its own fate, and because Hong Kong cannot guarantee itself what its future development path will be, investors are justifiably concerned about China's plans for and use of the territory. The operative words here are investor confidence. The economic success of Hong Kong depends upon this intangible, and were it not there, Hong Kong's economic viability would be undermined. The fifty-year deadline for the end of 'one country, two systems' begs the question as to whether or not there will be a crisis in relations in 50 years time. Will Hong Kong be allowed to continue with its separate economic system? At this point, when questions will need to be asked as to the changes that might need to be made in the political and economic system of Hong Kong, Hong Kong's economy could certainly be dealing with destabilisation.

Hong Kong is ultimately a city of business, and as such it is anxious to exploit investment opportunities in its economic hinterland. Hong Kong will still have a role for the West as a conduit of investment into China, as a base or regional headquarters for regional operations and as the best way into the Chinese market because it represents reduced costs vis-à-vis investing directly in China. This, importantly, is where it must differentiate itself from other Chinese cities, so that it will retain its place in the global economic community. Crucially, Hong Kong must continue to prove that it is more efficient to use the territory's marketplace to invest in China as opposed to investing in China directly.

China's policy toward Hong Kong

China has made Hong Kong an integral part of its economy, and yet China has allowed it to retain a separate economic system because it was the territory's capitalist mechanisms which the Mainland needed to encourage its own economic growth. Ever-increasing trade and investment flows between the two economies have served to weld them together. Hong Kong's economy is utilised by China as its international financial centre, because China is not prepared, structurally or otherwise, to create a similar financial enclave on the Mainland. The handover of Hong Kong in 1997 provided China with an established international marketplace which China has increasingly used to bolster growth of its companies and economy in general. China has consistently addressed the territory from the frame of reference of how Hong Kong could serve the Mainland's economic development, from the beginning of China's own reforms, during the negotiations, and leading up to and after the handover. China formed a business-orientated government for the territory and has allowed increasing numbers of Chinese companies to conduct business and fundraising activities in Hong Kong. However, Chinese company involvement in the territory, because it is backed by the state, poses problems for the integrity of the Hong Kong economy. Both China and Hong Kong have a responsibility to make sure that the territory's economic autonomy is not compromised in order to maintain investor confidence and thus Hong Kong's status as an international financial centre.

Appendix

Data on Chinese companies were collected in Hong Kong from three major sources. Studies conducted by investment banks and asset management firms were important for the insight they were able to provide into Chinese business activity. The research utilised the firms' detailed knowledge of the Hong Kong and Chinese markets to compile extensive reports into the operations of Chinese companies listed on the SEHK, otherwise known as red chips. I acquired these published studies in meetings with analysts from the various securities firms. A second source was published information from the Hong Kong Chinese Enterprises Association (HKCEA), the chamber of commerce for Chinese businesses in Hong Kong. Their membership directory revealed information about the number and scope of businesses in the territory. The HKCEA Annual Report detailed the history of certain companies as well as providing a unique insight into some of the reasons for Chinese company involvement in the Hong Kong economy. Data was also acquired from sources at the Hong Kong Trade Development Council library. These included newspaper articles, trade publications, and individual company reports.

The table lists 11 Chinese companies, nine of which have listed representation on the SEHK. Each company reports to a ministry or agency at the state, as opposed to the provincial, level. For each company its primary area of business is detailed, including what companies it may own or have a share in and in what other activities it may be involved in that sector. The table also specifies the secondary business operations of each company, if relevant. Typically, only the business activities of Chinese companies in Hong Kong are listed, while operations in China are omitted.

The evidence reveals that these 11 companies, which compose a fraction of the 492 companies which are members of the HKCEA, control a large portion of the

Hong Kong economy. CITIC Group, which is the most successful of Chinese companies, controls 25% of Cathay Pacific, Hong Kong's flagship airline, and 28.5% of Dragonair, the regional airline carrier. It also has a 20% stake in China Light and Power, a Hong Kong energy company. (These aren't even its primary business sector, which is infrastructure development.) Shipping and banking are Hong Kong's two largest industries, and Chinese companies have a massive presence in both sectors. Four of these conglomerates control banks which have branches and/or have their company headquarters in Hong Kong. In the shipping industry, four of these companies have shipping and trading interests, and all four operate terminals at various Hong Kong dockyards. China Merchants Group operates the largest barge fleet in the territory as well as owning numerous other vessels which transport everything from oil to cargo to passengers. China Travel Service is one of two authorised agents to handle railroad cargo between China and Hong Kong, and subsequently it has a 70% market share of Hong Kong bound rail freight. All of these companies but two own substantial property in the territory and are involved in property development.

While this list is designed to be as comprehensive as possible, not all Chinese business activity has been able to be accounted for. However, a range of sources were consulted and the evidence drawn from the research reveals the great extent to which Chinese companies are involved in the Hong Kong economy. One can conclude from this evidence that Chinese businesses have internalised certain market activities in Hong Kong which they believe are vital to their company strategy and operations. That is to say, Chinese companies view expansion into Hong Kong as an important part of their corporate growth.

company	CITIC Group	COSCO Hong Kong	China Merchants Group
reports to	State Council	Ministry of Communications	Ministry of Communications
listed companies	CITIC Pacific	COSCO Pacific	China Merchants Holdings Intl.
	Ka Wah Bank	Shun Shing (COSCO Land)	
	Continental Mariner	Lai Sun Hotels	
primary area of business	*infrastructure:*	*shipping and trading:*	*shipping and trading:*
	--Hong Kong tunnels	--container leasing and manufacturing	--largest barge fleet in Hong Kong
	--20% Tsing Yi MTR	--container terminal operation	--wharves
	development		--20% stake in Modern Terminals dockyards
			--13% Western Harbour Crossing
			--Kennedy Town Terminals
			--wharehouses in Western District
			--ocean going oil tankers, container ships, and
			coastal merchant vessels providing transport
			services between China and HK
other areas of business	*airlines:*	*tourism:*	*property and construction:*
	--25% Cathay Pacific	--hotels	--property in Western District
	--28.5% Dragonair		--CMG No.1&2 Godown
			--China Merchant Building
	power:		--redevelopment of shipping site
	--20% China Light & Power		--Chun Wo Holdings
	property and construction:		*banking:*
	--property investment		--Union Bank
	--property developments		
	--50% Hong Kong Resorts		*tourism and travel:*
			--runs fourth largest tourism co. in China
			--16 hotels in HK and China
			--CM Intl Travel Services Ltd.

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company	China Travel Service (Holdings)		China Overseas Holdings
reports to	Overseas Chinese Affairs Office		Ministry of Construction
listed companies	China Travel Intl. Investment		China Overseas Land
primary area of business	*travel and tourism:*		*property and construction:*
	--largest travel and tour operation in HK		--residential property development
	--20% of Citibus		--investment and management in office
	--fleet of Turbo Cat passenger boats		and commercial properties
	--hotels		
	--monopoly on running Mainland		
	group tours to HK and Macau		
other areas of business	*shipping and trading:*	*property and construction:*	*banking and finance:*
	--one of two authorised agents	--property development in	--investment management
	for handling railroad cargo between	Tai Po and Chiwan, HK	
	China and Hong Kong		
	--10% in freight-forwarding centre at	*infrastructure:*	
	Chep Lap Kok	--Route 3	
	--monopoly on Mainland-bound rail		
	freight from HK	*airlines:*	
	--10% in consortium to build and	--5% of Cathay Pacific	
	operate air cargo handling facility	runs HK's largest charter	
	at Chep Lap Kok	flight co.	
	--70% market share of HK bound		
	rail freight	*banking and finance:*	
		--investment management	

company	**China Resources Holdings**		
reports to	Ministry of Foreign Trade and		
	Economic Cooperation		
listed companies	China Resources Enterprise		
	Ng Fung Hong		
primary area of business	*shipping and trading:*		
	--warehouse and storage in HK	--China Resources Textiles Co.	
	--10% of Hongkong Intl. Terminals	accounts for 90% of poly-cotton	
	--cargo/container fleet	imports into HK annually	
	--wharfs and terminals	--cold storage operation estimated	
	--dominates commodity trade between	to have 30% market share in HK	
	China and HK		
other areas of business	*property and construction:*	*banking and finance:*	*infrastructure:*
	--property development projects	--50% Hong Kong Chinese Bank	--Route 3
	--owns co.s that are building residential,	--investment management	--Tait's Cairn Tunnel
	office, and commercial complexes in		
	HK and China	*consumer products and retail:*	*metals and mining:*
		--Chinese Arts and Crafts	--CR Metals and Minerals
	foods:	--CRC Dept. Stores	(one of HK's largest concrete
	--food distribution		and steel product importers)
	--supermarkets	*industrial:*	
	--Ng Fung Hong	--China Resources Machinery	*oil exploration:*
	--supplies HK with 30% of its annual	(machinery trading in HK)	--oil terminal
	foodstuff imports	--CR Petrochemicals Group	--China Resources Petroleum
		(25% of HK petrol market)	and Chemicals Co. imports 25%
	telecoms:	--CR Textiles	of HK's petroleum
	--People's Phone	(largest silk and cloth trader	
		in HK)	

company	**China Everbright Group**	**Poly Group Corp.**	**China National Aviation Corporation**
reports to	State Council	People's Liberation Army	Civil Aviation Administration
listed companies	China Everbright International	Poly Investment Holdings Ltd.	
	China Everbright IHD		
	China Everbright Tech		
primary area of business	*industrial:*	*property and construction:*	*airlines:*
	--manufacturing	--commercial and residential	--Dragonair
		property developments	
other areas of business	*telecoms:*		*travel and tourism:*
	--8% Hong Kong Telecom		--CNAC Travel Sevice Co. Ltd.

company		Bank of China Group		China Telecom
reports to		State Council		
listed companies		--		--
primary area of business		*banking and finance:*		*telecoms:*
		--Bank of China HK-Macau		--5.5% Hong Kong Telecom
		regional office		
		--insurance		
		--investment management		
other areas of business		--		--

Glossary of commonly used terms and abbreviations

APEC	Asia Pacific Economic Cooperation, free trade organisation for Pacific Rim nations
AMCHAM	American Chamber of Commerce
Basic Law	Constitution for Hong Kong under Chinese rule; written by drafting committee made up of Chinese and Hong Kong citizens
BHKF	Better Hong Kong Foundation, group formed by wealthy Hong Kong businesspeople to promote Hong Kong as a place to do business; typically supportive of China
CSRC	China Securities Regulatory Commission
Co-Hong	group of Chinese merchants entrusted with exclusively trading with foreign merchants at the southern Chinese port city of Guangzhou (Canton) in the first half of the 19th century
Democratic Alliance for the Betterment of Hong Kong	Pro-Beijing (meaning sympathetic to China) Hong Kong-based political party
ExecCo	Executive Council of Hong Kong, the Chief Executive's cabinet
HKCEA	Hong Kong Chinese Enterprise Association, chamber of commerce for Chinese companies in Hong Kong
HKMAO	Hong Kong Macao Affairs Office, Chinese ministry responsible for policy formation regarding Hong Kong and Macao
HKMA	Hong Kong Monetary Authority, Hong Kong's quasi-central bank
HKSAR	Hong Kong Special Administrative Region

HKTDC	Hong Kong Trade Development Council, government body responsible for promoting Hong Kong trade
hongs	The traditional British merchant companies in Hong Kong, including Swire's and Jardine Matheson
ICAC	Independent Commission Against Corruption
Joint Declaration	Official agreement between the People's Republic of China and the United Kingdom which allows for Hong Kong to be handed back to China at midnight 30 June 1997; registered as an international treaty with the United Nations
Joint Liaison Group	body made up of Chinese, British, and Hong Kong officials who have been entrusted with managing certain aspects of the handover such as re-writing Hong Kong laws to agree with the Basic Law
LegCo	Legislative Council
Liberal Party	Pro-business Hong Kong-based political party; strongly supports executive-led government
MOFTEC	Ministry of Foreign Trade and Economics
National People's Congress	China's legislature
Political Party Conference	Political congress of the Chinese Communist Party which meets every four years to decide policy issues and determine leadership positions
PLA	People's Liberation Army, China's national army
PRC	People's Republic of China
Preparatory Committee	150-member committee appointed by China, given the task of dealing with issues related to the handover; responsible for appointing the Selection Committee
Provisional Legislature	Legislature appointed by Selection Committee which would assume power in July 1997 until a new legislature could be elected; created because a suitable legislature which would sit through the handover was not agreed between Britain and China
SEHK	Stock Exchange of Hong Kong

Selection Committee	400-member committee responsible for electing the Provisional Legislature and the Chief Executive for Hong Kong who would take power in July 1997
SEZ	Special Economic Zone
SOE	State-owned enterprise
TVE	Township/village enterprise
WTO	World Trade Organisation
Xinhua	New China News Agency—China's unofficial representation in Hong Kong when the territory was under British sovereignty

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