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Reflections on the Economic Future of Hong Kong

Ted Hagelin

ABSTRACT

This Article assesses the economic future of Hong Kong after reunification with China. After reviewing Hong Kong's economic history, this Article discusses Hong Kong's present economic situation, and both the positive and negative influences on its economic future. The author identifies China's self-interest in Hong Kong's continued economic prosperity as a positive factor for Hong Kong's economy. China's self-interest stems largely from the recognition that Hong Kong's economic failure will impact China's politics, economics, and foreign relations. Negative developments within China, however, could lead to a precipitous downturn in Hong Kong's economy. Negative developments include potential military and political crises, government corruption, and further deterioration of U.S.-China relations. The article concludes, however, that Hong Kong continues to offer a highly favorable business environment for international investors, especially for U.S. businesses. Furthermore, Hong Kong will continue to offer a more stable investment environment than many other countries in Asia, Latin America, and Eastern Europe.

Mah jiù paa. Mouh jiù tiuh.
The horses will go on running.
The dancing will continue.

Deng Xiaoping's Pledge, in Cantonese,
to the People of Hong Kong

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1. PAUL THEROUX, KOWLOON TONG, Preface (1997).
I. INTRODUCTION

The reunification of Hong Kong, one of the world’s premier free market economies, with the People’s Republic of China (hereinafter P.R.C.), one of the world’s last remaining communist states, is an unprecedented political feat. Never before has a communist country attempted to absorb an autonomous, fully developed capitalist economy. Change of this magnitude inevitably creates great uncertainty. Every step is a first step, sometimes forward and sometimes backward. The three areas of uncertainty that have preoccupied observers of Hong Kong are politics, economics, and the relationship between the two.2 Other

contributors to this symposium have considered the possible political consequences of Hong Kong's reunification. This Article will focus on the realm of economics and will comment on the state of other institutions only as they impact Hong Kong's economy.

The economic consequences of reunification for Hong Kong are a matter of great concern for investors around the globe, but especially for those in the United States. The United States is Hong Kong's second largest trading partner after China. Additionally, Hong Kong is currently the world's eighth largest trading economy and tenth most important exporter of services. Hong Kong imported fifteen billion dollars worth of goods from the United States in 1995, representing an increase of nearly thirty percent over 1994. The United States is the second largest investor in manufacturing in Hong Kong, with eighty-eight factories, over eighteen thousand workers, and $2.6 billion in sales in 1995. Hong Kong is also vitally important to U.S. trans-Pacific trade, which totalled $409 billion in 1994, more than fifty percent greater than U.S. trans-Atlantic trade. Finally, Hong Kong is a major gateway for U.S.-China trade, with forty-two percent of U.S. exports to China and sixty percent of U.S. imports from China passing through Hong Kong.

This Article attempts to gauge the economic future of Hong Kong. Many disparate factors serve to shape a country's economy and direct its future course. These factors, which span the realms of military, political, legal, economic, and foreign policy affairs, are carefully assessed by investors to determine the aggregate risk exposure associated with an investment in a given country. Investor assessment of these environmental risks then determines the minimum level of financial return required on an investment in one country as opposed to another. Although these risks are often amorphous and difficult to quantify, international financial markets reduce these risks to a very

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4. Id. at 1.
6. Id.
7. Id.
8. Id.
specific rate of return. Ultimately, the greater the risk, the
greater the return required by investors and the higher the cost of
capital to a country. Today, countries around the world compete
for international investment funds. Those countries which can
provide low risk, stable investment environments will attract more
international capital at a reduced capital cost. This is the context
in which this Article examines Hong Kong's economy.

Recognizing the hazards of prediction and following
Shakespeare's prescription that the past is prologue to the future,
this Article first briefly reviews Hong Kong's economic history and
current economic circumstances. It then considers the positive
and negative influences on Hong Kong's economy. This
discussion is organized around a number of different
environmental influences, which are likely to contribute positively
to Hong Kong's future economic growth. Then, the Article reviews
some particular events, which the author believes could have a
negative impact on growth. This discussion covers an array of
concerns raised in the context of the unique tripartite relationship
that exists among the United States, Hong Kong, and China, as
well as by the relationship among the United States, Taiwan,
Japan, and South Korea.

The overall balance of these circumstances points to a highly
favorable investment climate in Hong Kong for years to come, but
there are events that could cause a precipitous downturn in the
Hong Kong economy. The United States has an important role to
play in encouraging stability and growth in Hong Kong, and in
Southern China generally. The prime beneficiaries of a carefully
crafted U.S. trade policy for the region would be U.S. businesses,
especially small and medium-sized companies.

II. HONG KONG'S ECONOMY: PAST AND PRESENT

Signs of prosperity abound in Hong Kong from the number of
Rolls-Royces and exclusive shops to high-rise office buildings and
never-ceasing harbor reclamation projects. First-time visitors to
Hong Kong often compare it to New York City, and there is a
striking similarity between the Hong Kong Island skyline viewed
from the Tsim Sha Tsui promenade and the Manhattan skyline
viewed from the Brooklyn Heights promenade. Closer inspection,
however, reveals an important difference between the two
metropolises. Unlike that of Manhattan, the Hong Kong skyline is
composed of ultra-modern buildings, few over twenty years old.
The modernity of Hong Kong, reflected also in its transportation
systems and public facilities, reminds one that Hong Kong's
prosperity is of relatively recent origin.
A. Early Economy

During the millennia of governance by Imperial China, Hong Kong was primarily a fishing village with a subsistence economy.\textsuperscript{11} A rocky island with steep hills, Hong Kong was merely one of hundreds of other islands scattered throughout the Pearl River estuary and was considered of little importance to China or to foreign explorers of the time. Hong Kong was either omitted or unrecognizable on Chinese maps of the Ch'ing period (1644-1911) and did not appear on any maritime charts until 1760.\textsuperscript{12} The Portuguese, who were the first European explorers in the region in the sixteenth century, chose the Macao peninsula, on the other side of the Pearl River delta, over Hong Kong as a settlement site. Hong Kong, however, did offer foreign travelers a safe port while waiting for the annual change in the prevailing winds in the South China Sea, but only at the risk of attack by the numerous pirates who also took shelter in the many coves and bays of the Pearl River estuary.\textsuperscript{13}

The great commercial center of Southern China at that time, and the principal destination of foreign traders, was Canton. Situated at the headwaters of the Pearl River some seventy miles upstream from Hong Kong, Canton was the gateway to mainland China. Foreign trade through Canton in 1831 was estimated to be nearly $50 million, with opium by far the largest foreign import, and tea and silk the largest foreign exports.\textsuperscript{14} The ceding of Hong Kong to Britain in 1842, followed by the ceding of the Kowloon Peninsula in 1860, and the ninety-nine year lease of the New Territories in 1898 were the result of Britain's insistence upon free trade in opium backed by overwhelming military force.

Hong Kong's economy expanded during the early colonial period, but was still primarily dependent upon the opium trade with mainland China.\textsuperscript{15} This was the era of the great British trading hongs fictionalized in James Clavell's novels.\textsuperscript{16} The two largest of the original hongs were Jardine Matheson and its arch

\textsuperscript{11} In an account of an early discussion regarding Hong Kong held in the Grand Council of China in Peking circa 1843, Hong Kong is referred to as a barren, isolated island which provided a lair for pirates, but is otherwise uninhabited except for a few dozen scattered families of poor fishing folk. \textit{See Frank Welsh, A Borrowed Place: The History of Hong Kong} 11-13 (1993).

\textsuperscript{12} \textit{Id.} at 13.

\textsuperscript{13} \textit{Id.} at 11-13.

\textsuperscript{14} \textit{Id.} at 47.

\textsuperscript{15} Trade in opium was not, in fact, banned in Hong Kong until the conclusion of World War II. \textit{Id.} at 364.

\textsuperscript{16} \textit{See James Clavell, Noble House} (1981); \textit{James Clavell, Tai-Pan} (1966).
rival, Dent's. Over time, the hongs expanded the scope of trading activities beyond opium (although Jardine Matheson to this day uses the poppy flower as its corporate logo) and developed extensive docks and warehouses on the Hong Kong Island side of what had become Victoria Harbor. All in all, however, the first hundred years of British rule of Hong Kong saw only modest economic growth based almost entirely on shipping and trade, as well as smuggling.

B. Economic Expansion

The first stimulus to a manufacturing economy in Hong Kong came during the 1950s when Hong Kong's role as a trade entrepot for southern China was suddenly terminated by a United Nations declared blockade of China. Hong Kong's fledgling manufacturing industries, many led by immigrant Shanghai businessmen, grew throughout the 1950s, primarily producing inexpensive toys, textiles, and low-end electronic products. The Vietnam War gave further impetus to Hong Kong's expanding manufacturing base through the 1960s. However, it was not foreign events, but social chaos in China, that irrevocably altered the course of Hong Kong's economic future.

During China's Cultural Revolution (roughly 1963-1976), millions of mainland Chinese fled to Hong Kong to escape the ravages of anarchy and economic deprivation. The new immigrants gave Hong Kong an abundance of low-wage labor, which quickly attracted foreign investment in a variety of new manufacturing plants. Although relatively low skilled, Hong Kong's immigrant labor pool possessed a boundless determination to succeed, and the discipline and dedication necessary to master new skills.

17. Welsh, supra note 11, at 52.
18. See Michael J. Enright et al., The Hong Kong Advantage 5 (1997).
19. See Made By Hong Kong 16-17 (Suzanne Berger & Richard Lester eds., 1997).
20. For a discussion of Hong Kong's historical development, see Yin-Ping Ho, Trade, Industrial Restructuring and Development in Hong Kong 1-16 (1992). For a discussion of the changes produced by the renewal of relations between Hong Kong and Guangdong in 1979, see The Hong Kong-Guangdong Link: Partnership in Flux 49-59 (Reginald Kwok & Alvin So eds., 1995).
21. For a discussion of Hong Kong's historical development, see Ho, supra note 20, at 1-16. For a discussion of the changes produced by the renewal of relations between Hong Kong and Guangdong in 1979, see The Hong Kong-Guangdong Link, supra note 20, at 49-59.
It was during the decade of the 1980s that Hong Kong's economy finally reached its full potential. This growth was fueled not only by the maturation of Hong Kong's labor force and economic institutions, but also by changes across the border in China. With the ascension of Deng Xiaoping in 1979, China embarked on a series of radical economic reforms. Foremost among these reforms was the establishment of "special economic zones" (hereinafter SEZs), which were to operate as free trade centers to attract foreign investment and technology. Shenzhen, across the border from the New Territories and a less than an hour train ride from Kowloon, was designated by Deng as the first of the SEZs. The impact on Hong Kong was immediate. Shenzhen offered a new, low-wage labor pool, inexpensive land, and substantial tax advantages. Investors in Hong Kong quickly began moving their manufacturing operations to Shenzhen, and Hong Kong began the transition to a service-based economy, providing financial, legal, and managerial support for the new manufacturing enterprises.

C. Hong Kong Today

Hong Kong has emerged from a "barren island" a hundred years ago, to one of the world's foremost commercial centers. The influence of Hong Kong's global economy reaches far beyond Hong Kong's tiny geographical bounds, relatively small population, and limited natural resources. By 1996, Hong Kong's per capita Gross Domestic Product (hereinafter GDP) had risen to about $25,300, only slightly below that of the United States, and its annual GDP growth from 1985-1995 averaged six percent, approximately double that of the United States. Unemployment during this same period has averaged under two percent, well below the average in the United States.

22. See Ho, supra note 20, at 1-16; THE HONG KONG-GUANGDONG LINK, supra note 20, at 49-59.
24. See ENRIGHT ET AL., supra note 18, at 53.
25. See HONG KONG: OPPORTUNITY ASIA, supra note 3, at 1-2; Comment & Analysis; Statistics; Tables; Forecast, BARCLAYS BANK INT'L FIN. OUTLOOK, Aug. 1997, at 38. For a discussion of the structural changes brought on by economic growth, see GAVIN PEEBLES, HONG KONG'S ECONOMY: AN INTRODUCTORY MACROECONOMIC ANALYSIS 69-72 (1988). Hong Kong's GDP growth, however, has slowed in recent years. See FROM COLONY TO SAR: HONG KONG'S CHALLENGES AHEAD 120 (Joseph Y.S. Cheng & Sonny S.H. Lo eds., 1995) [hereinafter FROM COLONY TO SAR].
Hong Kong confronts the same economic problems as other developed nations, including inflation, underemployment, income inequality, and adherence to a conservative fiscal policy in the face of demand for new social programs. Nonetheless, Hong Kong's spectacular economic growth has attracted investment from around the world. Eighty-five of the top 100 banks in the world have operations in Hong Kong; more than 750 corporations have located their regional headquarters in Hong Kong; and over 540 companies are now listed on the Hong Kong stock exchange. In 1995, total assets and liabilities of the Hong Kong banking industry were estimated to be over one trillion dollars and total market capitalization for the 542 public companies listed on the Hong Kong Stock Exchange was over $300 billion. Hong Kong's service sector today accounts for over eighty-three percent of its GDP. Professional services, including banking, finance, insurance, management, law, and science and engineering, constitute an ever-increasing share of the service sector.

For many years, Hong Kong government policy has been designed to create a favorable investment climate for business enterprises. Hong Kong's relatively low personal income tax rate (currently 15%) and corporate income tax rate (currently 16.5%) have remained stable for many years. Hong Kong has no capital gains or sales tax. Low taxes are a substantial inducement to business investment. Hong Kong has also long followed a conservative fiscal policy, rarely incurring a deficit between revenue and spending. This policy has lessened inflationary pressure in the economy and has freed capital for investment in the private sector. Finally, Hong Kong has pegged the Hong Kong dollar to the U.S. dollar at the rate of HK$7.8 to US$1.0. This dollar peg has remained fixed since 1983, making the Hong Kong dollar highly stable. This stability, coupled with Hong Kong's large foreign currency reserves, protects the Hong Kong dollar against the currency speculation experienced by other countries in the Far East.

27. See FROM COLONY TO SAR, supra note 25, at 137-46.
29. See HONG KONG: OPPORTUNITY ASIA, supra note 3, at 5.
30. See U.S. AND HONG KONG: SOME IMPORTANT FACTS, supra note 5.
31. See HONG KONG: OPPORTUNITY ASIA, supra note 3, at 3. There is some debate in Hong Kong, however, over the most appropriate investment strategy for the SAR in the future. See FROM COLONY TO SAR, supra note 25, at 127.
32. For a discussion of the linked exchange rate and macroeconomic policy, see MANAGING THE NEW HONG KONG ECONOMY, supra note 28, at 54-75.
Hong Kong's laws are also designed to encourage investment. As part of the reunification process, Hong Kong was required to undertake massive revisions of its domestic laws to assure their compliance with the provisions of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (hereinafter Basic Law). Hong Kong's new laws continue to protect investor interests and, in some cases, expand investor rights. Intellectual property rights were particularly important in Hong Kong's law reform efforts. Hong Kong has adopted new laws governing patents, copyrights, trademarks, and integrated circuits, and is now in full compliance with the requirements of the Trade Related Aspects of Intellectual Property Agreement of the World Trade Organization (hereinafter WTO). The strengthening of Hong Kong's intellectual property laws will encourage investment in technology-related fields such as research, development, testing, and advanced manufacturing.

Hong Kong's rich pool of professional workers is built upon an excellent educational system. About one quarter of Hong Kong's young people receive a university degree, with engineering, information technology, computer science, and management the most popular majors. There are seven government-financed universities in Hong Kong, with a total enrollment of over seventy thousand students. Hong Kong funds two technical colleges and seven technical institutes, which enroll over seventy thousand students. Public spending on education is backed by a deep cultural tradition that prizes education for the opportunities it brings. Education is serious business in Hong Kong, and all parents work to see that their children attend the best schools and receive the best grades.

Hong Kong has also invested in its physical infrastructure to support its service economy. Hong Kong has developed a state-
of-the-art telecommunications system and boasts of more cellular phones and more miles of fiber optic cable per capita than any other nation. Hong Kong also has modern sea, road, rail, and air transportation systems, which are continually improved. The new Chek Lap Kok airport and connecting bridges (the largest capital construction project in the history of the world), a new container terminal and harbor tunnel, and a major new west coast rail line to China are among the more noteworthy of Hong Kong's current capital construction projects. This infrastructure investment will allow for efficient market transactions in Hong Kong over the next two decades by facilitating the exchange of business information, enabling the provision of new professional services, and speeding up the transportation of goods.  

Finally, Hong Kong enjoys unique advantages of geography and geology. Hong Kong is situated in the middle of major shipping routes between East Asia, Europe, and North America. Hong Kong also occupies a strategic location within China, sitting on the southeastern edge of the Pearl River estuary, through which passes over thirty percent of China's foreign trade. Furthermore, Hong Kong provides container ships one of the finest natural deep-water harbors in the world (as well as one of the most modern port facilities). In Chinese cosmology, Hong Kong has excellent "feng shui."  

As if to emphasize Hong Kong's economic achievements or to express investor optimism in Hong Kong's economic future, the economy soared in 1997. In the period leading up to the handover of Hong Kong on June 30, 1997, the Hang Seng Index (the Hong Kong stock exchange equivalent to the Dow Jones Average) regularly reached new record highs and real estate prices nearly doubled.

38. Hong Kong's explosive economic growth has brought with it a number of serious environmental challenges. See MANAGING THE NEW HONG KONG ECONOMY, supra note 28, at 127-45.
40. Feng Shui (pronounced "fung shoy") is based on ancient Chinese principles of geomancy which seek to establish a desired harmony between all things in nature. Within this system of relationships, some are favored and some are disfavored. Earth, sky, wind, water, magnetism and energy are consulted to determine the preferred location, shape, arrangement and orientation of objects. Although feng shui might seem a strange and inexact art, in China a feng shui expert is consulted before construction of every building.
D. Hong Kong-China Relations

Hong Kong's economy has become inextricably intertwined with that of China. Hong Kong is China's largest trading partner, accounting for approximately one third of China's foreign exchange earnings. It is estimated that seventy percent of commercial investment in China today either originates in, or flows through, Hong Kong. Hong Kong direct investment in China by the end of 1995 was estimated to be about $70 billion, while Chinese direct investment in Hong Kong was estimated to be about $25 billion, over $20 billion of which was invested in real estate between 1993 and 1994. Eighteen Chinese banks are registered in Hong Kong, seventeen major Chinese state enterprises are listed on the Hong Kong stock exchange (the so-called "red chip" companies), and mainland Chinese companies have invested heavily in virtually all of Hong Kong's major infrastructure projects.

China is a vast and complex country undergoing profound political, social, and economic changes. Within China, powerful forces (represented primarily by party, government, and military institutions) compete over resources, authority, and policy objectives. China's relationship with Hong Kong reflects the complexity of this process as well as the very different histories of China and Hong Kong over the past 150 years. Hong Kong's prosperity and its liberal political and economic institutions have stood in marked contrast to developments in mainland China for most of this century. This disparity has long strained China-Hong Kong relations, and has posed troublesome questions for

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43. See HONG KONG: OPPORTUNITY ASIA, supra note 3, at 11. See also Enright, supra note 28, at 9.
45. See HONG KONG: OPPORTUNITY ASIA, supra note 3, at 11.
46. See Skeen, supra note 2, at 190 (citing Matt Miller, China Pours Cash into Hong Kong—Down Payment on Future City It Takes Over in '97, SAN DIEGO UNION-TRIB., July 25, 1993, at A1).
47. See HONG KONG: OPPORTUNITY ASIA, supra note 3, at 11.
48. Mark L. Clifford, Red Chips Risky, BUS. WEEK, June 9, 1997, at 50-51. "Red chip" companies also include Hong Kong and non-state-owned companies which have substantial mainland investment.
49. See HONG KONG: OPPORTUNITY ASIA, supra note 3, at 11-12; Ho, supra note 20, at 230-33.
51. These disparities have fueled resentment on the mainland. See THE HONG KONG-GUANGDONG LINK, supra note 20, at 42.
the Beijing government. British colonial rule of Hong Kong, of course, further complicated the China-Hong Kong relationship. The Sino-British negotiations on the post-reunification status of Hong Kong, which deteriorated progressively in the months leading up to the handover, revealed deep differences and resentments between the parties.

To the credit of both countries, China and Britain were able to salvage from this difficult situation a set of agreements on Hong Kong's future political and economic status. These agreements grant Hong Kong broad autonomy, which is, however, ultimately subject to Chinese sovereignty and the authority of the National People's Congress (hereinafter NPC) sitting in Beijing. Accordingly, the question is whether China will abide by the terms of these agreements and govern Hong Kong in a way that will support its existing public and private institutions.

Many observers have noted that Britain has no effective recourse in the event China fails to abide by the terms of the Basic Law: economic pressure on China by Britain alone would have little impact, and military enforcement is not an option for Britain. What will motivate China's policy toward Hong Kong in the end will be China's self-interest in pursuing its external and internal national goals. China's overriding external goal is to advance its international stature in order to assume an increasing leadership role in Asia. China's overriding internal goal is to promote the growth of the economy in order to improve its citizens' living standards and attract a continuing flow of foreign investment. China-Hong Kong relations, then, must be analyzed within the context of China's self-interests and goals.

E. Hong Kong Tomorrow

Milton Friedman has proclaimed Hong Kong as "perhaps the best example of free trade in the world," and the Heritage Foundation's 1996 Index of Economic Freedom cited Hong Kong as "one of the most accessible markets in the world," with 'very few' barriers to imports and 'virtually no barriers to foreign investors.' Hong Kong has unquestionably achieved the


53. See Ho, supra note 20, at 237-49 (analyzing the Joint Declaration and forecasting post-reversion problems).

54. See Skeen, supra note 2, at 186.

55. See HONG KONG: OPPORTUNITY ASIA, supra note 3, at 1.
economic conditions necessary to sustain substantial future growth. The question is whether Hong Kong can preserve its remarkable economic freedom, and thus continue to grow, while operating under Chinese sovereignty. How will China treat Hong Kong in the future? Which Chinese policies will benefit the Hong Kong economy and which will harm it? What will motivate China to pursue one policy objective over another? The discussion below demonstrates that there is a substantial likelihood of a mutually productive relationship forming between Hong Kong and China, and that this relationship should lead to increased investment opportunities and expanded economic growth throughout the Southern China region.

III. Positive Environmental Influences: China's Stake in Hong Kong's Economic Future

Stable environments encourage investment. Instability in a country's basic social institutions increases investors' risks. In the face of heightened risks, investors either supply less capital or demand a higher rate of return. Both of these situations have a negative effect on a country's economy and on investor confidence in its future. The stability of Hong Kong's basic social institutions in the future will depend heavily upon Chinese policy initiatives.56 Will China be inclined to support Hong Kong's social institutions and stimulate Hong Kong's further economic growth? What internal and external considerations will guide China's policy on Hong Kong? How will China's "one country-two systems" political arrangement with Hong Kong work in practice? How are investors to interpret China's often stated economic goal of pursuing a "socialist market economy"? These questions are addressed below in terms of the legal, political, economic, and foreign policy environments in which the China-Hong Kong relationship will operate.

A. The Legal Environment

The starting point for any discussion of the legal environment surrounding China's relationship to Hong Kong is the Basic Law, under which China has pledged to govern Hong Kong for the next fifty years. The Basic Law establishes Hong Kong as a Special Administrative Region (hereinafter Hong Kong SAR) which is entitled "to exercise a high degree of autonomy and enjoy

executive, legislative and independent judicial power.”

Chapters 5 and 6 of the Basic Law deal specifically with the economic status of Hong Kong and explicitly set forth the following key points:

- The Hong Kong SAR is directed to “protect the right of individuals and legal persons to the acquisition, use, disposal and inheritance of property.”

- The Hong Kong SAR is granted the right to have independent financial, taxation, and monetary systems.

- The Hong Kong SAR is granted the right to “use its financial revenues exclusively for its own purposes” and expressly exempted from taxation by the Central People’s Government.

- The Hong Kong SAR is urged to pursue policies which promote “free trade and safeguard the free movement of goods, intangible assets and capital,” and which also encourage “investments, technological progress and the development of new industries.”

The Basic Law, however, also contains two important qualifications to Hong Kong’s autonomy. First, the NPC is granted final authority to interpret the provisions of the Basic Law. The scope of Hong Kong’s autonomy, therefore, is ultimately dependent upon decisions made in Beijing. Second, although the Basic Law grants Hong Kong broad economic freedom, it also commands that Hong Kong operate on a balanced budget. Article 107 of the Basic Law states:

The Hong Kong Special Administrative Region shall follow the principle of keeping expenditures within the limits of revenues in drawing up its budget, and strive to achieve fiscal balance, avoid deficits, and keep the budget commensurate with the growth rate of its gross domestic product.

Again, the NPC has final authority to monitor Hong Kong’s fiscal operations and to approve its annual budget. This authority gives the NPC considerable de facto power over Hong Kong’s budget process and, ultimately, over Hong Kong’s choice of economic

57. Basic Law, art. 2.
58. Id. art. 105.
59. Id. arts. 106, 110, 111.
60. Id. art. 106.
61. Id. art. 115.
62. Id. art. 118. Specifically, Articles 139 and 140 provide for Hong Kong to maintain its own intellectual property system and to remain a separate cultural jurisdiction from the rest of China. See also Hong Kong’s Transition to Chinese Sovereignty; Legal and Business Issues, US-China Business Council, Oct. 1996, at 20.
63. Basic Law, art. 107.
The generality of the language used in the Basic Law affords China considerable policy discretion in exercising its ultimate political and budgetary powers. The question is whether China will opt for policies with regard to Hong Kong that support the tenets of the Basic Law—political and economic autonomy for Hong Kong and free trade among Hong Kong, China, and the world.

There are good reasons to expect that China will abide by the spirit, as well as the letter, of the Basic Law. At their core, these reasons reflect China's need to establish the legitimacy of its own laws and legal institutions, both externally and internally. Legitimacy is used here in the sense of respect for, and trust in, a nation's legal system regardless of disagreement with substantive provisions of the law. Externally, legal legitimacy is important for China to assure the dozens of other countries with which China has treaty relationships that China will fairly interpret and fully abide by the terms of its international agreements. China's long sought membership in the WTO has added to the importance of legal legitimacy as a policy goal. As a member of the WTO, China will become subject to a wide range of international obligations, many of which will require changes in Chinese domestic laws and practices. It is important for China to persuade the present WTO member states that it has the competence and commitment to uphold international laws. China has a long history of abiding by international agreements. It adhered to various British treaties through the most xenophobic Maoist years, despite non-recognition of these treaties by the P.R.C. government and despite universal P.R.C. claims that these treaties were unjust in their creation and execution. China will likely seek to affirm this tradition in its legal relations with Hong Kong.

Legal legitimacy is also important for China in its internal affairs. A mere twenty-five years ago, China was a lawless society, ruled by Red Guard mobs and the personal whims of young party cadres. The lawlessness of this era was pointedly

64. See From Colony to SAR, supra note 25, at 146-49.
65. Article 17 specifically states "the Standing Committee may return any law in question" that is "not in conformity" with the Basic Law. Basic Law, art. 17.
66. See Barclays Bank Int'l Financial Outlook, supra note 25, at 38.
68. See Larry Yung et al., Risk, Guanxi and 40% Luck: An Interview with CITIC Pacific Chief Larry Yung, Time Asia (Int'l ed.), June 30, 1997, at 22.
69. See Ho, supra note 20, at 242 (quoting Jao, Y.C., Hong Kong's Future as a Financial Centre, Issues & Studies, June 1986, at 121).
evident in the attacks on the legal profession. Lawyers were one of the most persecuted groups throughout the Cultural Revolution. As a result of these attacks, China emerged from the Cultural Revolution with no laws and with a woeful lack of competent lawyers.  

Against this backdrop, China began to rebuild its legal system beginning in the early 1980s. Re-establishing a functioning legal system was important for both symbolic and practical reasons. A functioning legal system symbolized a return to normalcy for the Chinese people and provided the crucial framework for the new forms of commerce necessary to revitalize the slumbering economy. The legal reforms that China has undertaken in the last fifteen years have affected every facet of Chinese society. In the realm of economic law alone, China has enacted a plethora of statutes and regulations, governing such matters as domestic and foreign contracts, foreign direct investments, business organizations, technology transfers, intellectual property rights, real estate transactions, banking operations, and securities markets. Despite persistent U.S. criticism of the Chinese legal system, arguably no nation in history has achieved more massive legal reform in so short a time.

China's pride in its evolving legal system, and its appreciation of the importance of the rule of law in its domestic history and its future international relations, are likely to motivate China to abide by a fair and reasonable interpretation of the provisions of the Basic Law.

B. The Political Environment

China also has a significant political stake in the continuation of Hong Kong's economic prosperity. China understands that the surest way to achieve political authority in Hong Kong is to expand the Hong Kong economy. The great majority of Hong Kong citizens accepted long ago the realities of reunification. As long as this constituency is afforded continued economic opportunity, there will be few meaningful challenges to Beijing's governance. The reverse situation, however, could pose serious problems for China. In the face of a strong economy, Hong Kong residents are borrowing, and Hong Kong banks are


lending, at record levels, especially in the real estate market.\textsuperscript{73} A major downturn in the economy could precipitate a decline in real estate prices, which, in turn, could threaten the solvency of many hundreds of thousands of families, commercial enterprises, and banks in Hong Kong.\textsuperscript{74} This chain of events would surely increase Hong Kong's political instability, especially if such a downturn was blamed on policies emanating from Beijing. China clearly hopes to avoid this scenario.

China's stake in Hong Kong's future prosperity is also dictated by its international political aspirations. China would like to be recognized as an economic superpower in the twenty-first century and needs positive external perceptions of its governmental policies and administrative efficiency to achieve this status. The cornerstone of China's economic policy reforms is the establishment of SEZs, free market zones in a number of coastal cities. The ideological contradictions and practical incompatibility of nurturing market economies within a communist country have been bridged by China through the concept of a "socialist market economy."\textsuperscript{75} Like the concept of "one country-two systems," the concept of a "socialist market economy" has met with skepticism, especially among Western countries. China is anxious to demonstrate the soundness of its economic policies and institutional arrangements in order to combat these international reservations.\textsuperscript{76} Credibility in these areas is a matter of "face" to China.\textsuperscript{77}

Hong Kong poses the toughest test yet to China's hybrid economic policies. Hong Kong enjoys far more economic freedom than the mainland SEZs and has a far more developed private market economy. Beijing officials understand that Hong Kong's prosperity will be used as a measure to gauge the efficacy of China's current economic policies and, ultimately, the future direction of the Chinese economy. These considerations are likely

\textsuperscript{73} See Noel Fung, Mainland officials worry over local bubble economy, S. CHINA MORNING POST, May 29, 1997, at 3.
\textsuperscript{74} Id.
\textsuperscript{75} In theory, but not always in practice, China's socialist market economy is directed by central planning in Beijing but implemented through private market mechanisms in the special economic zones.
\textsuperscript{76} See Mushkat, supra note 50, at 122-24.
\textsuperscript{77} The Chinese concept of "face" involves doing everything possible to protect your own reputation and that of your family and friends, and "stoically accepting the natural and man-made vicissitudes of life." BOYE LAFAYETTE DEMENTE, CHINESE ETIQUETTE AND ETHICS IN BUSINESS 169 (2d ed. 1994). "Face" also involves avoiding actions which cause others to lose face thereby promoting social harmony. Some believe that face is a more powerful motivator of Chinese behavior than traditional Western concepts such as fairness, efficiency and logic. See id. at 181 (stating that face contributes to business inefficiency and social harmony).
to motivate China to play an affirmative role in promoting Hong Kong's economic development and to avoid actions that could be interpreted as contrary to Hong Kong's economic welfare.\textsuperscript{78}

C. The Economic Environment

China's direct financial self-interest in a strong Hong Kong economy is considerable.\textsuperscript{79} Hong Kong has long been the engine of economic growth in the Southern China region and has helped the explosive development of the SEZs in the Guangdong Province.\textsuperscript{80} The Guangdong SEZs are vitally important to the overall Chinese economy. Although other regions of China are also experiencing strong growth, Guangdong will remain a mainstay of the national economy for decades to come. A brief look at Guangdong reveals the magnitude of China's financial interest.\textsuperscript{81}

Guangdong, China's southernmost province, has a population of sixty-five million people, seven million more than Britain, but only six percent of China's total population.\textsuperscript{82} The Guangdong economy has grown rapidly over the last fifteen years and is estimated today to account for over one-third of China's total exports, more than double the export level of six years ago.\textsuperscript{83} Exports, of course, are dearly prized by China because they generate foreign exchange revenue and reserves. Hong Kong's investment in Guangdong has been substantial. It is estimated that in 1995 over four million workers in Guangdong were employed by Hong Kong companies. This workforce was supported by $28 billion worth of investment in Guangdong by more than fifty-three thousand Hong Kong enterprises.\textsuperscript{84}

The three major commercial cities in Guangdong are Guangzhou (formerly Canton), Shenzhen, and Zhuhai.\textsuperscript{85} Of the three, Shenzhen, directly across the border from Hong Kong, has

\textsuperscript{78} See Mushkat, supra note 50, at 112-14, for a more pessimistic set of views on Hong Kong's political and economic future.

\textsuperscript{79} For a discussion of the growing economic relationship between Hong Kong and China, see From Colony to SAR, supra note 25, at 117-25.

\textsuperscript{80} See Skeen, supra note 2, at 204.

\textsuperscript{81} For a good discussion of the history of the Hong Kong-Guangdong relationship, see The Hong Kong-Guangdong Link, supra note 20, at 32-92.

\textsuperscript{82} See Hong Kong: Opportunity Asia, supra note 3, at 12.

\textsuperscript{83} Id.

\textsuperscript{84} Id. at 14.

\textsuperscript{85} Collectively with Hong Kong, these three commercial centers have been referred to as the "South China Economic Circle," the "Pearl River Delta Economic Region," and the "Southern China Economic Zone." This Article will refer to them as "Southern China."
experienced the most dramatic economic growth. Deng Xiaoping was personally responsible for designating Shenzhen as China's first SEZ, a radical reform initiative which ultimately altered the course of China's entire economy. In fifteen years, Shenzhen has changed from a farming village of a few thousand people to a modern metropolis of 3.4 million people. Shenzhen's economy has been growing at the astounding rate of fifteen to twenty percent per year for more than a decade (twenty-three percent in 1995). Shenzhen's GDP was estimated at 71.5 billion yuan ($8.5 billion) in 1995 and is predicted to reach 143 billion yuan ($17 billion) by the year 2000. Its foreign trade reached $38.7 billion in 1995.

Shenzhen's economic growth has been fueled by substantial foreign investment. Between 1979 and 1995, Shenzhen entered into over seventeen thousand foreign investment agreements valued at nearly $21.5 billion. At the end of 1995, more than twelve thousand foreign funded companies were operating in Shenzhen. Hong Kong accounted for approximately sixty-six percent of the total foreign investment in Shenzhen.

The future growth of these Southern China SEZs is unquestionably tied to the performance of the Hong Kong economy. Hong Kong has long provided the Guangdong SEZs, especially Shenzhen, with a rich pool of financial and human capital. In order to continue their substantial economic growth, these Southern China SEZs will continue to draw from, and be dependent upon, Hong Kong's extensive capital investment and professional services. If these resources are diminished because

86. See Shenzen Plays Hong Kong Game, 33 ASIAN BUS. 50-53 (1997); The Hong Kong-Guangdong Link, supra note 20, at 68.
88. Shenzhen Investment Guide 1996, at 10 (Shenzhen Municipal Investment Promoting Center). For a discussion of Shenzhen's unique role in the Guangdong economy, see Greater China, supra note 44, at 91.
89. Shenzhen Investment Guide 1996, supra note 88, at 2. See also Shenzen Plays Hong Kong Game, supra note 85.
91. Id.
92. Id.
93. See Tung Chee-hwa sets out vision of economic development, supra note 72. The Hong Kong-Guangdong economic interdependence is rooted in the regional specialization of skills occurring throughout Asia where countries undergoing a transition from labor-intensive to knowledge-intensive economies play different roles at different times in the Far East Asia market.
94. See The Hong Kong-Guangdong Link, supra note 20, at 80-82.
95. See Sarah Davison, Strong Economy Underpins Hong Kong '97 Confidence, REUTERS N. AM. WIRE, May 21, 1997; The Hong Kong-Guangdong Link, supra note 20, at 180-85 (analogizing Hong Kong's relationship with the Guangdong SEZs to that of the "comprador" with the British trading hongs. The
of a downturn in the Hong Kong economy, the mainland will feel the consequences.96

Although there are indications that the focus of China's economic development efforts is shifting from Southern China to other regions, Guangdong, and especially Shenzhen, will continue to be mainstays of the overall mainland economy for years to come. To the extent China's national economy is dependent upon the Guangdong economy, and the Guangdong economy is dependent upon Hong Kong, China will have a strong incentive to promote Hong Kong's future economic growth.

D. The Foreign Policy Environment

China's stake in Hong Kong is also infused with political concerns for China's future relations with Taiwan.97 The reunification of Taiwan with the mainland has long been China's paramount foreign policy goal. Unlike Hong Kong, the reunification of Taiwan is not based so much on territorial claims as it is on political imperatives. For China, Taiwan represents an unresolved civil war. Until reunification of Taiwan is achieved, the specter of two Chinas will continue to haunt Beijing's leaders and destabilize intra-governmental relations. Beijing clearly understands the connection between the fate of Hong Kong under Chinese sovereignty and the prospects for reunification of Taiwan.98 Taiwan will be the most interested foreign observer of Hong Kong in the post-handover period, and Hong Kong's relative success or failure will surely affect Taiwanese public opinion on the wisdom of rejoining the mainland. This is not to suggest that Hong Kong's economic success will lead easily or inevitably to the reunification of Taiwan with the mainland; it does mean, however, that Hong Kong's continued success would significantly improve prospects for reunification and that its failure would definitely make reunification more difficult.

The reunification of Taiwan will be a far more challenging undertaking than the reunification of Hong Kong. Taiwan's political and economic systems are quite different from those of

\footnotesize{comprador was the senior Chinese officer in a hong, fluent in the local language and knowledgeable about local customs. The comprador often acted as an intermediary between foreign owned hongs and Chinese businesses).}

96. Of course, the professional exchange between Hong Kong and China is two-way, and Hong Kong can benefit from Chinese professional expertise in a number of areas. For example, China is more advanced than Hong Kong in industrial research and development because of China's expansive industrial base. See Ho, supra note 20, at 236.

97. See A Report on China's Economic Future (CNN broadcast, Aug. 7, 1997); MUSHKAT, supra note 50, at 82.

98. See Ho, supra note 20, at 243 (suggesting the possibility that a successful reversion would lead to the reunification of Taiwan).
Hong Kong and would require a unique set of governmental arrangements to be embraced within China's government structure. If China mismanages Hong Kong, many will doubt China's competence to manage the more complex Taiwan reunification, and reunification discussions would be more difficult. This outcome would retard the accomplishment of China's most prized foreign policy objective—the return of Taiwan to the motherland. It would also perpetuate the Chinese status quo, an unstable situation fraught with political and military uncertainty, and postpone closure of the most important chapter in China's modern history.

China's need to demonstrate the success of a reunified Hong Kong to promote the prospects of a reunified Taiwan gives China a powerful incentive to do whatever is reasonable to advance Hong Kong's economic well-being.99 Parallels are already apparent between China's past relationship with Hong Kong and its evolving relationship with Taiwan. The formal governmental relationship now established between Hong Kong and China was preceded by nearly two decades of increasing cross-border investment. Economic integration set the stage for political reunification. A similar pattern is evident today with respect to China and Taiwan. Trade and investment between the two have grown steadily over the last ten years, and Fujian Province, a coastal province directly across the Straits from Taiwan, has become one of China's most rapidly growing SEZs.100 The increasing commercial interaction between China and Taiwan bodes well for a successful reconciliation of the two entities.101

IV. NEGATIVE DEVELOPMENTS: WHAT COULD GO WRONG

Despite environmental circumstances which appear to incline China toward favorable, if not preferential, treatment of Hong Kong, other potential developments could adversely affect the Hong Kong economy. Some of these developments are beyond direct national policy control, such as currency fluctuations and stock market prices, while others are largely subject to the will of the Chinese government. Developments in the latter group that could precipitate a downturn in the Hong Kong economy include potential military and political crises, government corruption,

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99. See Yee, supra note 2, at 630-31.
100. See GREATER CHINA, supra note 44, at 90-93.
101. See id. at 31-33 (referring to the evolving China-Hong Kong-Taiwan economic relationship as "Greater China").
redirection of China's investment incentives, and further deterioration of United States-China relations.

A. Military Developments

The military situation in Asia is complicated by many factors. First, there are two unresolved civil wars: the Taiwan conflict discussed above and the conflict on the Korean peninsula. Second, there is the deep, historic antagonism between China and Japan, the two rival claimants to superpower status in the region. Third, there is the relative independence of military forces throughout Asia, especially the People's Liberation Army (hereinafter P.L.A.) in China. Finally, there is the evolving foreign policy of the United States concerning the U.S. role in the region in particular concerning Taiwan, Japan, and South Korea.

The complex military situation in Asia has generated divergent viewpoints on the prospects for peaceful coexistence there, particularly in light of differing interpretations of China's goals and assessments of China's capabilities. These differing perceptions of China have been sharpened in recent years by domestic constituencies within the United States and China, who view their internal political interests best served through challenge and confrontation between the two governments. A pessimistic perspective regarding China is clearly and thoughtfully set forth in the recent best-seller, *The Coming Conflict with China.*

The authors of *The Coming Conflict with China*, both long-term China watchers, suggest that U.S. and Chinese interests will inevitably collide as China emerges as a military and economic power in Asia. They fear an armed conflict could arise between the United States and China in the event China attempts to reclaim Taiwan by military force or economic coercion. The authors portray China that seeks to rapidly expand its sphere of influence in Asia through modernization of its armed forces, assertion of widespread territorial claims, and resort to military action. China's military exercises in the Taiwan Straits immediately preceding the Taiwanese elections are cited as an example of China's willingness to employ extreme measures in pursuit of its regional ambitions. Although the authors provide a good deal of evidence in support of this negative portrayal of China, they also acknowledge the practical limitations on China's regional ambitions.

102. Richard Bernstein & Ross Munro, *The Coming Conflict with China* (1997). The following discussion is drawn generally from this work.

103. See id. at 153.
China must continue to expand its economic base not only to support modernization of its armed forces, but also to improve the living conditions of its citizens and thus strengthen public support of the government. If China were to become involved in a military confrontation in Asia, it would disrupt the domestic economy by diverting resources from civilian investments, such as capital construction projects and consumer-goods manufacturing plants, to military investments, such as long-range air and naval defense systems. This diversion of resources would retard China's development of critical infrastructure projects in the areas of transportation, telecommunications, and energy, all of which are necessary for future economic growth. Diverting these resources would reduce the current standard of living for tens of millions of Chinese citizens who have only recently enjoyed improved living conditions after generations of economic mismanagement. These domestic risks, combined with uncertainty regarding the full capability of its military-industrial complex, serve to constrain China's regional ambitions, to the extent they do exist.

There is, of course, a more benign perspective of China, often advanced by business associations representing firms with direct investments there. This perspective places less emphasis on China's military ambitions and more on its economic ambitions. Although criticized for its business bias, this view has the benefit of being informed by the economic possibilities of modern China. The pro-investment picture portrays China as a country offering enormous international business opportunities, the realization of which require stable political conditions in Beijing and thus the avoidance of any direct United States-China conflicts. This view sees the historic economic reforms that China has undertaken as evidence that Chinese policy is being driven more by private sector growth than by military expansion.

Further evidence that economic interests dominate Chinese public policy is found in the extensive foreign business holdings of Chinese companies and especially the P.L.A. Unlike the U.S. armed forces, the P.L.A. is largely self-financed through the operation of an estimated twenty thousand businesses.

104. It is noteworthy in this regard that China has never interfered militarily in Hong Kong in the past, despite provocations and opportunities. See Mushkat, supra note 50, at 83-86.
105. For a table of alternative economic policy positions debated in the P.R.C., see id. at 100.
106. Some of this foreign investment is intended to take advantage of growth opportunities in neighboring economies, and some is intended for reinvestment on the mainland. Chinese domestic law favors foreign investment, over internal investment, thereby encouraging Chinese investors to channel funds through foreign-owned enterprises.
 worldwide. Many of these businesses are based in Southern China and Hong Kong, giving the P.L.A. a direct stake in the peace and prosperity of the region. While an army in business may seem strange from a western perspective and may raise awkward institutional questions, the arrangement conforms to an important economic principle: matching the costs and benefits of alternative actions. An army in business will personally bear the costs of the economic disruption brought by war and personally gain from the economic growth made possible by peace.

In the final analysis, however, even if China is inclined to use military power in pursuit of regional ambitions, Chinese policy will be significantly tempered by the possibility of counterproductive outcomes. The military exercises in the Straits of Taiwan had a number of negative consequences for China. The exercises did little to alter the course of the Taiwanese elections. They raised new security fears in the region, especially in Japan, which was pressed into closer military alliance with the United States. They also drove down the prices on the Taiwan stock exchange by nearly thirty percent, substantially shrinking the Taiwanese capital available for investment on the mainland. Military exercises directed toward Hong Kong would likely produce similar outcomes. These potentially counterproductive consequences serve as a strong deterrent to any Chinese military initiatives.

B. Political Developments

Political crises on the mainland or in Hong Kong could also precipitate an economic downturn. The volatility of the relationship between politics and economics was dramatically illustrated in the wake of the Tiananmen Square incident with a precipitous decline in foreign investment and trade. Although this sudden disruption of capital flow was reversed over the next two years, the event provides a warning regarding the link between political instability and economic disruption. Future political crises would likely result in a withdrawal of investment capital and, more importantly, exodus of professional and

107. See Bernstein & Munro, supra note 102, at 130-31, 144-46.
108. Although the military exercises in the Straits of Taiwan left no doubt regarding the seriousness of China's intent to reunify with Taiwan, the equally unequivocal U.S. response might have irrevocably committed the U.S. to coming to Taiwan's defense in the event of an invasion from the mainland. If China was sending a message, it paid a high price to do so.
109. The decline was estimated at a minimum of $7 billion to $8 billion in tourism alone. See Salisbury, supra note 87, at 459; The Business Environment in Hong Kong, supra note 23, at 159.
managerial workers from Hong Kong. About one quarter of Hong
Kong's citizens hold dual passports, and most dual passport
holders are professional and managerial workers. An exodus of
these workers from Hong Kong would depress the Hong Kong
economy and have a negative impact on the Guangdong economy,
especially Shenzhen. This threat to its domestic economy will
steer China's Hong Kong policy toward cooperation and
compromise with the new Hong Kong SAR, and away from direct,
and potentially volatile, political confrontations.

China has limited the scope of Hong Kong's political
freedoms, most notably with respect to activities that support the
Taiwanese independence movement. These boundaries,
however, are quite broad and afford China a good deal of
flexibility in fashioning solutions to the political problems ahead.

Fortunately for China, Hong Kong does not have a long
tradition of democracy. Although there are a number of party
leaders in Hong Kong advocating further democratic reforms and
individual rights (most notably Martin Lee, head of Hong Kong's
Democratic Party), the majority of Hong Kong citizens are either
apolitical or have only moderate expectations of expanded political
and civil rights. This political indifference is at least partly
explained by the extraordinary growth of the Hong Kong economy
in the absence of any meaningful democratic institutions. Hong
Kong citizens have seen that economic advancement does not
require the full panoply of democratic freedoms enjoyed in the
West.

There is one political freedom, however, that must be
preserved if Hong Kong's economy is to continue to flourish. The
free exchange of business information and ideas is essential to
the operation of a market economy. China must afford Hong
Kong's citizens ample freedom of speech and press to allow for
efficient business communication. This market imperative
provides a foundation for further freedom of speech and press in
the realm of political affairs and constrains China in any attempt
at censorship.

If forced to choose between expanded political and civil rights
and expanded economic opportunity, many of Hong Kong citizens
would likely support the latter. The preference of economic
opportunity over political and civil rights might reflect a
pragmatic assessment of Hong Kong's current status. Economic
opportunity can generate personal wealth, which is seen as more

110. See Ho, supra note 20, at 103-04. For a contrary look at the so-called
"brain drain" problem, see Enright et al., supra note 18, at 291-92.
111. Tung Chee-hwa sets out vision of economic development, supra note 72.
112. See generally From Colony to SAR, supra note 25 (discussing freedom
of the media in Hong Kong).
permanent than freedoms provided by government and more mobile in the event of changes in government policy. Hong Kong is ultimately about business: its citizens include some of the most able and creative business leaders in the world. As long as economic opportunity exists for Hong Kong entrepreneurs, politics will likely play a subordinate role in Hong Kong society and in Hong Kong's political relationship with China.

C. Public Corruption

Unlike military or political crises, corruption does not cause a sudden disruption of economic activity. Corruption weakens private markets over time as the cumulative effect of government misconduct distorts competitive incentive and supply and demand. In the long term, the negative consequences of corruption on an economy can be as great as the consequences of social crises and may be more difficult to remedy. Corruption is sometimes claimed to be a culturally relative concept: one society's corruption is another's normal business practice. While there is no doubt an element of truth in this claim, especially in China where government officials are poorly paid and personal relationships (guanxi) are the cornerstone of economic activity, this does not alter the negative impact of corruption on the economy.114

Public corruption (theft, bribery, and other illegal conduct by government officials) misallocates economic resources and creates inefficiencies in market competition. It also acts as a hidden tax system in which neither the taxpayer nor the tax collector is known or accountable.115 Corruption biases official decisions in favor of personal interests. The public welfare, expressed through consumer and investor demand, is thwarted when goods and services are allocated on the basis of individual or institutional self-interest. Corruption can also serve to reward the less

113. Guanxi (pronounced "gwaahn-shee") is the network of personal connections which governs virtually every facet of Chinese society, both public and private. See DeMente, supra note 77, at 218. Guanxi is the "oil of life" in China; guanxi is the means by which all transactions are accomplished and the measure of an individual's power and wealth. Id. The Chinese spend a great deal of time and money nurturing personal connections (building guanxi) in order to increase personal prestige and to further professional or business opportunities. Id. However, guanxi is not synonymous with bribery; it is rooted in deep cultural conventions having more to do with interpersonal respect and friendship than with money per se.

114. See McCurry, supra note 67.

115. It is estimated that corruption adds 5 to 10% to the cost of doing business in China. See Yee, supra note 2, at 642 (citing Maggie Farley, China Makes Itself in Hong Kong, L.A. TIMES, May 2, 1995, at 41).
efficient, but more influential, firms in a market, thereby disrupting the competitive equilibrium. When a firm obtains a government contract or license through the favor of a corrupt public official, other firms in the market attempting to compete on the basis of superior quality or price are unfairly disadvantaged and discouraged from pursuing of enhanced efficiency. The corruption tax, like any tax, adds to the cost of doing business, and this cost is generally passed on to consumers in the form of higher prices. Unlike official taxes, however, the revenues from corruption are not reinvested in the economic infrastructure in a way that benefits the taxpayer or the public at large.

The prospect of rising corruption in Hong Kong government agencies and the police department is often cited as a potential threat to Hong Kong’s future economic growth.\(^\text{116}\) Despite periodic crackdowns and toughening of laws, China continues to be considered one of the world’s more corrupt countries.\(^\text{117}\) The Chinese government itself acknowledges the extent of corruption in its government institutions. The Supreme People’s Procuratorate (the equivalent to the U.S. Attorney General) is currently investigating a record number\(^\text{118}\) of corruption cases, and the Ministry of Finance and State Planning has recently issued an official public notice (“Notice Concerning the Strengthening of Supervision and Control of Administrative Fees Involving Foreign Investment Enterprises”) to combat the tide of false fees being charged to foreign companies.

The Hong Kong government, on the other hand, is remarkably free of corruption. This singular feat has been achieved primarily through the Hong Kong Independent Commission Against Corruption (hereinafter ICAC), formed in 1974.\(^\text{119}\) Prior to this time, Hong Kong, like many of its Asian neighbors, was plagued by public corruption, especially in its police department. The ICAC has proven extremely effective in fighting corruption. After ridding Hong Kong of police corruption, the ICAC focused on corrupt practices in many other areas of Hong Kong government; today police cases account for a small fraction of annual prosecutions.\(^\text{120}\) The ICAC is widely credited

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117. See Khanna, supra note 9, at 2.
119. See Welsh, supra note 11, at 492.
120. Id. at 493.
for dramatically reducing corruption in Hong Kong, and the Basic Law recognizes its importance.\textsuperscript{121}

Article 57 of the Basic Law reads: "A Commission Against Corruption shall be established in the Hong Kong Special Administrative Region. It shall function independently and be accountable to the Chief Executive."\textsuperscript{122} Although Article 57 does not expressly provide for the continuation of the current ICAC, it clearly envisions a commission having substantially similar autonomy and authority.\textsuperscript{123} There is some concern in Hong Kong, however, over the future power and independence of any anticorruption commission, especially involving matters that have a direct impact on Chinese financial interests, such as mainland companies listed on the Hang Seng Exchange or Hong Kong companies having substantial mainland investment. Other observers expect that the ICAC will continue to function as it did before reunification because of widespread public support for anticorruption efforts and investor fears that corruption will weaken the Hong Kong economy.

Of all the potential threats to Hong Kong's future prosperity, corruption is probably the most serious.\textsuperscript{124} Fighting corruption will require commitment and cooperation on both sides of the Hong Kong SAR border, and the existing ICAC seems to be the best vehicle through which to channel such efforts. International investors will closely watch the future of the ICAC or its successor for signs of weakness indicating a reversal of Hong Kong's aggressive anticorruption campaign and a resultant regression in Hong Kong's business customs and climate.

D. Redirection of Investment Incentives

Another often mentioned, but less serious, threat to Hong Kong's economy is the development of Shanghai. Shanghai, with a population of over thirteen million, has long been a center of industry and commerce. Prior to 1949, Shanghai attracted significant international investment because of its size, its location on China's east coast, and its receptiveness to foreign businesses. Under the Communist Party, Shanghai developed into a major producer and consumer market, with Shanghainese goods and management practices reputed to be the best in China.

\textsuperscript{121} See Enright et al., supra note 18, at 283-84.
\textsuperscript{122} Basic Law, art. 57.
\textsuperscript{123} See Hong Kong's Transition to Chinese Sovereignty: Legal and Business Issues, supra note 62.
\textsuperscript{124} See Davison, supra note 95. Concern is also frequently expressed over the threat posed by the ascendancy of the Chinese Communist Party to Hong Kong's independent judiciary. See Mushkat, supra note 50, at 112.
In 1990, the Chinese State Council declared that it would open a new SEZ in Shanghai—the Pudong New Area. The investment incentives granted by the central government were enhanced by preferential policies of the Shanghai government, and today Shanghai is the largest and fastest-growing city in China.\textsuperscript{125}

Shanghai's explosive growth has been the direct result of policies adopted in Beijing, more so than of historical circumstances or geography. The central government continues to direct investment to Shanghai, and Shanghai's economic development is a national priority. Beijing's preferential treatment of Shanghai can be explained in a number of ways. Shanghai's development is important to that of China's interior eastern corridor, a region that has not yet seen much economic growth. Also, Jiang Zemin, former mayor of Shanghai, and a number of other senior national leaders are from that city. Whatever the rationale for Shanghai's preferential treatment, some worry the result will be the same: Shanghai's economy will grow at Hong Kong's expense.

However, this concern is likely overstated. Both Shanghai and Hong Kong will prosper if the overall Chinese economy continues to grow; both will suffer if it does not. These two metropolises are not locked in a battle over a static sum of international investment, but are both dependent on an increasing amount of foreign trade for further development. Shanghai and Hong Kong are also over a thousand miles apart and serve as hubs for two distinct economic regions of China: Shanghai for the Jiangsu and Zhejiang provinces on China's central east coast, and Hong Kong for the Guangdong province in the far south of China. There should be ample economic growth in each of these regions to stimulate future development of both Shanghai and Hong Kong.\textsuperscript{126}

Hong Kong also enjoys certain advantages over Shanghai as a commercial and financial center. Hong Kong is at the center of the expanding trade throughout Southeast Asia and serves as the regional headquarters for multinational businesses operating in Taiwan, Thailand, Vietnam, Indonesia, Malaysia, and the Philippines. Hong Kong also has an enviable economic infrastructure including state-of-the-art transportation, communication, and energy facilities. Finally, Hong Kong has an abundance of technical, managerial, and legal specialists, and a tradition of quality professional service. For all of these reasons, it is unlikely that Hong Kong's future economic growth will be adversely affected by the economic development of Shanghai.

\textsuperscript{125} See ENRIGHT ET AL., supra note 18, at 258-64.
\textsuperscript{126} See id. at 264-67.
E. Deterioration in United States-China Relations

The last threat to Hong Kong's future economy discussed in this Article is the prospect of further deterioration in United States-China relations.\(^{127}\) The United States criticism of China has focused on two areas—trade and human rights. Although now officially delinked, the relationship between these two policy concerns continues to be complicated and contentious. Some argue that trade and human rights are in direct opposition and that the current U.S. policy emphasis on trade comes directly at the expense of human rights. Others argue that expanded trade is the surest path to long-term democratic reforms in China. A number of groups urge a much tougher trade posture toward China, whether to rectify the nearly forty billion dollar trade surplus that China now enjoys, or to punish China for infringement of U.S. intellectual property rights, or to pressure China to improve human rights. Still others press for a more liberal trade policy with China so that U.S. firms, and ultimately the U.S. economy can benefit from China's development, and so that U.S. national security interests are served by encouraging economic growth, and hence political stability, in China.

One point that most observers agree upon, however, is that economic sanctions are the only means available to the United States to influence Chinese policy regardless of the subject. Official government protests, lectures, or criticisms regarding Chinese policy are either ineffective or countereffective. China's isolationist past has left it with a great fear of foreign interference in domestic affairs and a fierce sense of national independence. The United States would clearly not resort to military power to challenge Chinese policies or actions involving trade or human rights. The United States and China have far more to lose than to gain from a military confrontation in the region and only an extreme situation could provoke the two into armed conflict. Economic sanctions, therefore, are the only levers available to the United States, whether the U.S. objective is trade parity, intellectual property protection, political reform, or human rights.

Unfortunately, Hong Kong would bear a substantial share of the direct costs created by any new trade sanctions or restrictions imposed on China by the United States. Sanctions would harm Hong Kong investment in Guangdong, limit the flow of Chinese investment into Hong Kong, depress the Hang Seng Exchange, reduce commercial activity (especially in the fields of shipping and manufacturing), and threaten the livelihood of thousands of

skilled professionals throughout Southern China. It is estimated that the revocation of Most Favored Nation trading status for China could cost Hong Kong over fifteen billion dollars in overall lost trade and could cost the Guangdong economy an additional four billion to six billion dollars in lost re-exports through Hong Kong.\textsuperscript{128} As Hong Kong becomes increasingly integrated into the Chinese economy, it will become ever more difficult to punish China without also punishing Hong Kong. United States policy, therefore, must carefully weigh the negative consequences for Hong Kong of any economic sanctions imposed on China. It is clearly not in the best interests of the United States to contribute to the disruption of the Hong Kong economy. This would alienate the United States from the foremost free market city in Asia, risk the loss of U.S. access to its most important gateway to China, and strain Hong Kong’s relationship with China, thus decreasing political stability on both sides of the border.

United States policy could also trap Hong Kong between its allegiance to China and its alleged adherence to bilateral and multilateral international obligations. Under the terms of the United States-Hong Kong Policy Act of 1992,\textsuperscript{129} the United States will continue to deal with Hong Kong as a completely autonomous area in the realm of trade and economics, and all existing treaties and international agreements between Hong Kong and the United States will continue in force. The Act also provides that the United States will continue to honor its obligations to Hong Kong under international agreements “so long as Hong Kong reciprocates,” and grants the President the authority to issue an executive order suspending Hong Kong’s independent status from China.\textsuperscript{130} Given the Act and the existing U.S. accords with Hong Kong, it would not be difficult for the United States to attempt to pressure Hong Kong into supporting U.S. trade policy toward China by insisting that the desired actions are required under United States-Hong Kong agreements. The United States, for example, could demand that Hong Kong, as an independent trading partner, assist the United States through extraordinary measures to enforce Chinese export quotas or to confiscate pirated intellectual property. Such a demand would impede commerce in Hong Kong and place Hong Kong in a potentially untenable position with respect to China.

The bilateral leverage that the United States has over Hong Kong on trade and economic matters is further strengthened

\textsuperscript{128} See GREATER CHINA, supra note 44, at 90.
\textsuperscript{130} See Skeen, supra note 2, at 203.
through the U.S. leadership role in the WTO, of which Hong Kong is a member, but China is not.\textsuperscript{131} The United States could use Hong Kong's membership in the WTO as a basis to insist upon Hong Kong's compliance with a range of free trade practices arguably required by the WTO. The United States could also enlist the support of other WTO member nations to achieve desired changes in Hong Kong trade policy. United States involvement in Hong Kong trade policy is further complicated by the role that the United States has also assumed with respect to China within the WTO. The United States has undertaken, in the name of the WTO, to set the conditions for China's WTO membership and to be the final arbiter of China's compliance with these conditions. The United States has assumed significant responsibilities in trade and economic matters, both in Hong Kong and China. These responsibilities carry with them attendant risks requiring careful attention and analysis.\textsuperscript{132}

In the tripartite relationship among the United States, Hong Kong, and China, the United States must deal separately with Hong Kong and China, but recognize that the two are politically and economically inseparable. United States policy should seek creative means to aid both Hong Kong and China, in light of the inevitable changes that Hong Kong will undergo and in light of the continuing institutional reforms in China. China's one country-two systems relationship with Hong Kong will pose ongoing problems for U.S. trade policy in the region.\textsuperscript{133} The United States will have to distinguish carefully between its dealings with Hong Kong as an independent trading partner and WTO member and as an administrative region of China. In either case, however, U.S. interests would be disserved by the disruption of the Hong Kong economy.

In the long run, the Hong Kong economy likely will be most influenced by the overall climate of United States-China relations. The United States has had difficulty fashioning a positive policy toward China in the midst of strong domestic protests over Chinese policies. These protests come from a wide range of domestic interest groups, including advocates on matters of human rights, political rights, religious rights, labor rights, intellectual property rights, and free trade rights. Current United States-China policy has been designed largely in response to the goals of these domestic advocacy groups and, as a result, is

\textsuperscript{131} China has confirmed Hong Kong's complete and continuing autonomy in its external commercial relations after 1997. Id. at 195.

\textsuperscript{132} See Yee, supra note 2, at 633-38 (examining potential problems with Hong Kong's GATT membership and China's need to join GATT).

\textsuperscript{133} See Ho, supra note 20, at 240-49 (noting several versions of post-reversion scenarios).
overwhelmingly critical of China on a wide range of issues.\footnote{134} Future United States-China policy should shift from criticism of China to constructive support of China's internal reforms and international relations. There are a number of ways in which the U.S.-China relationship could be cast on a more positive footing.

First, the United States could acknowledge the progress that China has made and focus less on its shortcomings. This acknowledgement would strengthen reform efforts in China and lessen tensions between the two countries. Second, the United States could work to stabilize commercial relations with China by awarding China permanent MFN trading status and by endorsing China's membership in the WTO. Finally, the United States could defuse the China-Taiwan situation by working openly and actively with both sides to pursue eventual reunification. China, in turn, could pledge to continue its economic reforms, open its market to U.S. goods and services, reduce the trade deficit, and renounce the use of military force to achieve national objectives. Although there are many obstacles to a positive rapprochement in United States-China relations, there is also a great deal to be gained by both parties, as well as by Hong Kong and other countries throughout East Asia.

V. CONCLUSION

The discussion above has attempted to set forth the factors that will most likely influence Hong Kong's future economic growth and to assess their effects. The author concludes that Hong Kong continues to offer a highly favorable business environment for international investors. This investment environment is particularly propitious for U.S. businesses for a number of reasons.

Over time, there will be a correction of the United States-China trade imbalance, creating greater investment opportunities for U.S. businesses. Hong Kong can provide U.S. companies with a critical gateway to China in order to realize these new investment opportunities. Many of these new opportunities will come in the form of investment by small and medium-sized U.S. companies. This is a business sector in which the United States excels and which many believe is essential to the next generation of economic development in Southern China. Also in demand will

\footnote{134}{Many have said this is due to the "doom and gloom" scenarios painted by visiting politician Martin Lee and his democratic colleagues who have dominated the American political and media discourse. See Hadar, supra note 127.}
be services that have evolved in the United States to support small and medium-sized companies, such as venture capital financing, management consulting, and technology licensing. In short, the U.S. economy appears to possess precisely the strengths needed to fuel the next wave of growth in Southern China, and U.S. small and medium-sized companies appear to be highly complementary investment partners for Chinese enterprises.

Moreover, there is a wide range of investment opportunities available in the Hong Kong-Guangdong region, including investments in banking and financial services, capital construction and real estate, and manufacturing and assembly operations. Some of the industries that are experiencing the greatest relative growth in the region include telecommunications equipment and services, computer and information systems, consumer electronic goods and toys, and clothing and textiles. Investors can also structure investments in a variety of ways to accommodate their desired risk exposure. The broad-based demand for foreign investment in the Hong Kong-Guangdong region, coupled with the flexible investment options available, could generate billions of dollars of new business for U.S. companies.

This Article ends where it began. What matters most in the final analysis is how Hong Kong compares to other nations as a location for investment. Is the risk-return calculus for Hong Kong superior to that offered by other countries around the world? The answer is yes. Hong Kong will continue to offer a more stable investment environment than many other countries in Asia, Eastern Europe, and South America. The strong demand in Hong Kong for foreign capital and technology will continue to produce high rates of return on Hong Kong investments. Although a number of events could derail the future Hong Kong economy, it currently has a great deal of momentum, and there are no obvious obstacles on the tracks.

The Hong Kong people have a saying: "No one has ever made money betting against Hong Kong." This is not the time to try.