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**HONG KONG'S EXTERNAL  
RELATIONS**

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## PROCEEDINGS

ERICA DOWNS: The China Center is delighted to co-sponsor today's panel discussion and keynote presentation with the Center for Northeast Asian Policy Studies here at Brookings and the *Hong Kong Journal*.

The topic of Hong Kong's external relations is a very interesting one because Hong Kong has a very interesting and unusual international persona in that it's part of the People's Republic of China, but it has a separate political system and an independent customs territory.

We are very fortunate to have a superb group of speakers here today to provide some insights into various dimensions of Hong Kong's external relations, and now I'd like to turn this over to Richard Bush, the director of the Center for Northeast Asian Policy Studies to introduce the speakers and to moderate the rest of this event. And I'd actually like to invite our speakers to join us here on the podium.

And again on behalf of the China Center, I want to join Richard and CNAPS and the *Hong Kong Journal* in thanking the speakers and all of you for joining us today.

RICHARD BUSH: Good morning. I'm Richard Bush, the director of the Center for Northeast Asian Policy Studies, and it's my pleasure to welcome you here today. Hong Kong has many loyal followers many of whom are in the room today. You are also very punctual, which we appreciate.

The origin for this session was an inspiration by our former CNAPS fellow, Simon Shen, and we sort of saw the value of doing something on this topic, Hong Kong's external relations. I think we have three different and interesting cuts at the issue. Hong Kong is an international financial center which our good friend and sort of frequent speaker, Bill Overholt, will cover. Mike Martin from the Congressional Research Service will talk about Hong Kong's important role in fighting money laundering. And then Simon himself will talk about Hong Kong's relations with Taiwan. And then Bob Keatley, the editor of the *Hong Kong Journal* will offer some commentary. We're grateful to Bob for his sort of moral and material support for this effort.

You have the bios in front of you, so I'm not going to needlessly consume time describing their careers. I'd like to invite Bill to begin the proceedings.

WILLIAM OVERHOLT: Well, first let me say how happy I am to

be here today. Brookings programs on Asia are a huge contribution to our country. Bob Keatley has done a fantastic job of keeping intellectual discussion about Hong Kong lively and serious.

I can't resist starting with an anecdote. Back in March of 1996, the Hong Kong Monetary Authority had somebody call me up and say would you go to Washington and testify to the House Banking Committee, they think that when China takes over Hong Kong, the Hong Kong financial system's going to collapse and that might seriously damage the U.S. financial system.

And I said, I just can't do it, I'm moving house that day and I have a divorce hearing that day and sorry.

Joseph Yam called me up and said, Bill, we'd really appreciate it. And I told him the same story. He said, Bill, you're the only one who can do this, the only one in Hong Kong who can do this. I said, you mean you think I'm the only one dumb enough to go and take the abuse?

And he said, yes, something like that. But they're very seriously concerned about the coming collapse. And so I went and testified how China would keep its promises, and the Hong Kong financial system was much better regulated and capitalized and resilient than the U.S. banking system. That was not what people expected to hear.

At the time everybody knew that the major markets were New York, London, and Tokyo. HSBC was busily shifting its headquarters from Hong Kong to London. But by a couple years ago, Hong Kong had so eclipsed Tokyo that nobody talked about Tokyo anymore as the Asian financial center. It was New York, London, and Hong Kong. And this year HSBC had been shifting its headquarters back.

There are all sorts of different financial markets, and comments about those financial markets are quite different for different categories, so let me just go through a few of them. First, London, the city of London, ranks international financial centers, and their take is surprised that they're number one. Actually, New York and London are virtually tied. Hong Kong is barely behind, and then there's a big gap and there's everybody else. And that ranking is quite consistent with what anyone in the financial markets would tell you.

The stark exchanges in the banking markets have been the most important markets. You can see that the Japanese markets are still bigger than Hong Kong, about the same as Hong Kong plus Shenzhen. If you know the companies, you know that Hong Kong and Shenzhen have a very close relationship. But the Japanese markets are for Japanese companies. You don't

see major foreign companies going to Tokyo very often to list. Hong Kong is an international market, and Hong Kong dwarfs most of the other competitors. It's about the same in market cap as Shanghai. Shanghai's going to be bigger, but, again, like Tokyo, Shanghai is a domestic market. Hong Kong is an international market and Hong Kong's about five times larger than Singapore.

I was just reading one of the articles about -- from a year ago by Philip Bowring, about how the financial crisis might seriously damage Hong Kong's standing. The reality is that in new issues, during the crisis China, and especially Hong Kong, surged ahead of the New York Stock Exchange in new listings, so Hong Kong issues about 50 percent more stock than the New York Stock Exchange. NASDAQ is still substantially bigger. You put the Chinese exchanges together and they're now ahead of London and New York.

As is so often with the conventional wisdom, the perception that going back to China would damage Hong Kong is exactly the opposite of reality. And you had 3 years in which the -- 2005 to 2007, in which new issues were 20 percent greater than the previous 19 years combined. And then last year almost as much was raised in those previous three years. So you've got just an extraordinary takeoff going on here.

The average oversubscription of a listing in Hong Kong last year was 190 times. People wanted, ponied up to buy 190 times as much of a share issue as was on offer. And increasingly, companies are not so interested in -- companies that list in Hong Kong are not so interested in having a secondary listing in the U.S. or the U.K. or elsewhere.

If you look at bond markets, it's a completely different story. Asian bond markets are large in countries where the government issues a lot of debt. Hong Kong doesn't have any debt so it lags behind places like Tokyo and Seoul. It's going nowhere in bonds until a Chinese corporate bond market develops. And that's going to take a while, because developing a serious Chinese corporate bond market is going to require vast reforms in Chinese accounting practices. Otherwise nobody's going to buy the stuff and -- but when that happens, both Hong Kong and Shanghai should boom.

In derivatives, leadership is all over the place. I won't go through this in detail. Hong Kong is dominant in exchange traded fund options. That's kind of the leading sector of derivative development. But other people, for instance in commodity futures, it's natural that the largest commodity buyer in the world, China, is going to dominate trading in that. And I think what you're going to see there is that Shanghai surpasses London as the predominant global place for trading commodities.

So why has this happened? Well, the most fundamental reason is that standards have remained high in Hong Kong. The CFA Institute has Hong Kong ranked very high and says it's rising higher. I have to mention that the Asian Corporate Governance Association criticizes Hong Kong for declining a bit in the last year. Hong Kong and Singapore kind of go back and forth as to who is number one. But notice Hong Kong and Singapore at about the same place in the lead. In other words, this huge drop downward to Japan, Taiwan, and others, that's crucial. Nobody really doubts that integrity is highest in Singapore and Hong Kong.

The British legal system remains completely intact, and the senior judges are often better -- better reputation and better qualified -- than their predecessors under Governor Patton; extremely cosmopolitan culture as well as market, free market in most senses; convertible currency; and an open market for corporate control. That's something you don't have in Tokyo, you don't have in Shanghai, and you're not going to have that in either place for a long, long time. I expect it'll happen faster in Shanghai than it does in Japan.

What are the drivers of this dynamism? Well, fairly obvious: economic growth going on all around; the desire of Chinese companies to list in Hong Kong even though they pay a huge price for that listing; the convenience of Hong Kong for Chinese who want to do financial business with non-mainland banks; and, above all, support from the Chinese government. When they do experiments with liberalization of the RNB, they do them in Hong Kong. And when there are difficult times, as there were at the beginning of this decade after the crash, the Chinese government comes in very supportive.

That's so different from the conventional wisdom in the media up to '97 and a little bit afterwards that, well, China's going to step on Hong Kong in order to raise Shanghai up. That's never been the mentality in Beijing.

So Chinese companies want to come down and list in Hong Kong even though the typical PE ratio in Shanghai is around 18 and the typical PE in Hong Kong is substantially lower. And it's hard to exaggerate the huge price they pay in the amount of money they get in their fund-raising for listing in Hong Kong. But they want to operate under capitalist laws, they want to operate under an international legal system, they want to gain experience for their international operations, and they want Hong Kong analysts covering their companies.

So you've had this enormous wave of Chinese companies listing in Hong Kong and, as a result, instead of being primarily a property market, which was the case up until almost 1997, Hong Kong now has tech companies and construction companies and mining companies and nine of the largest listed companies in Hong Kong are from the mainland now.

So what about this competition between Hong Kong and Shanghai that's so preoccupied commentators outside? Well, as I mentioned, China -- China's been consistently supportive of Hong Kong. They've never seen the game as a zero-sum game. And they're right; it's not a zero-sum game. Studies going all the way back to the beginning in the last century show that Hong Kong thrives the most when Shanghai is particularly vibrant. It's the opposite of a zero-sum game. These cities grow together. But every study has shown that in international finance Hong Kong still simply dwarfs Shanghai.

Within Hong Kong the share of GDP represented by financial business has almost doubled in 15 years. The key difference, obviously, is that -- in Shanghai is a domestic market; Hong Kong is more internationalized than London and New York. And when capital controls are finally removed to benefit Shanghai, Hong Kong will be positioned to benefit disproportionately.

The banking market in Hong Kong just has overwhelming advantages: a huge number of banks from all over the world, the world's leading banks, intense competition, very supportive legal system. Banking regulators have been much more serious and competent than our own banking regulators by a margin, a huge margin. There's no comparison. So Hong Kong remains supreme there.

Instead of mainland destroying Hong Kong, what's happened is that Hong Kong has facilitated the mainland's development. Typically, there have been half a dozen Hong Kong Monetary Authority executives seconded to help improve the regulatory system. People like Laura Cha become, in her case, become deputy chair of the Securities Regulation Commission. Other people become deputy chair of the Banking Regulatory Commission. Joseph Yam, the longest-serving head of the Hong Kong Monetary Authority, has been a senior and influential advisor into all the systems. Hong Kong has driven modernization in China.

One of my most noteworthy experiences, during the 16 years when I lived in Hong Kong, was when Liu Mingkang decided to clean up Bank of China, he came to Hong Kong to announce it. He came down and he called together all the senior -- most senior banking executives in Hong Kong. And he stood in front of a room, about this many people, and he said, now, you may have noticed that last year we wrote off 25 percent of our assets. And this year the level of nonperforming loans we're reporting is the same as last year.

He said, you may wonder why that happened. He said, that's because we weren't telling the truth last year. He said, in the meantime, we have learned that if we're going to fix our bank, we have to play it straight with you and we have to play it straight with ourselves.

It was just a stunning moment. And the fact that he felt the place to say that was in Hong Kong I think says a lot about the Beijing view of Hong Kong. I would argue that he's the most effective bank -- the most competent bank regulator in the world today. That tie to Hong Kong has helped that.

I'm not going to go into a lot of detail, but as China experiments with liberalization of the RMB, they always go to Hong Kong and let the Hong Kong institutions get the most benefits. This is quite deliberate again, the exact opposite of trying to suppress Hong Kong in favor of Shanghai.

Why has it been so difficult for others to catch up? Well, part of it's just technical. It is so difficult to create a system where you can trade simultaneously in stocks, debt, all the other financial instruments in multiple currencies. Other places just haven't been able to do it, technically. Hong Kong has: Free capital flows, contrasts with Shanghai, free market for corporate control, nonpolitical listing criteria, English language, completely free flow of information, and communications and travel. That balance is changing and Taipei's losing some of its disadvantage, but it's got a long way before it can catch up with Hong Kong.

Pretty free flow of people. No big difficulties getting visas, limited government manipulation of the economy, cosmopolitan culture, international legal system, geographic convenience, a lot of bureaucracy in Hong Kong in terms of not being proactive in reform. The Hong Kong Civil Service is a very conservative institution, but in terms of getting the job done and avoiding corruption, they know how to do that. And as we encumber our financial institutions with regulations, increasingly, financial institutions are going to move to Hong Kong.

The competition does win in some areas. China, as I mentioned, is going to remain dominant in the indefinite future in commodities, in things like Chinese mortgages. Shanghai companies are always going to compete. The basic banking functions are going to be done in Shanghai. Singapore effect, subsidizes fund management companies to move Hong Kong to Singapore and call it their regional headquarters. Hong Kong will not do that. That has been a big, big period for Singapore in terms of number of fund management institutions headquartered there. It's had a huge cost, too, in that the subsidies come out of the returns on Singapore's reserves, and those returns have typically been very low.

So basic message: Hong Kong is thriving to an extent that really says New York better watch out. It's not a question of Shanghai overwhelming Hong Kong, it's a question of London and New York competing with Hong

Kong.

Thank you.

*(Applause)*

DR. BUSH: Thank you very much, Bill. It's very illuminating. Bill has covered the way Hong Kong contributes to the flow of all kinds of financial things in ways that we want.

Michael's going to talk about the movement of money that we don't want. Michael?

MICHAEL MARTIN: First off, thank you very much to Brookings as well as Robert Keatley for the opportunity to speak here today. It's always a joy to be over at Brookings for events like this. I generally learn more than I can impart in my time, so I look forward to learning more today.

Before I get into my presentation, first a disclaimer and then a disclosure to the disclaimer. I am here as Michael Martin. I do work for CRS, but I'm not here representing the views of the Congressional Research Service, the Library of Congress, the U.S. Government, or even the Hong Kong government. These are my views and only my views. So that's the disclaimer.

The disclosure, I was employed by the Hong Kong Trade Development Council from 1994 to 1998, spanning the handover period as well as the age of financial crisis; a very interesting time to be there. I had previously worked at Hong Kong Baptist University. I have a history in Hong Kong longer back than I want to disclose at the moment.

Second, I had the great fortune of meeting and then marrying a woman from Hong Kong almost 14 years ago, so my wife is from Hong Kong, my mother-in-law, and three of my brothers-in-law, and their families still live in Hong Kong. I consider Hong Kong a second home, so if you want a completely unbiased view of Hong Kong, I am not the person to speak.

And to go over in a slightly different angle, some of the things that Bill talked about, and I chose today to particularly take more of a Hong Kong-centered view of this issue than to take a pan-international view or a U.S. view. I do this for two reasons -- Kerry Dumbaugh is nodding her head, she's saying "typical Mike" -- trying to be a little bit contentious, a little bit trying to push for a discussion in debate rather than taking the easier path.

So my first point -- and Bill's already hit on this and emphasized

this point -- financial services are vital to Hong Kong and Hong Kong's economy. There are 23 local banks. It's down from in the past -- there have been some mergers -- 131 foreign banks in Hong Kong. This is according to the Hong Kong Monetary Authority. If you include other financial services, industry monitored, or registered, or licensed by the Hong Kong Monetary Authority, you come up with nearly 300 different financial entities. It's a big sector of the economy.

Bill spoke about it in a different way in terms of the growth; here it is in terms of the percentage of GDP 16.1 percent. That's second only to international trade in terms of sectors contributing to GDP.

And then up to the global financial crisis, financial services was one of the fastest-growing sectors of Hong Kong's economy, so it was big and getting bigger. This was emphasized most recently by Chief Executive Donald Tsang Mon-Kuen in his policy address almost a year ago today in which he said, "The financial service industry is one of the most important pillars supporting our economy. It is vital and, as such, the implication is the reputation of the financial service sector is a premier value to Hong Kong. Anything that would indicate that it is not reputable, that it is not honest would be harmful to Hong Kong's economy, its vibrancy, and to the people of Hong Kong."

To that end, Hong Kong has become party to most of the major international conventions having to do with money laundering, having to do with counterterrorism financing in the regulatory environment: the Palermo, the Vienna Convention, the Convention on Suppression of Financing of Terrorism. Hong Kong is a party to those agreements.

In addition, it is a member of the Financial Action Taskforce, or as they call it FATF; that's a nice acronym FATF. And within that, Hong Kong has made a high priority of abiding by the FATF 40 + 9 recommendations: 40 regular recommendations and the 9 special recommendations. To do so, Hong Kong passes -- has passed a number of ordinances to comply with those international conventions. Here's just a few of them. You'll notice the revision in 1997, when you had the handover, they had to go through a legal process of changing the British laws into Chinese laws. So there's kind of a transition that took place during that time period. But also notice they continue to amend these laws, these ordinances.

Moving now inside the Hong Kong government, there are a number of agencies that are involved in trying to prevent and then prosecute experiences with money laundering or terrorism financing. The Financial Service and Treasury Bureau is sort of the lead agency on these particular issues at this time. Within the Security Bureau, the Hong Kong police force and the Customs and Excise Department are two lead agencies. They work together under the Joint

Financial Intelligence Unit, so there are regular meetings. I happen to know some of the people involved in which they share information about possible activities that may constitute money laundering or terrorism financing.

The Department of Justice is also involved, and then an interesting entity which I assume many of you know about, the ICAC. This was originally set up a number of years ago to deal with corruption inside the Hong Kong government. It is under the chief executive directly. It has now become increasingly active in looking at corruption activities outside of the government, particularly in the corporate community.

There is also a number of regulatory bodies that aren't quite governmental that are involved in the anti-money laundering and counterterrorism financing activities. The Hong Kong Monetary Authority, the Office of the Commissioner of Insurance, Securities in Future Submission, all of these regulatory bodies as well as the government bodies are coordinated under the authority of the financial secretary. And it is his responsibility to try to make sure that the different entities are communicating with each other about issues.

As I said earlier, Hong Kong is part of FATF, and in June 2008, they came out with a mutual report and they evaluate; Hong Kong participates in the process on Hong Kong's anti-money laundering and counterterrorism financing activities. Here are some quotes from that report:

First off, "Investigations have found no evidence of terrorist funds moving through Hong Kong. None." Basically, if you're a terrorist and you want to move your money around, don't try Hong Kong. Basically, there are other places in Asia that are much easier to do it.

Second, "The laundering of drug proceeds has declined in recent years and is increasingly derived from trafficking for domestic use. So international drug financing again, they're not finding Hong Kong a safe haven for this; they're doing it elsewhere."

Third, "The primary domestic sources of laundering funds in Hong Kong are illegal: gambling, fraud, financial crimes, loan sharking, and vice." Now, anybody who's lived and worked in Hong Kong, there's a word that comes to mind. I'll get to that in a second on what's that about.

And then, finally, "Supervision is effective for the banking, insurance, and securities sectors, but weak or nonexistent for many types of DNFBPs, Designated Nonfinancial Businesses and Professionals."

You could also add to that remittance agents and money changers.

And this is an area, an issue that I'm going to talk a little bit more about later in my presentation. Basically, it's saying the formal financial sectors things are fine, much like Bill was saying. But when you're looking at informal channels which aren't so important in the United States that we may not be as aware of, Hong Kong, this is where the issue lies.

So what are the key issues for Hong Kong, from a Hong Kong perspective on money laundering and counterterrorism financing? Well, first off, counterterrorism financing is a priority, and it's important for Hong Kong, don't mistake what I'm saying. But evidence would indicate it shouldn't be the top priority. It isn't the primary issue for Hong Kong. They cooperate well with the United States on this issue, but it's generally recognized that is not the problem. More it's the money laundering, and here let me step aside for a second and clarify how I'm using the term "money laundering" because it can be used in different ways.

Some places they talk about the attempt to basically hide or move around funds from illegal sources. I'm expanding that. I'm talking about the attempt to move funds illegally to avoid taxes, tax evasion, to avoid capital controls. I'm talking about the illegal movement of funds, not just illegally obtained funds. So the funds themselves may have been obtained in a legal fashion in the home country, but they are now trying to move it to avoid some regulatory oversight.

So what's one of the first issues? Well, if you go back to -- if I went back to the previous slide when I listed out the sources, people from Hong Kong will immediately know triads is what's going on here, organized crime groups in Hong Kong. They're still quite active and the Hong Kong police force, to be honest, has had a rather interesting relationship with triads over the last 20 or 30 years. If we go back further even more interesting, but we won't go into that right now. But it continues to be an issue in Hong Kong, and they're very actively pursuing organized crime.

A second major source is money from mainland China. Now, Bill was talking about the upside, shall we say, of that money, but because China has capital controls and has strict regulations over the movement of foreign exchange and Hong Kong does not. There are a number of mainland companies that attempt to use Hong Kong to circumvent oversight in the mainland. They basically move their money into Hong Kong through various means in order to avoid supervision in mainland China.

This has been official for Hong Kong, but can get into situations of tax evasion in mainland China, hiding foreign exchange which should be reported to mainland authorities, or attempts to make investments via Hong Kong that

would otherwise be illegal in mainland China. So this is an issue for Hong Kong.

A last source, which is much broader than I think most people realize, is hot money. For those of you who may have watched this phenomena over the last two or three years, if you do sort of capital account balancing month by month in mainland China, there's often tens of billions of dollars that somehow end up as foreign exchange reserves in mainland China that cannot be attributed to trade or investments or other normal sources, normally phrased as "hot money."

The question -- two questions come to my mind in my research on this. One is where is it going? But the other thing is, where is it coming from? Now, there's been a lot of focus on where the money is going in mainland China and whether it's feeding the property markets, et cetera. But there's also in my mind a lot of less curiosity about where those funds are coming from. In many cases, I speculate that there are speculative investors trying to evade capital controls in mainland China, but also international investors who see high rates of return available in mainland China but do not have an easy legal conduit in which to get the money into the mainland markets. Hong Kong has been an avenue for moving that money across the border.

This presents the problem for Hong Kong of being in a unique situation. It is, as Bill was pointing out, a financial center for many types of transactions in mainland China. Chinese capital flows out of Hong Kong -- or out of the mainland via Hong Kong in many cases. Similarly, international capital flows into China via Hong Kong for many of the reasons that Bill talked about.

Another situation which we could talk about more is what I'll call the mere convertibility of renminbi in Hong Kong. For those of you that have traveled the Hong Kong recently, it is interesting to be able to me to go into a shop in Mong Kok and buy something with renminbi. Nobody blinks anymore.

They also are developing a renminbi bond market in Hong Kong. I think the estimate's worth something between one and 2 billion U.S. dollars, most recent issues. And another unique aspect of Hong Kong is, in general terms, a sort of *laissez faire* policy, so regulations where they exist are tight and stringently maintained, but where there are no regulations, let the market prevail.

Let me go back to the FATF recommendations at the beginning, and one of the things from contacts I have in Hong Kong that comes to mind is this role of remittance agents in Hong Kong for the movement of funds that are trying to evade detection. Remittance agents in Hong Kong are required to register, but are not licensed by the Hong Kong government, a minor distinction which the Hong Kong government, I'll get to, is trying to address. The FATF

report identified this as a serious loophole that basically remittance agents are a vehicle whereby money laundering can occur.

Under Hong Kong ordinances, all citizens and entities are required to report suspicious transactions. Now, I don't know U.S. financial regulations, but I'm not sure that anybody, literally anybody in the United States if they hear about a suspicious financial transaction has to report it to the authorities. So *laissez faire* up to a point.

Remittance agents operate as a major mechanism for moving funds across the border. Basically what you have is a pairing of partners: one on the mainland, one in Hong Kong. The person who is trying to move money across into the mainland gives it to their remittance agent in Hong Kong, the remittance agent in Hong Kong contacts their mainland partner and basically says, credit this person for this much money in the mainland, and in Hong Kong they receive the money. No money moves across the border. It is invisible financial transaction, but as a result somebody in the mainland ends up with a large amount of money which they can invest in renminbi.

You also get movement in the other direction, same way. Finally, on that point and I'll talk more about the remittance agents in a moment, but as I said, the Hong Kong authorities have taken the heart of these recommendations from FATF, and they're in the process of developing new ordinance to close up this loophole. My understanding is the idea is to create regulations for remittance agents very similar to those of the banking sector licensing requirements, reporting requirements which are currently not required.

Let me finish, then, for with a little bit on what I see as implications for the United States of the situation of Hong Kong. I want to emphasize, currently Hong Kong is perceived as a low-risk situation, at least for counterterrorism financing. There's very little evidence of it going on, although continuous activities between the United States and Hong Kong and the international community on that matter.

In terms of money laundering, the priority isn't drug money, internationally, but it is more these evasive maneuvers on international finance. As a result, as I was trying to imply, Hong Kong is slightly different priorities in how they look at these two issues in the United States. But if I can build a little bit on what Bill was saying earlier, I think Hong Kong can be very useful for the United States to get a sense of what's coming down the road, because Hong Kong is already facing issues that we in the United States may be facing in the future.

There is a policy, a looking outward policy, in mainland China. Chinese companies are being encouraged to invest internationally. We are going

to start seeing more mainland capital flowing around the world into the United States, and these may be, hopefully, done via legal means, but in some cases there may be attempts to evade laws in the mainland as well as the United States. Hong Kong is already addressing this issue and is trying to prevent illegal transaction in Hong Kong.

Second, and on that I will finish, I would argue that this would be a good time to talk to our colleagues in Hong Kong about how they handle their relationship with their mainland counterparts over the last -- where are we -- 13 years they have developed quite a rapport with their mainland counterparts, relationships of trusts that could be an example for the United States in regulatory environments on how to develop relationships in the future when the United States may be dealing with mainland companies that are trying to evade taxes in mainland China.

I will finish on that note. I am here for questions. I prefer question-and-answer period in long presentations. Thank you for your time and your patience.

*(Applause)*

DR. BUSH: Thank you very much, Mike. That was terrific. Now, we turn to Simon and Hong Kong's relations with Taiwan.

Simon?

SIMON SHEN: Thanks very much. I'm very glad to be back at Brookings. Thanks, Richard and Robert, for inviting me to the panel. It's very encouraging to see that there are so many people interested in Hong Kong or there are still many people interested in Hong Kong.

The topic today I've modified a little bit to cover Hong Kong's bilateral relations in general, including the Hong Kong, Taiwan, Japanese, and a little bit about U.S. relations. But I'll explain a little bit about the rationale of the presentation first.

External relations of Hong Kong was originally one of the most neglected subjects in international relations in my home town. I work on international relations. I'm one of the few IR scholars in Hong Kong. We always feel we're alone in Hong Kong. And this topic is already one of the most lonely topics because there are so few people studying the topic.

But in the previous months after my proposal to organize this panel, there have been three to four cases happening in Hong Kong that involved Hong Kong's external relations that had caused the attention for most people in

town. Therefore, I think it's the best timing to go through the topic.

To start with, according to our basic laws, the status of Hong Kong is fundamentally different from the status of colonial Hong Kong. Our law is authorized by the embassies of the National People's Congress of the PRC when the colony was -- the northern colony was promulgated by the U.K., so the statuses are totally different depending on the embassy to authorize everything that we are having. So, due to that, we don't have any nullifying power for sovereignties from the PRC. That's the National Education keep reminding us from primary 1 right now.

But since then, we have to cover what we are allowed to do. So, according to Basic Law Article 13, you only have to read the highlights. The Central People's Government shall be responsible for the foreign affairs relating to the Hong Kong SAR, but the Hong Kong government can handle external affairs on its own in accordance with this law.

So, what is foreign affairs and what is external affairs? The two are very hard to be distinguished, and it's almost impossible to distinguish between the two. So, a lot of scholars are trying to spell out the real meaning of foreign affairs and external affairs, but at the end they acknowledge the fact that it is hard to draw a black and white line. So, we have to read the other laws.

According to Articles 150 and 151, we can use the name Hong Kong, China in the appropriate fields to enter the world organizations -- so, this is another interesting point -- in the appropriate fields, including the economic trade, financial, monetary, shipping, communications, tourism, culture and sports fields.

So, what is missing here? As we have read -- as we have listened for more than 50 minutes, Hong Kong is a very key member in the (inaudible) campaign in the world. But we don't have this more security here, so do we have the rights to handle external security issues? And these kinds of things would become part of the control (inaudible). So, we are using the title "Hong Kong, China" to enter the World Trade Organization, APEC, FIFA, etc.

So, according to another article, we can join the People's Republic of China, part of the official diplomatic missions of the Chinese team, so China nominated Margaret Chen from Hong Kong, as the World Health Organization chief campaigner as part of the Chinese official representation.

So, we have all these laws allowing us to do external relations, but there are also grey areas. The biggest grey area rests on this one but diplomatic relations against external relations. So, we have consulted different legal experts

in Hong Kong, acknowledging the fact that it's impossible to distinguish between the two.

So, what is the identity of Hong Kong? In recent studies, there are different academics, including myself, that are trying to (inaudible) the nature and identity of Hong Kong in the global arena by comparing the identity of Hong Kong with places like Jersey Island of England, maybe Christmas Island of Australia, and so forth.

So, regionally, I've used the terms of "sovereignty," which is coming out of some post-cold war studies. However, according to some of the commentators, the word "sub-sovereignty" is too irritating, because sovereignty is inseparable. Then we have read some reports, official reports, and those by the central policy units of Hong Kong, which has used the word "sub-nation" to describe Hong Kong, which should be even more irritating.

So, at the end, I think the consensus, the official consensus, that we don't have to use the academic jargons for the public. "One country, Two Systems" is the only term that is safe right now, so we are one country, two system unique. However, I think external relations of Hong Kong is a topic that has a lot of potential to contribute to Chinese diplomacy. If Beijing and Hong Kong had mutual trust, the fact that Hong Kong can handle external relations and would grant Beijing to do a lot of things that the other provinces cannot grant them to do.

So, there are four cases that I would like to introduce today relating to the grey areas. So, if Beijing freely chose the authority of Hong Kong, a lot of contributions can be made by Hong Kong people upon the authorization of the basic law, of course.

The first case is the Manila Hostage crisis, so I think all of us would know what has happened. After the crisis, our chief executive, Donald Tsang had made two phone calls to the president of the Philippines, and then problems arised. Is he authorized to make the phone calls? As a chief executive, is he able to call the president of a sovereign state directly? This question is very hard to be answered. So, again, the basic laws have to be consulted. Is it part of external relations, or is it part of the diplomatic relations that a central government should be handling? The chief executive was arguing that he knew the president when he was a kid, so that's a personal contact. And then he was also utilizing the APEC platform to call him, because Hong Kong is a APEC member and the Philippines is an APEC member as well. He also emphasized that he has called after approval has been sought from Beijing. However, at the end, the president of the Philippines keep complaining that the Hong Kong government is not behaving properly by calling them directly. It's not right according to the

diplomatic rules. So, what would be the right ways to do so?

After the crisis in Hong Kong, a lot of people are very angry, and they would demand the Hong Kong government to do more and to do better. So, this is a photo taken before a demonstration run by the Hong Kong people against the Philippine government for a stronger and better post-crisis management.

So, at the end, what's happened? It became a fundamental crisis to discuss the role of the Hong Kong external relations.

This is a report that I have taken out of the South China Morning Post a few days ago, so it has a full coverage of what has happened. So, the allegation is copied here. One of the commentators, called Anthony Yuen, criticized the Hong Kong government for overreacting and said Donald Tsang should not have called Aquino as they were not on an equal footing. The Philippine president, according to him, is a state leader while the Hong Kong Chief Executive is not. So, please be careful. If there is anyone who can make a call, it must be the president Hu Jintao. So, that was the arguments made by the commentator, Mr. Yuen.

However, Simon Shen, that's me, who studies in international relations said Hong Kong actually enjoys the sub-sovereign studies, which allows it to handle certain foreign affairs. But that's a misquotation. I mean external affairs. Otherwise, I would be in trouble.

The Basic Law enshrines the rights that Beijing do if Hong Kong's defense and diplomacy of the city has a high degree of autonomy in external relations. So, this become a grey area. So what has happened at the end? This is the Q&A made by the newspaper. So, some people are not happy because (d) the Basic Law states Hong Kong's diplomatic affairs should be handled by the central government. But what did Simon Shen say? The Basic Law enshrines the rights for Hong Kong to develop foreign relations in certain areas and the real answer should be external relations.

By the end, Beijing decided it's too complicated to argue, so at the end the consensus is that the chief executive has the right to call him, because that's a special case, so we can make some special arrangements. So, at the end it's hard to argue that he has a right to call, and it's also hard to argue that he doesn't have the right to call. So, special arrangement.

So, at the end we have to make it clear whether they have the right to do so. If the chief executive has to write a letter to the president, according to diplomatic guidelines, the letter has to be signed as follows -- I'm writing on behalf of the highest authority of the signature of Treaty X from Hong Kong to

your highest authority -- so that whether you are addressing to the president or the director or the province leader, that would not be an issue. However, we don't have this training, so I think the government would be able to learn something more after this issue.

The second case relating to the theme of external relations is about Hong Kong-Taiwan relations. The highest Taiwan representatives in Hong Kong -- the Chung Wha Travel Service Agency, but don't ask for their tours. They are indeed part of the office of the Mainland Affairs office.

And another -- Kwang Hwa Information and Cultural Center was also represented in Taiwan, so these are the official representatives of Taiwan and Hong Kong.

So, what are the current developments of Hong Kong-Taiwan relations? For the most updated developments, we can read the January issue of the Hong Kong Journal, which is printed here. But what I would like to highlight here is that the Hong Kong-Taiwan bilateral relations had gone through a very difficult moment since they hand over. Between the years of 1997 to 2002, Hong Kong-Taiwan relations was actually handled by a guy called a special advisor to the chief executive, Mr. Paul Yip, who was one of my previous bosses. The post was a very special post. It's not a full-time position; it's an honorary position, but the position was designed to handle Taiwan, so it's an informal channel. Taiwan at that time was not very happy about this, to think Hong Kong was not paying sufficient attention. So, after 2002, the post was abolished and Taiwan became part of the official duties handled by the Constitutional and Mainland Affairs Bureau -- CMAB. And head of this bureau, Steven Lam, was known as the walking recorder in Hong Kong. I'm glad that our colleagues from the government hasn't arrived, but anyway they know what I'm talking about.

So, at the beginning, he was very passive, the head of Taiwan, because at that time under DPP government it was when Taiwan -- Hong Kong doesn't have the green light to handle Taiwan aggressively. But since 2008 when the KMT took over the power again the CMAB and Steven Lam in particular became very active to promote Hong Kong-Taiwan relations. So, this is the up-and-downs.

Previously, there are lots of taboos for the Hong Kong people to handle Taiwan due to the same grey areas, the difference between external relations and diplomatic relations. Once upon a time we have the Twin-city Forums between Taipei and Hong Kong. Some problems arise. What would be the capacity for Taipei and Hong Kong? What would be the correspondence? Hard questions.

When the DPP was the ruling party, the Hong Kong political parties would be a little bit pressure to have direct communication with them. If they are not behaving or speaking properly, they might step into some very sensitive areas.

The entrance of Taiwanese legislatures and officials sometimes are difficult. Sometimes they are very difficult to get visas for different reasons. The perceptions on One Country, Two Systems in Taiwan isn't particularly good because Beijing wished to use Hong Kong as a showcase to recover for the Taiwan sovereignty, so One Country, Two Systems isn't a popular term.

So, at the end, in the previous decade the role of the so-called White Cloves had been very prominent in handling Hong Kong-Taiwan relations. The Hong Kong Policy Research Institute, which was run by Mr. Paul Yip, the special advisor, was once upon a time responsible for handling this kind of informal contest within Hong Kong and Taiwan, and on the Taiwan side, the Friends of Hong Kong and Macau Association played a similar role, and at the time being the central policy units had authorized us to study some reports on Taiwan. However, after 2008, we have the green light to do a lot of new things. Hong Kong suddenly became the official intermediary of construct economic integration and also political integration, and the change was almost all of a sudden. The Hong Kong people are not prepared. I'm not sure whether the Taiwanese are prepared, but suddenly we have this new rule. So, after 2008 this seems to be very, very positive.

The Hong Kong Trade Development Council in Taipei was open in 2008, which is the de facto ETOs in Taiwan. The Taiwan-Hong Kong Economic and Cultural Cooperation Council under the MAC was set up and its correspondence in Hong Kong was also established. The first Hong Kong-Taiwan cities exchange forum was held last year. Lots of official contacts between the two sides have been sent, so these developments are very rapid, almost unthinkable before 2008.

This year, our foremost chief executive, C. H. Tung, had visited Taipei in March, personally but very symbolically. In particular, the ECCPC is granted in some official role for Hong Kong to handle Taiwan affairs. Our financial secretary, John Tsang, who is the honorary chair person of the ECCPC, just visited Taipei last month. So, some of the Taiwan officials also called for increasing the standard for a Taiwan office in Hong Kong to handle Hong Kong relations. However, behind all these positive gestures, there are new problems faced by the Hong Kong-Taiwan relations.

When Taiwan and mainland China sign ECFA, a lot of Hong Kong people are feeling being threatened. Ideally, Hong Kong has signed CEFA with

mainland, Taiwan has signed ECFA. So, if Hong Kong can sign a new FTA arrangement with Taiwan, that would be a strategic triangle in the greater China region. However, a lot of Hong Kong people are worrying if the opening of direct three links and the signing of ECFA will have directly threatened Hong Kong's role as the original entrepreneurs of British China.

Also, it's very uncertain whether the current warm relations between Hong Kong and Taiwan would be unchanged if DPP became the ruling party again. No one knows. Sometimes Beijing will not be too happy about the interruption between some people in Hong Kong and Taipei due to their common ideological backgrounds, such as the colonial complex and so forth. So, we don't know how long can the good relations be sustained. So, if Taiwan has a new ruling party, then we would have more evidence, but it's hard to tell right now.

The third case, the Diaoyutai or the Senkaku crisis. Originally it wasn't involved Hong Kong, and Hong Kong was not relevant. But what is relevant is that there are also some anti-Japanese sentiments in Hong Kong. It's not too strong, but they are very symbolic.

Historically, the Diaoyutai activists in Hong Kong had play a great role in protecting the sovereignty of these islands in the '70s and '80s. At that time, Beijing was not too strong. In this case, they are busy for other reasons. So, the Hong Kong activists had played a very strong role. But right now are they still allowed to play this role?

This is a ship owned by the Hong Kong people, which is supposed to be sailing to the region to protect the sovereignty of China, but they are not allowed to set off at the end. The ship was owned by the Action Committee for Defending the Diaoyu Islands, which is associated with the traditional left wing organization of Hong Kong called "April 5th Action." So, it was trying to go to the region on behalf of themselves and Hong Kong. At first they were investigated by the Health Department, because they had received complaints that there are mice in the boat, so they're not allowed to set off.

For a second time they are being stopped by the Marine Department claiming that the boat has not been properly registered and they are not doing fishing, because the registration is doing fishing so they cannot go.

It's raised new questions to the autonomy of Hong Kong. If they are not able to go to the region due to the aforementioned reasons, a lot of tourists would not be able to go for the same reasons. It's hard to define pure fishing or simple truism. So, the organizations are trying to put the case in front of the law courts by challenging whether the government has a right to stop them. So, the questions remains: Is people's diplomacy part of diplomacy or part of external

relations? We don't know.

The final case about Hong Kong-U.S. relations -- we have already covered many different aspects -- financial aspects, security aspects on Hong Kong-U.S. relations, and obviously the Hong Kong-U.S. relations is naturally underpinned by Hong Kong's role in Sino-American relations.

So, we don't have to repeat what the other speakers have mentioned, but we just have to cover some controversies of the U.S. presence in Hong Kong according to the same laws. So, sometimes the provision commentators would raise an articles to express their worries, because diplomatic and external relations are hard to be separated. For instance, sometimes some organizations in Hong Kong receive funding from the United States, most notably the NDI, so according to some of the probation commentators it's extremely sensitive.

Sometimes, some Hong Kong legislators would like to come to the States to attend Congressional hearings according to them is in the grey area. Some of the commentators are very worried about the so-called color revolution. So, some would suggest basic article 23, which would clearly define what would the limitations for Hong Kong people to have interactions with the foreign countries would be a solution. But some have strong reservations. However, an interesting case in this year is that the probation lobby is generally very happy to its role played by Washington to handle the political reforms in Hong Kong a few months ago, because they had signaled green lights for Beijing's proposal.

So, again it's very hard to draw a line between the limits -- what would be the taller of the roles to be play in public.

So, what would be the conclusion? One Country, Two System is an innovation, and it's almost unprecedented. But it's very hard to theorize the details of this proposal. What would be the limitations; what would be the definitions of external relations, etc., is very hard to draw a line. So, there are new potential problems and challenges faced by the governments of Hong Kong and Beijing. However, if properly managed, external relations of Hong Kong would have great assets for China's diplomacy.

This is the concluding remarks made by the official CPU report, which was written by the Shanghai International Relations Research Institute, whose director is the brother of the foreign minister of China. The report suggested that Hong Kong might do the things that Beijing is not convenient to do, because it some potential to handle external relations on behalf of Hong Kong, China instead of China directly. So, if Hong Kong is granted the right to do so, China will have different representations in the world. For instance, in APEC, in

WTO, it would have more than one vote, and that would be a great asset for the PRC.

So, I'd like to stop by the final words. In the mentality of the Hong Kong people, we always remember one soccer match in which the Hong Kong team lost 0 to 7 to the China's team. Most football fans in Hong Kong suggested that it's a conspiracy. We're not that bad even though we're bad. Zero to 7 is too insulting. So, they think Hong Kong is so patriotic in a sense that no one should worry about anything. So, thanks so much for your attention. Thank you.

DR. BUSH: Thank you very much, Simon. Bob, we've had three great presentations. It's now up to you to offer some coach and comments.

ROBERT KEATLEY: If I stay here.

DR. BUSH: If you -- do whatever you want.

MR. KEATLEY: Thank you. Thank you all for coming. They were three excellent presentations, and I won't take a great deal of time commenting on them, because I know you want to get to some questions.

One thing that we did not discuss here in this panel is not about Hong Kong politics, but there is an effort to bring full, local democracy to Hong Kong, and it's often said that the capitalists and the communists joined forces to prevent it from happening. I really want to ask are politics a hindrance, an obstacle to the development of Hong Kong as a financial center and a business center? Do people worry about more populace governments, higher taxes, and all of that possibly coming down the road and making them a little reluctant to appear? One of the more outspoken people in Hong Kong on that subject you probably all know is Ronnie Chan, and in an interview not too long ago, he said popularism will lead to socialism. Hong Kong will be over if we go for socialism. All the countries with the highest debts are Western countries whose governments are elected by the people. Western democracy is a dead end. To the best of my knowledge, he keeps his American passport, but that thought, not so blunt, is often heard in Hong Kong, and again I wonder if you see that as a thing in the background that might make some people reluctant to do business there or to move their financial business there.

On the markets, Bill, it's sometimes said that Hong Kong for all its growth is more Sinocentric than it should be or could be. Mainland and Hong Kong companies dominate, but could it or should it do more to bring in companies for listening from other parts of Asia or other parts of the world? Is that desirable or necessary? Is it a thing that they should pay more attention to?

Some critics say the reason there hasn't been much is that the Hong Kong government itself doesn't show a great deal of policy initiative and activism in trying to grow and take advantage of opportunities rather than carry on doing many of the same things that's always done.

So, maybe those a few things that people might want to hear about or ask about.

As far as money laundering, it's apparently not a serious problem in the drug field, but I'd want to ask something anyway. U.S. Treasury estimates that somewhere between 19 billion and 39 billion U.S. dollars -- that shows how imprecise estimates are -- of drug money goes from the U.S. every year to Mexico and Colombia. They're not sure the division between them.

It is said that much of it is laundered in many ways and returns to the U.S. often in a form of real estate investments. Is there any reason to think that some of that passes through Hong Kong as one of the many, many places? This is not exactly money laundering, but one often reads that Hong Kong is an interesting or useful conduit for people doing illegal things that involve money.

Viktor Bout, the Russian arms dealer now languishing in a Bangkok jail, apparently has used Hong Kong as one of many cutouts as he's moved money around buying and selling arms.

Sometimes you'll read about equipment headed to Iran for possible use in the nuclear program there and often there'll be a Hong Kong stop, at least on paper, along the way as the financing and shipping of material takes place. Is that kind of thing a serious concern? And can anything be done about it? The laws of founding companies are quite liberal and loose and I'm not sure Hong Kong wants to do anything to change that.

As far as Hong Kong and Taiwan are concerned, one of the announced and repeated reasons why Beijing says it created the one country, two systems approach for Hong Kong is to set an example for Taiwan, because I think Deng Xiaoping proposed something like that for Taiwan many years ago, and the idea being that if China sets a good example in Hong Kong and has a relationship that Hong Kong's quite comfortable with, the people of Taiwan might feel a little more comfortable about having a variation of some kind, not a duplicate, relationship with the mainland. I don't find a lot of enthusiasm for that idea when I visit Taiwan, but that is one of Beijing's announced purposes. What could Beijing do, if anything, that would -- about Hong Kong that would give the people in Taiwan a little more confidence about the kind of future relationship they may have? Are there some undone things, such as liberalizing the political system, that might go down well in Taiwan?

I thought maybe we could start with a few of those things and then let people in the audience ask a few questions.

DR. BUSH: Thank you very much, Bob. Maybe just come down the row, Bill? Would you like to respond first?

DR. OVERHOLT: Okay. Well, let me start with a relatively easy one -- is Hong Kong too Sino-centric and is there a lack of policy initiative from the government? It certainly has been Sino-centric. China's been the great opportunity. Hong Kong has focused on the great opportunity. Japan has all sorts of vested interests that make it difficult for Japanese companies to list or be traded in Hong Kong. The other countries are dynamic but small.

My inclination is that the greater diversification will come organically. Geographic diversification will come organically. Tai companies, for instance, I think will increasingly list in Hong Kong. So, I'm not very concerned about that. But the inertia of the Hong Kong civil service is a big problem.

The civil service in Hong Kong plays the role that the U.S. Congress plays in our country of inhibiting forward looking change, and whether you look at education reform or competition policy reform or at proactive financial market reform, the civil service does what it does, what it was taught to do by the British. It's very good at processing. The British didn't want to create a civil service with a strategic vision. Companies choosing where to locate in Hong Kong or Shanghai, according to my interviews, one of those smaller but significant criterias, if you want a system where rudimentary processing in middle and lower levels by international standards and in rudimentary English, you go to Hong Kong. If you want a visionary chief executive who speaks perfect English, you go to Shanghai. And that pretty much describes both the business system and the government systems of the two places.

The question of democratization's impact on the financial system - - that is a complicated one. I don't think there's a great issue about democratization impacting the financial system. I think there is a great question in the minds of Hong Kong people about how it would affect the economic system more generally. Democracy works best where the center of gravity is an educated middle class, a society shaped like a diamond where people are -- the majority of people are arguing over common interests in the middle.

When you have a society that's landlords and peasants, like India, it doesn't work so well, and Hong Kong's a little bit like that, because you have this extraordinarily wealthy elite and then you have a very, very poor lower half.

Half of the people in Hong Kong still live in public subsidized housing. All the political rhetoric coming from this impoverished underclass is socialist, and if you look at the proposals of the Democrats or of the pro-Beijing conservatives in the legislature, it sounds like Ronnie Chan is right. It's extraordinary. Never -- this stuff would never be tolerated in the U.S. The proposals would never have a chance. They'd be laughed out.

But the other aspect of this is that if there were real democracy, the politicians would be forced to confront real consequences and be responsible. When your legislator who has to pander to voters and there are no consequences, surprise, you get even more pandering than you get here. So, because of the structure of society and because of what public opinion polls and the legislators who are elected say, there really is a serious controversy, and anybody who just says oh, democracy will be fine isn't taking it seriously. I tend to believe that a much more rapid democratization could be quite -- than is occurring could be good for Hong Kong and its economy.

In the long run I do think that a kind of instant transition, say, in 1998, could possibly have had quite disruptive consequences for the economy, because -- but that is a serious question on which different people can reasonably have different answers.

DR. BUSH: Thank you very much, Bill. Mike?

DR. MARTIN: I'll use my prerogative as being on the panel to address maybe a couple of points that weren't necessarily intended for me, but I'll do it anyways. So, I'll start with the one that was intended for me.

In some ways I agree with you in that this is indeed the serious issue I think for Hong Kong in terms of what I was defining as money laundering, that is to say, the movement of money via Hong Kong to avoid regulations or laws in other countries. However, it is subject to Hong Kong law. So, a transaction that is perfectly legal in Hong Kong, even though the United States or other country might not like it, doesn't make it inherently illegal and improper. So, that's one thing to bear in mind.

Second aspect is that with that in mind, for example on the Iran sanctions, the U.N. sanctions, Hong Kong has passed a local ordinance that would basically require the maintenance or the abiding by those -- the terms of those sanctions. So, Hong Kong is a responsible party in that respect. So, point taken, and in fact in some way that's what I was trying to emphasize. It is indeed those type of movements of funds that Hong Kong tends to focus on, less so international drug money or counterterrorism financing, and I want to reemphasize I am not saying that they don't pay attention to those issues. They

work quite adamantly and hard on the international stage for that, but it really isn't for Hong Kong. The primary thing that would threaten its reputation or threaten its role is the international financial hub in Asia.

Well, let me talk a little bit on Ronnie Chan's quote. I know Ronnie Chan. I've known him for a number of years. And democracy -- I would start out by saying we should bear in mind what exactly is going on in Hong Kong. There were the two changes made, but this doesn't mean rapid transition to an open, democratic process in Hong Kong. You still have -- you know, I'm sorry to get weedy, but you still have functional constituencies where you have corporate voting and are elected by a few dozen people effectively. So, we're not jumping from one extreme to another in Hong Kong in terms of democracy. And then procedures, the actual process whereby the new five members of the legislative council are to be elected. Still -- there still has to be ordinance passed to determine how the process takes place. Similarly, the expansion of what I call the selection committee for the chief executive -- the details on how that's going to be done still has to be worked out, and I would put down that the presumption is that China -- Beijing is going to have quite an influence over who are going to be additional the members of that selection committee. So, yes, we're making movement, but this isn't a complete change in character as the democratic process, the political process in Hong Kong -- at least my understanding of it at this time.

The other thing I'd bear in mind, and I've said this on a number of occasions, if you were to take, for example, the Democratic Party in Hong Kong and transpose it in the United States, they'd probably feel more comfortable in the Republican Party than they would in the Democratic Party. The Democratic Party, the wild-eyed radicals according to some in Hong Kong, are actually fairly conservative businessmen and professionals.

Hong Kong hasn't had a minimum wage law for many, many years, and I think they're still debating it at this point. So, the radical change that we're talking about -- I mean, a minimum wage law is a radical change in Hong Kong. We've had one in the United States for a number of years, so, I mean, we could discuss it more but the changes that may be possible under the new chief executive system and the new ledge-co I don't think we're going to see a shift to socialism in Hong Kong in five years. If it happens, it'll be an interesting historical event, but I just don't see dramatic change in the economic system in Hong Kong under the reform -- the political reforms that are being discussed.

One other comment I wanted to make. Sino-centrism. As I said, I was in Hong Kong from '94 to '98, and for those of us who were there, there was this -- for a while there was a -- people couldn't see past July 1, 1997. It was just

like the end of the world. Some people were actually fearful that it was going to be the end of the world for Hong Kong. But about a year or so before, there seemed to be a sudden change in attitude in Hong Kong, and there's a realization that there would be a July 2nd and that something needs to be done to prepare for it. And there were a number of studies about what Hong Kong should be like post-handover.

There was a book made by Hong Kong that came out, and there's another book called *Hong Kong Advantage* in which there was a big debate on to what extent should Hong Kong basically tie its horse to the driving engine that makes metaphors of the mainland economy, or should it diversify its portfolio, to use a financial concept, and expand its economic network throughout the region. I happened to be a party to that discussion at the time because of my job at the TDC. There wasn't a firm consensus or determination at that point. One could argue that under the first chief executive, Tung Chee Hwa, that it was sort of mugwampish you know, a little bit of this, a little bit of that, we'll see how it goes. But that may be due to two factors.

One, there was bound to be a sort of getting-to-know-you period for Hong Kong in the mainland government under this new system trying to develop, so there isn't a natural tendency for the eyes of Hong Kong to look north.

Second -- let's be frank -- in this time period where, remember, the Asian financial crisis transpires almost simultaneously with the handover. It was sort of interesting that most people worried about what's going to happen politically to Hong Kong, and I would say the most dramatic event of 1997 for Hong Kong was the financial crisis, the attack on the Hong Kong currency, the attack on the Hong Kong stock market transpired. But that in the aftermath as the Asian financial crisis started to resolve itself, what was the best investment opportunity in Asia at the time? If you were an investor looking for business opportunities, would it not be natural to look north to China? So, there may be a good commercial basis set for this 10- to 12-year period. Hong Kong has been somewhat Sinocentric. So, probably too much but I'll stop there.

DR. BUSH: No, it's not too much. It's very good. Simon.

MR. SHEN: Thank you. Just a quick supplementation to co-host. There are indeed some changes in Hong Kong. We have a new (inaudible) need of social democracy, which is trying to play the so-called socialist role, but the actual impact is that everyone else is being pushed to the middle and the mainstream. So, it's a new feature.

But let me address my question to directly to one country, two

system in Taiwan. The Taiwanese are not enthusiastic about the proposal for different reasons. And yet Beijing's policy choice to Hong Kong and Taiwan almost totally different. Right now Beijing is trying to give Taiwan as much flexibility as it can. Taiwan can enter the World Health Organization as an observer. The diplomatic -- the country's organizing Taiwan unless being taken by Beijing. At some point, we wonder if Beijing would give Taiwan some new countries, but at the end of the road, Taiwan is still part of China, so such possibilities can be given. But in policy choice Hong Kong is totally different. We just have a new boss. The Macau in Hong Kong Affairs organization of a state council. And the director is new, and according to reports the number one priority of them is to encourage the psychological reunification of Hong Kong, which means we hand over. Hong Kong is over is reunified into the PRC. But our psychology is not yet there, so we need to do something more to ensure that we're part of China. So, that would be the priority of Beijing's Hong Kong policy.

So, on one hand it wants to grow in flexibilities for Taiwan. On the other hand national educations will become the key issues of Hong Kong. So, the two sides would only become more different in the long run. So, I don't think one country, two system would be that attractive for the families.

DR. BUSH: Thanks to each of the speakers and to Bob for his comments. We now throw it open to you, the audience, for about half an hour, 45 minutes. When I call on you, please wait for the mike and then identify yourself and say to whom your question is directed.

Joe. It's coming.

QUESTION: Thank you. Thank you very much for an excellent presentation, Richard, which you put together here. Recently, I was --

DR. BUSH: You're Joe Snyder.

QUESTION: Sorry. Joe Snyder, a retired Foreign Service officer. I was recently giving a talk in which -- it was about Hong Kong -- and I was talking about how the Hong Kong legal system is a strong legal system, untainted by any kind of corruption as many people have said here. Also I said that it was not subject to influence from the mainland. Unfortunately, there was a lawyer in the audience who took issue particularly with the last statement, that the legal system was, in deed, occasionally interfered with by the mainland. And I'd like to know -- because you had experience there and all of you have been talking about the legal system in Hong Kong -- is there much influence? Are decisions overturned by mainland authorities within the Hong Kong legal system? I know, of course, political systems are much under control by Beijing, but I'd like to

know what the story is with the legal system.

DR. BUSH: Who'd like to take that one? Bill?

DR. OVERHOLT: The National People's Congress has the right to interpret the Basic Law and occasionally there are issues, like standards for people from the mainland to assert their Right to Abode in Hong Kong, what conditions, what processes. And the National People's Congress asserts its right, but it's very rare. They don't ever step in and say, you know, "Joe Schmo who's just been found guilty is actually innocent." They're very respectful of the British legal tradition under which Hong Kong has been administered for such a long time. And so I would argue that it's quite minimal, and it's completely consistent with the terms under which -- with all the promises that were made at the time of the handover. And the Chief Justice, who took charge after the handover, was a much more assertive and forceful and respected leader than his predecessor. He got slapped down at one point for treading on what the National People's Congress saw as its authority, particularly in the area of immigration.

But I don't think it's fair or unbalanced to say that, you know, they've done a lot of interference. There's very little overt corruption in the Hong Kong legal system. What there is a kind of incest. The system is so small that in two sides of a case, the lawyers are likely to be much closer to each other than they are to their individual clients. And so things given in confidence to your own lawyer -- I have some personal experience with this -- get traded at the bar with the opposing lawyer that evening. And they don't like to step on each other's toes or discredit each other, and they will collaborate to raise the costs for both sides for mutual benefit. It's much more common in some areas than in others, but the fact that it's a relatively closed system in what is effectively a small town because the part of the legal system that deals with each other is confined to an elite.

And the other aspect of the legal system is that it is so expensive and so cumbersome that the vast majority of the people don't want to have anything to do with it. Again, it's not a popular thing to say, but it functions the way we expect a legal system in a democracy to function, with remarkable efficiency and lack of corruption by world standards. The footnotes I just gave are important footnotes if you're part of the bottom 70 percent of the income distribution and have a legal problem. It's also very significant for Fortune 500 companies who, if you interview them will say, "Why did you move to Shanghai when the rule of law in Hong Kong is so good?" I say, "Well, the Mayor of Shanghai has such an interest in a reputation for fairness and justice that if we have a problem we call up the Mayor." And it's much faster and much more predictable and much less expensive than the Hong Kong legal system. If you're not in the Fortune 500, the Mayor may be too busy to take your call, and you really that Hong Kong legal system. And, of course, you have the risk that

sometimes the attitude -- you get a Mayor in Shanghai whose attitudes are a little different. So there are some important footnotes to the efficiency and functionality and integrity of the Hong Kong legal system, but by comparison with other places in the world, it's a lot better than most places in Western Europe.

DR. BUSH: Well, thank you. Would anybody else like to supplement? Bob?

MR. KEATLEY: Very briefly. Hong Kong has just -- now has a new Chief Justice; the one that Bill referred to retired. I just think there's -- I understand there's some concern that his willingness to uphold civic rights, may be less zealous than his predecessor, and somewhere in the legal and political committee there's concern about that. There's also some concern that the government may becoming more willing to seek clarification on issues from the National People's Congress. And when you take a question to a large bureaucracy or political body, you may not get an answer that you really want to hear, but the answer you get must be applied. So these are worries that I'm aware of, not so much has happened, but there is a feeling that, as I say, there may be a little more will to go to Beijing to resolve difficult issues rather than settle them locally.

DR. BUSH: Thanks. Who has the next question? Kerry?

QUESTION: Thank you. Kerry Dumbaugh with CNA. I have two questions. First, as a former colleague of Mike Martin's at the Congressional Research Service, I can't resist asking the question about the U.S.-Hong Kong Policy Act, which I helped worked on when I was in CRS. There's a clause in there that was very important at the time, considered very meaningful for Hong Kong's status, and that is that the President could take away the special treatment the United States was giving to Hong Kong if Hong Kong were judged to not be acting autonomously. Well, based on what we all have watched in the last 13 years and what our speakers have said, is that even a clause that's enforceable? I mean, what is an autonomous decision and what is not an autonomous decision? Is this a part of the U.S.-Hong Kong Policy Act that has outlived its usefulness? I could never have asked that question or addressed it in my former occupation.

The next question is I just wanted to ask Bill. You mentioned the Chinese companies that are listing on the Hong Kong Stock Exchange and how much they're looking for that kind of discipline, that kind of oversight. Could you elaborate on the kind of companies that are listing and compare what that anxiousness -- to have that kind of discipline and oversight -- how that compares to the way these companies are interacting in other countries in which they're investing? Is that kind of discipline following them or is it not?

DR. BUSH: Mike?

DR. MARTIN: Just to make sure I got this straight, Kerry, you want me to answer a question about an Act that you helped write when you're helping in a situation where if you were still at CRS you wouldn't be able to answer the question? Okay, good. Thank you. I appreciate this. In deed, that language does exist in the Act. Your memory is still good on that. Is it functional? Well, I could take the usual CRS answer: Functional is whatever Congress decides is functional. If they want to interpret events as an indication that Hong Kong is no longer acting autonomously, then something can be done. So Congress could pass legislation or a resolution calling on the President to utilize this language. Similarly, the President could point to certain events if he were so to choose and say, "Hong Kong's no longer acting autonomously; done." Now I don't know about reporting requirements back or information back to Congress. I'll have to brush up on my Hong Kong Policy Act.

So I think that's the quick and short of it, but I think what you're really getting at is, how do we gauge autonomously in Hong Kong? In fact, we'll go back to the earlier question about the legal system. I would echo what Bill said. In terms of business contracts, regular transactions, or what not, the fingerprints of Beijing don't seem to be coming to play by and large. What I think is interesting is that there have been several cases -- he referred to one of them, the Right of Abode. You could also talk about the election reforms as another example. There are a couple of more, that in some ways where in Hong Kong, there seems to be an irresolvable political difference of opinion on how to move forward that either the Hong Kong government proactively went to Beijing and asked for a clarification or Beijing proactively decided okay, we're going to resolve this, we're going to take care of it. On the Right of Abode, Tung Chee Hwa went to Beijing and said, "Interpret this for us." And I'm not a lawyer, my wife's happy about that. I'm an economist, she's not necessarily happy about that. But anyway, it seemed pretty clear from the language, according to some lawyers that I spoke to, which way the court interpretation should be. And, in deed, the Court of Final Appeal ruled that one way, but Beijing decided that what it wrote meant something different than what other people thought it meant. That's my personal take on it, but it did resolve a political problem in Hong Kong -- and by the way, the decision from Beijing was the one that most of the people of Hong Kong supported. It was what the populous wanted. On the election reforms, I will say oops, I'm out of time and I'll pass. Over to Bill.

DR. OVERHOLT: On your question about what companies are looking for when they go to Hong Kong, they want to be -- it's much less onerous to be answerable to shareholders than it is to be answerable to party secretaries and such like. There's a freedom of action, a freedom of dealing with money.

There's the security of dealing with international legal systems whose rules are acknowledged, the contracts are acknowledged back in the mainland, when you've got an overseas listing. So these guys would like to be able to make money under predictable rules and with minimal political interference. It's not very different from capitalists anywhere. They want to be capitalists. They like making money. Do they carry those standards overseas? I'm not sure I understand what you're getting at. Their governance structures, their accounting, not always up to U.S. SEC standards, but a lot better than what it used to be in the mainland. Those things carry over. And when they go to Africa, they raise local living standards. They also take a bunch of Chinese workers and don't use the local people, and the local people find that objectionable, but that doesn't have anything to do with whether they're based in Hong Kong or Beijing or Shanghai. So I think on balance it is positive for the way they behave overseas because accounting and things and corporate governance do make them a little bit easier to deal with. But I think the big issues for how they behave in this country or how they behave in Africa don't have much to do with what jurisdiction they're registered under.

DR. BUSH: I have a supplement to Mike's answer to Kerry's first question about the degree of autonomy and why the United States cares. I was responsible in the summer of 1992 for doing the House version of the U.S.-Hong Kong Policy Act, and I think the issue that members and the administration were most concerned about at that time and today is export controls. There is a different treatment for Hong Kong than there is for China. Hong Kong gets that better treatment because it guards its borders and its Customs Service works so hard to make sure that there's not a leakage of prohibited technology into China. If we -- if the U.S. government came to the conclusion that Hong Kong no longer cared about preserving that barrier, we would treat Hong Kong exactly the same way we treat China. I think, fortunately, the Hong Kong government and the Hong Kong elite understand they have a profound interest in maintaining that differential and in preserving the capacity to maintain it. If we saw a negative trend, I'm sure that we would work quietly with the Hong Kong authorities to make sure that that trend was reversed.

Let's see, I saw Beverly Hong in the back.

QUESTION: Beverly Hong-Fincher. I just have a comment or two about Sino-centrism. I think the Hong Kong people -- what they demonstrate is more Sino-chauvinism rather than centrism from all, you know, has been expressed by all the panelists here. I remember when Professor Wong Hong Wu who was president or vice chancellor of Hong Kong University, the thing that impressed them they said was how chauvinistic Chinese, the Hong Kong people, are. Now as many of you know, that Professor Wong Hong Wu comes from most -- at that time -- from Australia and then from Malaysia and then Indonesia. So

they were impressed by that and so am I. So Hong Kong people are chauvinist Chinese, but not centrist Chinese.

Another comment I would like to know about Mr. Simon Xu Hui Shen. And I just wanted -- as a linguist, I'm very curious about the spelling of Xu Hui. I wonder if that is an illustration of "One Country, Two Systems." Thank you.

DR. BUSH: Who would like to take on the chauvinism issue? Any takers? Comment? No comment. Simon, do you want to engage in linguistic analysis?

MR. SHEN: This is the first time I've encountered this question. My parents had a different pronunciation system. When I was born, I was born in 1968. At that time they anticipate "One Country, Two Systems" happening so they used a different system for my name. So, in deed, you are right. So Xu Hui Shen is the Mandarin pronunciation, but I'm a Cantonese-speaking person.

DR. BUSH: Okay. Who's -- right up here in front. Wait for the mic please. Is there a mike up in front? Here we come.

QUESTION: Hi, I'm Amy Tsui. I'm with BNA's International Trade Reporter. I wanted to ask about the issue of the RMB in terms of the -- the RMB has been a big issue on Capitol Hill recently and probably in the future. I wanted to get the panelists' view as to how they see China's transition to reform on the RMB. And also, I believe Fred Bergsten at the Peterson Institute has made a suggestion that the United States could buy RMB and to counter some of the Chinese buying of U.S. treasury bonds, and I wanted to get the panelists' viewpoint on that and how Hong Kong's role in the RMB and their activities with China work with that?

DR. BUSH: Bill, that sounds like a question for you.

DR. OVERHOLT: Starting from the early '90s, China had a policy of moving to a freely convertible RMB. It then realized that its banking system could be devastated in the same way that Thailand's and Korea's and so on were if they didn't reform their banks first. So they changed that and went back to a fixed RMB in a way that for seven years overvalued the RMB substantially from 1994 to 2001 or 2002. That system was then altered in the middle of this decade because they saw their interest, as in gradual liberalization, they allowed it to rise about 21 percent.

And then the global financial crisis hit, and they again froze their policy. It's very important to understand the circumstances behind that.

Guangdong Province lost 25 million jobs almost overnight, 25 million jobs. Our congressmen complain about the loss of 2.3 or 3.3 million jobs, manufacturing jobs, in this country, very few of which have anything to do with China and that's over a 10-year period. Here you're talking about a province that loses 25 million jobs in a year. Detroit has about 4 million people. Dongguan in the financial crisis had 4 million people who had to move back to the countryside because there were no jobs.

What our politicians and media know about China during the financial crisis is largely confined to 9.1 percent economic growth, which is a remarkable achievement, but it disguises the incredible trauma that happened along the most dynamic parts of the coast in this period. And you've got a government in Beijing, an administration, which came in dedicated to a harmonious society. Harmonious means many things at many levels, but one of the things it meant was we're not going to do anymore what Zhu Rongji did, lose 50 million state enterprise jobs in 10 years and 25 million manufacturing jobs in 10 years. It's just too much trauma. Our society can't take it. People were really angry at Zhu Rongji the last 18 months.

And so just when they're suffering all this trauma, we put huge tariffs on their tires. Not arguing that they'd done anything wrong, in that case just selling tires too successfully to us. And we put this big move on about the currency. I think it is time for China to move on the currency for its own reasons. They're going to have an inflow of hot money that could become a tsunami if the currency stays fixed. They're going to have trouble shifting from domestic -- toward higher domestic consumption-led growth. There are half a dozen reasons why they're going to need to shift. Contrary to what many of legislators and contrary to that Bill Cline paper that Fred relies on, the Chinese currency has almost nothing to do with U.S. jobs. And reforming the Chinese currency -- the savings gap is what drives the trade deficit and reforming the currency will do very little to the trade deficit. So this is a great political game. It's a way of avoiding, of our politicians avoiding the real issues. So we -- when we make a big issue out of this, we're just making it more difficult for the Chinese to move. And we're pretending -- it's a way for us to avoid the fundamental economic issues that we need to face. The Chinese are in the same position. Their politicians are doing the same thing we are. This is too difficult, too delicate, and the fact is that they're going to need to move on the currency fairly quickly, gradually but quickly, for their own reasons. But when you understand the kind of social trauma they're dealing with, you will understand why there is this tremendous fight in Beijing between the Commerce Department which is worried about all these jobs along the coast and other people who are worried about long-run shift, and the need for a long-run shift in the strategy of economic development. The issue has just gotten completely out of control politically on both sides of the Pacific.

DR. BUSH: Question up here? Oh, I'm sorry. Mike, please.

DR. MARTIN: I know Kerry's probably saying, "Mike, why are you doing this?" I can pretty safely say that regardless of what happens with the Fair Trade Act for short hand, that there will continue to be in Congress interest in U.S.-China economic relations. So I'm not going to make any prediction on what's going to happen in the future, but regardless of what happens, the issue is not going away. That's just my professional assessment.

I'm going to take a slightly different tact on the renminbi. I'm going to shy away from the exchange rate regime directly, but what I will point to is that -- well, two things, I will make one quick comment. First, managed floats are the norm in Asia, not the exception. Hong Kong's currency is, in fact, linked to the U.S. dollar, has been for a number of years. So the idea of a free-floating currency is not a standard issue in Asia at this point. In fact, Japan just recently intervened in the international markets because of the exchange rate. And a couple of years ago, Korea intervened in the international markets because of the exchange rate. So this is one thing to bear in mind. Second comment to lead in the other part: When the global financial crisis started, I found it interesting to see what analogies, what issues in the past, people looked to get an understanding of what was happening. And I think in the U.S. media, you could quickly characterize as everybody started talking about the Great Depression. We were rather pessimistic at least at the initial phases if you remember about what may transpire. In Asia, it was the Asian financial crisis of 1997. It wasn't the Great Depression. And there is -- and I won't go into great details -- a very different interpretation of events in '97 in Asia, and much of Asia, than there is in the United States about why that happened and what happened. One issue involved in that is the issue of capital controls, and that's when I get back to the renminbi environment. I do see evidence that Beijing is interested in making the renminbi a more international currency. Whether in the Asia area predominantly or globally, time will tell. They are making efforts to make it a medium of exchange, a store of value, even a unit of account for international trade, standard practices and what functions that money has. That is not dependent on particular exchange rate regimes, nor does it necessarily require a level of liberal policy towards capital controls that we have in the United States. I'm not sure if it's been fully formulated in the minds of the leadership in China on how this is going to transpire, but it is something that I think warrants attention, not in a couple of years but in the longer term. And, in deed, there have been statements out of Hong Kong about whether or not somewhere down the road in a nebulous future that the link would shift from the U.S. dollar over to the renminbi.

DR. BUSH: Okay. We'll go right -- oh, please.

QUESTION: Very quick. Chris from *Hong Kong Perspective*. I want to supplement two points. A few moments ago, our neighbor Peterson Institute has published some reports and they have included Hong Kong and part of the reevaluation regimes to get the renminbi reordered. And that has greatly shocked the people of Hong Kong because they have never expected this. So at that time, some people in Hong Kong asked me to interview the people on opposite side, and they said it's not the unanimous consensus, it's just a suggestion. So I think the people in Hong Kong are quite worried about this. If even Hong Kong would be included in the evaluation debate, then that would be completely unthinkable.

The same point about the linkage. A lot of people in Hong Kong are talking about de-linking with U.S. dollars for the Hong Kong dollars and then to repacking renminbi. But I think the consensus seems to be that before the settlement of the renminbi and U.S. dollar exchange rate issue, a plan to reform would not be able to start. So that's my general comments. Thanks.

DR. BUSH: Okay. We'll go right here, and this will be the last question.

QUESTION: Hi. Sheldon Ray. Quick comment based on -- regarding Hong Kong's integrity that Bill's covered and the rest of the panel, I'd say the proof of that is in the pudding. Over the first decade of this century, through December 31 of '09, the U.S. S&P lost over 9 percent. The Hang Seng Index had a total return of 78 percent. Being next door to China is a factor, but I can tell you with certainty a lot of the underperformance in the U.S. is because of a lack of integrity, accounting fraud, and earnings manipulation that we really don't see in Hong Kong. Thank you.

DR. BUSH: On that note, we will break for lunch. And let me explain how we're going to do this logistically. For everybody in the crowd, we ask you to go out that door and then make a U-turn into the sort of corridor between the two function rooms, and there you will find the buffet lunch. I'm going to ask the panelists to go first and just out this door so that they can get their food first in reward for an outstanding performance. Please join me. And at an appropriate time after you return, we'll introduce Donald Tong. Thank you very much.

[Recess]

DR. BUSH: Ladies and gentlemen, I apologize for interrupting your luncheon discussions, but I think we should move on with our program. Our keynote address today is by Donald Tong who is the Hong Kong Commissioner for Economic and Trade Affairs. He's been in that position for just about a year.

Notwithstanding the things that Bill said about the Hong Kong Civil Service, the thing that impresses me about the sort of senior members of the Hong Kong government is how they have many, many talents. And I say this as a person who has basically only one talent, and so I really admire people like Donald. Donald is not only a diplomat -- he served here and in Canada -- he's served here before, he's serving here now, he served in Canada. He also was deeply involved in Hong Kong's Olympic Games in 2008. He's done food and hygiene, food and environmental hygiene. He worked on the new airport. There's nothing this man can't do. So it's a privilege to have him here to speak to us today and to cap off I think what's been a very good program. Donald?

DONALD TONG: Good afternoon, Richard, ladies and gentlemen, friends of Hong Kong. Thank you, again, for having me and for the kind words of introduction, Richard.

Today's topic is Hong Kong's external relations. As an international city, Hong Kong's ability to maintain good external relations with global players is crucial to our well being and successes. While the Hong Kong government has a very important role to play in fostering Hong Kong's external relations with the outside world, we must not neglect the significant contribution by our private sector and overseas investors, businessmen, and visitors to Hong Kong. They all play a key role in shaping our external relations and image overseas.

Before I dive into the details, let's just pause for a moment to look at today's topic again: Hong Kong's external relations. The simple fact is that more than a decade after the handover from Britain to China, more than a decade after many people predicted doom and gloom for Hong Kong and that Hong Kong would not have any external relations to speak of and would be consumed into the mainland, today we are talking about Hong Kong as a fully functioning and highly autonomous region within China. This high degree of autonomy is provided and guaranteed in our mini Constitution known as the Basic Law. The Basic Law provides for arrangements and practicality in other territories around the world, a local government with a suffering country, but remains highly autonomous. Under the concept of the "One Country, Two Systems," Hong Kong functions as a special administrative region who have extensive authorities and responsibilities while China takes care of Hong Kong's defense and national affairs. Hong Kong remains a free port and a separate customs territory from Mainland China, while at the same time maintaining a border with the mainland. In deed, crossing the border between Mainland China and Hong Kong would be like crossing the border between the U.S. and China rather than crossing borders between states within the U.S. Hong Kong issues its own passports. In addition, Hong Kong's law, economic, and monetary policies and currencies are separate from the mainland's. We have our own tax regime and pay no taxes to the

mainland authorities.

The Basic Law has nine chapters with 160 articles covering a mountain of other things Hong Kong's authority in conducting external relations. Article 13 of the Basic Law stipulates that the mainland is responsible for foreign affairs relating to Hong Kong, but authorizes Hong Kong to conduct relevant external affairs in accordance with the Basic Law. The handling of external affairs of Hong Kong is elaborated upon in other Basic Law provisions in myriad chapters, in particular Chapter 7, external affairs, with eight articles. This shows how important it is for Hong Kong to maintain its external relations with the rest of the world. Allow me to elaborate on three particular areas of Hong Kong's external affairs as set out in the Basic Law, namely application of multilateral treaties, agreements and relations with foreign states and international organizations, and our participation in international organizations.

First, application of multilateral treaties to Hong Kong: The Basic Law provides that international agreements to which the PRC, People's Republic of China, is not a party, but which were implemented in Hong Kong before the handover, may continue. At present, around 240 multilateral treaties are applicable to Hong Kong, including over 70 that do not apply to the mainland. This clearly demonstrates the unique position of Hong Kong as a highly autonomous region of China and showcases the realization of the "One Country, Two Systems" principle. Under the Basic Law, the mainland may also seek the use of Hong Kong government before extending international agreements to Hong Kong.

Second, conclusion of agreements: The Basic Law provides that Hong Kong may on its own using the name, "Hong Kong, China," maintain and develop relations, and conclude and implement agreements with foreign states and regions, and international organizations in areas such as economic affairs, trade, finance and monetary affairs, shipping, communication, tourism, cultural, and sports. Examples of this autonomy are Hong Kong's agreement with the European community on cooperation and mutual administrative assistance in customs matters, and an agreement with Israel on cooperation in information technology and communications. The Basic Law also provides that Hong Kong may, with China's authorization or assistance, negotiate or conclude agreements with foreign states or regions in three areas, including air services agreements and open flight agreements, visa abolition agreements, and mutual legal assistance agreements. Since the reunification, the Hong Kong government authorized by the mainland has concluded over 100 bilateral agreements with foreign states. A good example is the Mutual Legal Assistance Agreement Hong Kong signed with over 20 countries, including the U.S., all of which took effect after the changeover.

Third, participation in international organizations: As you know, full membership in certain international organizations such as the G-20, International Monetary Fund, and World Bank, is reserved for sovereign states. Why Hong Kong would not qualify to be a full member in these organizations? Hong Kong representatives as members of the China delegations participate in over 20 such international organizations. A good example is our Financial Secretary's attendance at the G-20 and World Bank and IMF meetings. In some instances, Hong Kong can also serve in other capacities in international organizations typically limited to sovereign states. For example, Hong Kong now serves as an associate member of a few international bodies, including the United Nations' Economic and Social Commission for Asia in the Pacific or ASCAP, World Tourism Organization, and International Maritime Organization. This not only widens our exposure, but it also gives Hong Kong an opportunity to exchange experiences in related fields with other member economies.

Using the name "Hong Kong, China," the Basic Law allows Hong Kong to participate in international and intergovernmental organizations not limited to sovereign states. We are now members of over 30 such organizations, including the Asian Development Bank, APAC Bank of International Settlements, Financial Stability Forum, World Custom Organization, and of course, the World Trade Organization. Our participation again widens our exposures and enhances our cooperation with other member economies.

In addition to Hong Kong's agreements with the world, nothing better exemplifies our ability to conduct external relations than the existence of the Hong Kong Economic and Trade Offices overseas. The very existence of our offices in Washington, D.C., New York, and San Francisco, separate from the Chinese Embassy and Consulate Generals in the U.S., underscores the "One Country, Two Systems" principle. In addition to the three offices in the U.S., our government has established another eight Hong Kong Economic and Trade Offices overseas. They are located in major cities of our important trading partners in Europe, Asia-Pacific region, and Canada. The key mission of these Hong Kong Economic and Trade offices is to promote Hong Kong's economic and trade investments and interests abroad by enhancing understanding of Hong Kong to opinion makers overseas and promoting closure of bilateral trade, economic, and cultural ties. We keep track of the barriers that might affect Hong Kong's economic and trading interests overseas and seek to explain our policies and developments to the business and commercial centers, think tanks, politicians, and the news media in our host countries. The Economic and Trade Offices also work closely with more than 60 overseas offices of the Hong Kong public bodies, such as Immerse Hong Kong, the Hong Kong Monetary Authority, the Hong Kong Trade Development Council, and the Hong Kong Tourism Board. Together we run a network across the world in promoting various trading and investment opportunities in Hong Kong, and of course, attracting tourists to visit Hong Kong.

Equally important for the external relations program is for overseas governments and international organizations to establish offices in Hong Kong. This not only fosters economic, trade, and cultural ties, but also helps Hong Kong maintain a presence in the international arena. At present, there are 58 consulate generals and 60 consulates in Hong Kong. A few important international organizations have also established offices in Hong Kong. This includes Commission of the European Communities, the Bank of International Settlements, the International Monetary Fund, the International Bank of Reconstruction and Development, and the International Finance Corporations.

Tourists, external investors, and economies also play a key role in fostering our external relations with other economies. At present, citizens from about 170 countries and territories around the world, including the U.S., enjoy visa-free access to Hong Kong. They could easily take advantage of Hong Kong's well-connected aviation hop to fly into Hong Kong from over 150 cities worldwide. Hong Kong is also an important MICE city, MICE standing for incentives, meetings, conventions, and exhibitions. Hong Kong is an important MICE location for over 300 such events. Just to name a few, the World Trade Organization Ministry meeting, the ITU, and of course, the major sports events like the Olympic and Paralympics Equestrian events and the East Asian Games. Despite the economic contraction last year, we had a record high of nearly 30 million visitors from around the world. Tourist arrivals in Hong Kong have grown further this year, escalating to 23.5 million in the first eight months, representing an increase of 24 percent over the same period last year. We are equally encouraged to see a continuous stream of foreign companies establishing a presence in Hong Kong after the handover. Notwithstanding the global economic crisis last year, a record 265 external companies have set up or spent their operations in Hong Kong. Around 6,400 overseas, mainland, and Taiwanese companies have offices in Hong Kong now, including some 3,600 that serve as regional headquarters or regional offices. Hong Kong was also the world's fourth largest recipient of foreign direct investment in the world and the second largest in Asia in 2009. The significant presence of external companies and investment in Hong Kong is a testament to Hong Kong's attraction as a key business destination. It also helps maintain a firm link between Hong Kong and global players around the world and brings a constant stream of business visitors to Hong Kong.

Now let's examine how Hong Kong's international trading position ties-in with our external relationship with other economies. Despite our limited size, Hong Kong ranked eleventh among leading world traders in 2009, accounting for 2.7 percent of the world's total trade. In 2009, the value of Hong Kong's total merchandise trade amounted to \$666 billion U.S. or 316 percent of Hong Kong's gross domestic product. Why this level of success from such a geographically small entity? One reason is Hong Kong's high degree of

autonomy in the conduct of its external commercial relations. But the economy of Hong Kong is very much externally oriented and highly dependent on trade with the rest of the world. We are firmly committed to an open-market policy, a policy that applies to all trade and all investments in Hong Kong. Hong Kong is a staunch supporter of the multilateral trading system and adheres to the World Trade Organization and GATT principles of nondiscrimination and most-favored-nation treatment. In fact, the free-trading mindset is a part of who we are in Hong Kong. No subsidy for any particular center of our economy, no trade barriers, no tariffs, and of course, equal treatment of foreign and local economies. So imports from the U.S. can compete freely with locally made products and imports from other countries.

Our container port, the third busiest in the world, handled nearly 21 million TEUs last year. This is our 20-foot-equivalent container units. Despite an economic crisis last year, we maintain an optimistic outlook on the global container traffic, and we are now undertaking a feasibility study on developing a tenth container terminal. Our upholding of barrier-free trade practices could also serve as a good reference for other similarly small-sized economies and a good showcase of the virtues for free trade. But don't take it just from me. For the sixteenth successive year, Hong Kong was ranked the world's freest economy by the Heritage Foundation and the *Wall Street Journal* in the recently published 2010 Index of Economic Freedom. Also, the Cato Institute's 2010 assessment of economic freedom around the globe pronounced Hong Kong again the world's freest economy.

Our freedom helps nurture one of the most important external relations, our bond with the U.S. Hong Kong and the U.S. have long enjoyed close ties. The U.S. is our second largest trading partner and fifth largest importer. In 2009, we imported over 21 billion of goods from the U.S., making us the thirteenth largest export destination for U.S. goods. No need to worry about trade deficit with us, as we only export some \$3.6 billion worth of goods to the U.S. President Obama has set a very important goal for the U.S. economy of topping exports in the next five years, and we trust Hong Kong will remain an important destination for U.S. products. American imports into Hong Kong have been growing in the past five years at an average annual rate of 7.7 percent. In 2008 alone, imports from the U.S. rose by 8.6 percent, demonstrating the vast U.S. commercial presence. The U.S. also tops the rest of countries with regional operations in Hong Kong, increasing to over 800 in a decade.

While many overseas companies may have chosen to go directly into Mainland China, a large number of overseas companies have chosen to establish or extend their presence in Hong Kong. In 2008, there were over 1 million Americans visiting or residing in Hong Kong. They represent one of the most significant foreign presences in Hong Kong, and they stand as a firm

example of Hong Kong's steep belief in building bridges across oceans. To mark an important milestone in having even closer bilateral ties and business cooperation between Hong Kong and the U.S., the two have signed a Memorandum of Understanding on cooperation in wine-related business on May 17th this year. As a result of this MOU, joint efforts on promoting wine-related trading, tourism, investment, and education have been strengthened. It may come as a bit of a surprise, but Hong Kong is now the fourth largest wine market for the U.S. Yes. The value of U.S. wine sold to Hong Kong has increased by over four times, to \$49 million last year, from 2007-2008 when we eliminated the duties on wine.

Hong Kong has also been a steadfast partner of the U.S. in tackling issues that are of mutual concern. On port security, for example, Hong Kong was one of the first ports to join the U.S. Container Security Initiative, a program that submits cargo data to the U.S. 24 hours in advance of shipping. For two years we have been voluntary participants in a secure flight initiative part of scanning during that period. About 35 percent of the U.S.-bound containers went through scanning machinery. Such in the past 12 months, Treasury Secretary Geithner, Commerce Secretary Locke, Transportation Secretary LaHood, and Assistant Secretary of State Campbell, all have visited Hong Kong along with a number of U.S. congressional members, state governors, and senior state government officials, and I can tell you, more to come. Their time is extremely precious, and by choosing to spend some in Hong Kong means that, from their perspective, there is high value in further cultivating the relationship. We can not agree more, and we continue to work to facilitate these high-level interactions.

Hong Kong is also a responsible global player. Hong Kong highly respects the rule of law, and we have always been a fair game player. As part of our external relations, we take very seriously the duty to fulfill international obligations and agreements while striving to ensure the transparency and protection of our system. On international property rights, for example, Hong Kong has an established legal framework for its protection in patents, trademarks, copyright, and registered designs. Our international property legal framework is fully compatible with our obligations under the WTO agreement on trade-related aspects of international property right trips.

Separately, in deterring tax avoidance, Hong Kong has stringent and effective anti-tax avoidance legislation and never applies any special tax concessions for the sake of attracting foreign capital. Hong Kong also does not have laws protecting bank secrecy. Hong Kong has fully committed and supported the Organization for Economic Cooperation and Development's, OECD's, effort to enhance tax transparency. In deed, Hong Kong is committed to pursuing the effective exchange of information on tax with foreign governments through comprehensive avoidance of double taxation agreements or in short,

CDTAs. We have recently concluded CDTAs with 14 economies and look forward to establishing CDTAs with other governments, including the U.S.

Few will dispute that Hong Kong is one of the safest cities in the world. The risk of Hong Kong becoming a target of terrorist attack is relatively low. Nevertheless, Hong Kong remains ever vigilant against the threat of terrorism. Many of the national conventions against terrorism already apply to Hong Kong, covering issues such as taking of hostages, hijacking of aircraft, and other acts of violence at airports, et cetera. Specific legislation is also in place to implement relevant United Nations' Security Council resolutions, and a financial action task force on money laundering recommendations and special recommendations against terrorism and terrorist financing. As the international and regional financial center, Hong Kong has taken robust measures on anti-money laundering and counter-financing of terrorism. A high-level committee has been established by our government to oversee Hong Kong's work in this area.

Hong Kong also serves as an important bridge. Hong Kong will maintain its position as a bridge between mainland China and the rest of the world, especially in the development of renminbi business and in making use of the established Closer Economic Policy Arrangement, or CEPA in short.

In recent years, Hong Kong has developed into the offshore renminbi center. Hong Kong is the first economy outside mainland China to conduct renminbi banking, offering deposit-taking, currency exchange remittance, and debit and credit card services. Hong Kong now handles 75 percent of mainland China's global cross-boundary trade in renminbi under the Renminbi Trade Settlement Pilot Scheme. This scheme allows mainland China and the provinces in 20 mainland provinces and cities to settle their merchandise trade, service trade, and other current account transactions with any part of the world in renminbi.

In addition, Hong Kong and foreign companies, such as McDonald's, allow the issue of renminbi bonds in Hong Kong, which has made us the only offshore renminbi bond market in the world. So, later on, you can expect to see more McDonald's in China.

All these developments will be conducive to the internationalization of renminbi. As I said before, free trading is in our blood. It is a fundamental aspect of our external relations.

Through the CEPA Free Trade Pact that Hong Kong has signed of the mainland, Hong Kong is able to derive full advantage of the world's fastest-growing economy. Under CEPA, all goods of Hong Kong origin are entitled to

tariff-free entry into the mainland market. Preferential access in 44 service areas covering nearly 280 liberalization measures in the mainland market are also awarded to Hong Kong service suppliers. The beauty of CEPA is that it is nationality-blind. As a result, overseas companies incorporated in Hong Kong, including American firms, can also enjoy its full benefits.

We're been talking mainly about Hong Kong's success most of today. But in case we forgot, in the years leading up to Hong Kong's handover to China in 1997, newspapers were reporting on the brain drain of Hong Kong. That a flight of the city's best and brightest would leave it an empty shell. How would Hong Kong ever survive after the changeover to China, the pundits asked? At the time, *Fortune* magazine pronounced the theft of Hong Kong and proclaimed that the city's future was summed up in two words: "It's over." As the article reported Hong Kong's role as a vibrant international, commercial, and financial hub was indisputably dying, and the city was destined to become a global backwater.

I think I speak for 7 million Hong Kongers when I paraphrase the great Mark Twain, the report of our death has been richly exaggerated.

I'm happy to answer any questions. Thanks, Richard.

DR. BUSH: Thank you very much, Donald, for that very comprehensive description and assessment. We'll now open the discussion up to questions. As before, when I recognize you, please wait for the mic and then identify yourself.

Who would like to go first? Ken?

KENNETH LIEBERTHAL: Ken Lieberthal, China Center at Brookings. First, thank you for really a well-organized and comprehensive overview. My question comes at Hong Kong's future from a somewhat different angle from what you were laying out. Shanghai aspires to become a global, financial center by the year 2020, and I guess my question is: What are the implications of that for Hong Kong? Do you see that as more complementary or more potentially competitive? And, so, what do you think the future holds on that?

Thank you.

COMMISSIONER TONG: Yes, I think one good example is look at how a big jet can fly. You need more than one engine. So, we are certainly going the same direction. China is like a big jet, and we believe that there is a complementary role for Hong Kong to work together not only with Shanghai, but also many other mainland cities like Beijing and also Guangzhou and whatnot.

Indeed, what we are now doing is we are working together with Shanghai in terms of the stock exchanges. We believe that there is room for us to exploit joint collaboration opportunity, creating a bigger market for all of us, and, indeed, of course, as far as Hong Kong is concerned, we do not take success for granted. And this is the reason why in addition to counting on our four traditional, economic pillars -- meaning logistics and trade, tourism, professional services, and also financial services -- we are now digressing in many other areas, including innovation technology, environmental services, education services, environmental services, you name it. And, of course, lately, one very important area is our development as the offshore renminbi center.

I think there is also one other important area. I think Hong Kong's system, for the time being, remains very different from the Mainland of China, although things may change on the Mainland. As long as there is restrictions on the inflow and outflow of capital in the mainland, and as long as renminbi has not yet become an international re-convertible currency, I think Hong Kong still commands a significant edge. It would be, perhaps, more difficult for any mainland cities to become an international, financial center without a freely convertible currency and also with free flow of capital.

Having said that, of course, Hong Kong also has some other distinct advantages, in particular our expertise and talent in the financial area, but, of course, we'll be more than happy to share experience and work with our mainland counterparts. By all means, we need more than one big engine.

DR. BUSH: Okay, another question. I'll ask a question. And this is about an element of Hong Kong's external relations that I don't think you touched on, and that is in the educational field. Hong Kong is both a Chinese city and an international city. What's the balance between those two in terms of Hong Kong's educational system and ambitions?

COMMISSIONER TONG: Thanks, Richard. I mentioned earlier on that one particular area which we are developing is on educational services. Of course, we welcome international students coming from the U.S., Britain, Australia, you name it, but a big chunk of them now come from the mainland, mainland China. Most of them are the brightest brains that we have in the mainland.

If I remember correctly, and I think I've got it right, around 8 percent of the total undergraduate, graduate population in universities in Hong Kong are from overseas and/or mainland. If you look at the percentage at the master degree level and beyond, the percentage would go up to like 12 percent. And Hong Kong certainly wants to become a major hub for providing education services for the mainland. And that's the reason why we have designated four

pieces of land in Hong Kong, to serve as private or financially autonomous colleges.

In addition, universities in Hong Kong are also intensifying their collaboration with the Mainland of China. Some of the universities are now, indeed, offering courses already across the border, and some of them may even set up their own campus in the mainland. So, I think there is a lot of scope for development in this area.

One other aspect is we are, indeed, offering scholarships for mainland students to study in Hong Kong, and we have changed our policy. So, for mainland students who have completed their college education in Hong Kong, they will be given one year to look for jobs. And with an unemployment rate of 4.2 percent, if we do nothing, it will be very difficult at all for these mainland graduates to find a job in Hong Kong. And once they can find a job in Hong Kong, it begins this one-year period after graduation, and provided that they stay in Hong Kong over seven years, then they will become a Hong Kong citizen. We want to retain them as some of our talent pool in Hong Kong.

DR. BUSH: Yes, Mike?

QUESTION: Michael Martin from CRS.

This actually dovetails into something that was alluded to earlier, which is the Hong Kong Transition Project and Michael DeGolyer have been doing some studies looking at demographic developments in Hong Kong. Particularly what he sees is a bifurcation of Hong Kong, that you're getting a smaller well-to-do part of the population, but that other employment opportunities in Hong Kong for the Hong Kong population are falling into low-paying, service sector-type employment, and that Hong Kong's middle class is basically being eradicated by economic trends.

And the other thing that he points out is that this influx of mainland competitors for relatively few jobs in Hong Kong is creating a disaffected youth in Hong Kong. That the younger generations feel like there's no economic opportunity in Hong Kong, they cannot compete with mainland competitors, and that there are very few jobs at the income level that their parents, now, probably their grandparents, but their parents enjoyed.

Could you comment on what the Hong Kong Government is doing to address this potential sort of elimination of Hong Kong's middle class and a dissatisfied youth?

COMMISSIONER TONG: Thanks. Obviously, it's an

increasingly competitive world, and I think Hong Kong isn't alone in that. I think that the same thing happens in the U.S. and China.

The most important thing is, number one, we continue to invest more in education. I think over 60 percent of our student population are high school graduates can now enjoy tertiary education. Not necessarily all having a degree, but sub-degree causes a swell, somewhat like community colleges out here. But, of course, there is a migration cost for people graduating with a sub-degree to then earn a degree. I know Simon knows it very well.

Another aspect, of course, is what I pointed out earlier on. I think we have to break new grounds. Obviously, we should not neglect the four important economic pillars, and we continue to expand on that. But, at the same time, we are also looking into some other areas like innovation and technology, like creative and art industry. So, these are sort of new areas. Environmental services, extremely important. So, we hope to break new grounds and create new opportunities.

To be frank, this is not the first time that Hong Kong faced challenges. I think for those of you who have been in Hong Kong around in the '70s or '80s and the '60s, you possibly remember that Hong Kong used to have a very vibrant light industry making plastic flowers, wicks, and whatnot. And where is all this now? We have lost all of this to the mainland of China. But that has also become, in a way, a driver, a driving force for the government to restructure the economy. I think the most important thing is we have to continue to invest in education and continue to look into these new areas. Hong Kong has a pretty good history and experience in doing that, and I'm pretty sure that we can continue to do that.

The last thing I wanted to say is a high unemployment rate for middle class or for our grassroots, no.

DR. BUSH: Beverly Hong-Fincher in the back?

QUESTION: Beverly Hong-Fincher. As you probably know, we now regard education as the whole country's, U.S., focus on now, and, particularly in the Washington, D.C., area. Would you consider some kind of foreign aide to us? Maybe you can start by telling us what percentage of your GDP is spent on education? And I know it is a huge figure in Washington, D.C. And maybe compared with Hong Kong's population and D.C. population, I appeal to you that you would give us some foreign aide. Thank you.

COMMISSIONER TONG: Thanks. I hope it's the other way around. The U.S. certainly is a much bigger economy than Hong Kong. The

reality is yes, we do have a surplus budget and we do have a pretty comfortable surplus, but I don't think it's good enough for the U.S.

You are absolutely right. Education is, indeed, the single biggest ticket item in the government expenditure. It takes up around 26 percent of our total government budget. So, you can see how big it is. And, of course, now that Hong Kong is migrating. Some of the colleges in Hong Kong, like Hong Kong University, used to have the three-year degree course, and now they are switching to a four-year degree course. Basically, standardizing all the colleges in Hong Kong. So the sort of education (inaudible) as far as the government is concerned will continue to go up.

We will not be able, I'm afraid, to give any foreign aide to students out here, but one thing for sure –

MS. HONG-FINCHER: (inaudible)

MR. TONG: Yes, I know. That's an insult. But one thing we have been working on, indeed, I've been visiting quite a number of colleges in the U.S. One area which we would like to do is student exchange, and I think this have been pretty successful. We, indeed, had quite a large number of U.S. exchange students in Hong Kong. If I remember correctly, it's close to 1,000. And we have at least an equal number of students studying here.

I'm also glad to say that some of the colleges have also established -- I don't know whether you have heard of SCAD -- Savannah College of Art and Design -- based in Georgia. It has just opened a new campus in Hong Kong, which is extremely useful for us in training students at graduate level and undergraduate level in the design and whatnot. So, this would help Hong Kong to build up its pool of talents for our creative in our industry, and I very much encourage more colleges would consider steps like this which I think would certainly help enhance student exchange between the two places.

DR. BUSH: Question? Bob?

QUESTION: Thank you. Hong Kong's free market system, of course, well-known and talked about here so much, but there's some areas of the local economy where there is little or no competition. It's believed real estate, construction, supermarkets, and so forth, and, for several years, there's been an effort to pass a competition law or an anti-cartel law, which never happens. What is the current status of that effort?

COMMISSIONER TONG: Yes. We have finished our consultation, our public consultation (inaudible) on our anti-competition bill.

And the government, the game plan is to introduce the anti-competition bill –

DR. BUSH: Pro-competition? You're saying –

COMMISSIONER TONG: Anti-competition. Oh, sorry, pro-competition, yes. It's a kind of misnomer. Yes, right, thanks for clarifying that. That would be the case of Bob's question.

Yes, the pro-competition bill, within this legislative session, obviously, there are also some controversial areas, and I do expect that this would not be a very easy exercise, but the government is committed in doing that, so as to offer a level playing field for all. Of course, we do understand that in certain areas simply because of economists' scale, despite the fact that you have this pro-competition law, there may be difficulties, but we'll just let the industry player decide. The most important thing is to want a level playing field for all.

MR. BUSH: I don't see any other questions, so, I think this is an appropriate time to bring our event to a close. I know that I've learned about Hong Kong in the course of the morning and luncheon. I want to thank all of you for coming. I want to thank the various panelists and the China Center and *Hong Kong Journal* for their sponsorship. In particular, I'd like to thank Donald for taking the time to join us, and for all the support of the Hong Kong Office here. Thanks a lot.

COMMISSIONER TONG: Thank you. Thank you, Richard.  
Thank you.

*(Applause)*

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