THE BROOKINGS INSTITUTION
CENTER FOR NORTHEAST ASIAN POLICY STUDIES

TOWARD AN INTEGRATING MARKET: THE FUTURE OF HONG KONG'S ECONOMY AND ITS INTERACTION WITH THE CHINESE MAINLAND

Dr. Wenhui Zhu
CNAPS Hong Kong Fellow, 2004-2005

October 2005

THE BROOKINGS INSTITUTION
1775 Massachusetts Avenue, NW
Washington, DC 20036-2188
Tel: 202-797-6000 Fax: 202-797-6004
www.brookings.edu

Abstract

After decades of steady growth and the smooth handover of sovereignty in 1997, Hong Kong's economy experienced stagnation from 1998 to 2003. The slowed development not only illustrated the erosion of the favorable conditions which had facilitated its economic miracle, but also reflected an underestimation of the great sensitivity to Hong Kong's economic performance in both the HKSARG and among the Central Authority policy makers in Beijing. More importantly, it highlighted the absence of an institutional framework in which the Mainland and Hong Kong economies could appropriately interact. The implementation of the Closer Economic Partnership Arrangement (CEPA) between Hong Kong and Beijing in 2003 was an adjustment of the new Beijing administration's economic policy toward Hong Kong and redefined Hong Kong's role in China's economy. The rebound of Hong Kong's economy, and the rapid restoration of confidence in the territory, seemed to validate this adjustment and paved the way for Hong Kong and the Mainland to take full advantage of each other's comparative advantages. In the long run, the sustainability and prosperity of Hong Kong's economy lie in what it contributes to China's development, rather than which and how many privileges China grants her. It is the convergence, instead of divergence, of the interests of the two sides that guarantees the future of Hong Kong's economy. Only from this convergence of interests of the two sides can the puzzle of "one country" versus "two systems" be resolved. As the Hong Kong system becomes more and more unique, it will be able to build more advantages. Hong Kong will be able to reap more benefits from the Chinese market, China can capitalize on Hong Kong's soft powers, and both sides will grow in an accelerating cycle. Accordingly, with regard to the economic relationship between the Mainland and Hong Kong, the "one country, two systems" principle could be extended into and elaborated as "one country, two systems, and an integrating market (from two separate parts with a division of labor)." It is the integrating process per se that brings about the benefits to two sides. How to manage this process, in terms of scope, speed, and depth, and how to maximize benefits from it, are the core policy questions for economic interaction between Beijing and Hong Kong. Beijing's economic confidence in Hong Kong, and its political tolerance of it, come from the sustainable prosperity of Hong Kong's seven million people.

1. Introduction

Hong Kong lost its 40-year-long momentum in economic development after the handover of its sovereignty to China in 1997. Consideration of this downturn, and the subsequent rebound, create several questions: What were the main reasons behind Hong Kong's economic stagnation around the turn of the new millennium? How did its economic performance affect the legitimacy of the Chief Executive and the efficacy of the Hong Kong Special Administrative Region Government (HKSARG)? As Hong Kong's political and economic circumstances deteriorated, Beijing, under the new leadership of President Hu Jintao and Premier Wen Jiabao, adjusted its policy toward Hong Kong by redefining Hong Kong's role in China's economy. How has this adjustment restored confidence in Hong Kong and contributed to its economic rebound since 2003? Did the adjustment create merely a one-time effect, or does it have any reciprocal and sustainable implications for the relationship between Hong Kong and the Mainland?

2. Hong Kong's economic miracle and its favorable conditions

Described as no more than a "barren rock," Hong Kong was established 160 years ago by the then-British Empire as a key port for the pursuit of its interests in China. Though Hong Kong's main economic role was as a gateway for trade in and out of China, for the greater part of the next 100 years the colony was overshadowed by Shanghai, a far more important trade and financial center. Nevertheless, with the founding of the People's Republic of China in 1949 and the outbreak of the Korean War in 1950 which severed many of the economic connections between China and the West, Hong Kong suffered and was forced to transform itself into a maritime and trade center for Southeast Asia.[1] Under pressure from an increasing population and other challenges, Hong Kong began its externally-oriented industrialization in the mid-1950s. The industrialization, which served as the main driving force for the following 30 years of economic prosperity, began with the development of labor-intensive industries such as textiles and clothing, founded mainly by immigrant Shanghai industrialists. Then toys, watches, and artificial flowers came along in early 1960s, with more and more local entrepreneurs joining the boom.[2] The process further evolved to include electronics and a newly-born computer industry in the 1970s. At the outset of the 1980s, Hong Kong's light manufacturing industries were so advanced that in Asia Hong Kong stood only behind Japan, an already-gigantic world industrial power. Over time, Hong Kong's status as a free port, the openness of its market, its legal framework, and its efficient administrative system allowed Hong Kong to become a business center for the growing Asian region, especially for the Chinese diaspora in Southeast Asia.

Several favorable conditions facilitated Hong Kong's economic miracle in the post-World War II era. First, there existed a general consensus between China's communist government and the British government on how to peacefully and pragmatically govern the territory. It was this long-lasting mutual understanding and accommodation that ultimately led to the Sino-British Joint Declaration on the Question of Hong Kong, concluded in 1984. On the one hand, Beijing's involvement in local affairs was highly restrained. To a large extent, from the 1950s to the 1980s, the Chinese government left Hong Kong primarily in the hands of the British and did not interfere.[3] On the other hand, the postwar British colonial policy entrusted power to the colonial authorities and accordingly the Hong Kong government was able to enjoy a great deal of political autonomy, or, to some extent, a monopoly on political power in administering the

---

[1] Liu Shuyong, "Hong Kong: A survey of its political and economic development over the past 150 years," *China Quarterly*, No.151(1997), pp. 588-589.

[2] Victor F.S. Sit, "Hong Kong's 'transferred' industrialization and industrial Geography," *Asian Survey*, Vol.38 No.9(1998), pp.880-904.

[3] For Beijing's Hong Kong policy, especially its consideration on economic affairs, see Lau Siu-kai, "The Hong Kong policy of the People's Republic of China, 1949-1997," *Journal of Contemporary China*, Vol.9, Iss.23(2000) pp. 77-94.

territory.[4] However, there was pressure to accommodate a huge and potentially destabilizing influx of refugees from the mainland. Therefore, it was necessary for colonial officials to maintain business confidence and economic development. "Stability was foremost in their minds as the main prerequisite for maintaining investor confidence and prosperity. Hong Kong's colonial government was based on principles of consultation and consensus, in keeping with the conventional Chinese preference for public harmony."[5] The economic performance of the territory and the material welfare of the people appeared to be the best guarantors of British rule in Hong Kong for the first two decades of the PRC's existence.[6]

The second favorable condition was that Hong Kong's government was pragmatic on local affairs.[7] It adopted *laissez faire* policies and did not intervene on social matters. The colonial government successfully insulated society and polity from one other. Depoliticization of the society became a necessary condition for effective governance, and local people were discouraged and dissuaded from engaging in political activities. At the same time, because it was difficult for the colonial government to justify itself in ideological or moral terms, it was essential to demonstrate the high qualities of its bureaucratic and meritocratic civil servants, such as their efficiency, competence, solicitude toward the public, incorruptibility, dedication to common interests, and ability to deliver services and benefits to the people.[8] Over the years, Hong Kong's civil service had developed into one of the best in the world. A world-class physical infrastructure including deep-water ports, a telecommunications network, and a highway system was quickly constructed and well maintained. More importantly, various westernized public goods, such as a legal framework, an education system, and an Independent Commission Against Corruption (ICAC), were introduced. Transparency and rule of law eventually took root in the territory. All of these achievements provided the human resources and institutional framework for Hong Kong's post-World War II prosperity.

Third, the post-War international economic environment assisted Hong Kong's rise.[9] In the course of economic growth, Hong Kong, as well as the other "tigers" (South Korea, Taiwan, and Singapore), chose to avoid the rhetoric of North-South confrontation. Instead they focused on prospering within the existing international economic regime. Unlike the others, Hong Kong never went through the process of growth-based import substitution and was always far more committed to free trade. In fact, for a lengthy period from the 1950s to the 1980s, Hong Kong was one of the few economies in Asia that

---

[4] Lau Siu-Kai, "Hong Kong's 'ungovernability' in the twilight of colonial rule," in Zhiling Lin and Thomas W. Robinson ed., *The Chinese and their future: Beijing, Taipei and Hong Kong* (Washington: The AEI Press, 1994), p291.
[5] Suzanne Pepper, "Elections, political change and Basic Law government: The Hong Kong system in search of a political form," *The China Quarterly*, No.162(2000), p421.
[6] Brian Hook and Miguel Santos Neves, "The role of Hong Kong and Macau in China's relations with Europe," *The China Quarterly*, No.169(2002), pp.109-111.
[7] Brian Hook, "British views of the legacy of the colonial administration of Hong Kong: A preliminary assessment," *The China Quarterly*, No.151(1997), pp. 564-566.
[8] Lau Siu-Kai, "Hong Kong's 'ungovernability' in the twilight of colonial rule," p290.
[9] Liu Shuyong, "Hong Kong: A Survey of Its Political and Economic Development over the Past 150 Years," p 590.

adopted open port and free trade policies. As a British colony, Hong Kong was attractive to international businesses who wanted to locate regional offices where they could rely on a predictable legal system and where there were cosmopolitan business circles in which western executives could feel more comfortable than in Tokyo, Taipei, or Seoul. For example, the U.S. Chamber of Commerce in Hong Kong grew rapidly after its establishment in 1969. Had the international economy in East Asia been more open to trade, Hong Kong might well have withered. But it had the good fortune to be part of a booming region in an expanding system of market economies, connecting East Asia to North America and Western Europe.[10]

To conclude, Hong Kong's postwar colonial government succeeded in legitimizing its rule primarily on the basis of performance,[11] particularly on economic performance and the consequential living standard improvement of local inhabitants.[12] The significant progress made by Hong Kong's economy not only bolstered the government's claim to legitimacy on the basis of performance, but also served as a key solvent of potential social and political conflicts. Therefore any unexpected economic stagnation might erode the legitimacy of the government and its ability to govern. As Siu-Kai Lau pointed out in 1993, "The implications of the economic slowdown for a government whose political legitimacy derives mainly from economic performance are adverse. If poor economic performance continues for a long time, the myth that colonial governance and the economic miracle of Hong Kong are organically linked will be broken, and the value of the government to people will diminish."[13]

Like other "tigers" in East Asia, as Hong Kong climbed up the "value ladder," it was believed that Hong Kong's economic and industrial structure could and should be developed further in the direction of high value manufacturing, such as operations that were capital-intensive in South Korea or technology-intensive in Taiwan and Singapore. But Hong Kong's path diverged from those of the other three. From the early 1980s, with the opening of China's economy, Hong Kong entrepreneurs sensed and immediately seized the vast opportunities in the neighboring Pearl River Delta region. Production capabilities were expanded across the border, perhaps tenfold or more, at costs that were only a fraction of Hong Kong's in terms of labor and land. Accordingly, the volume of Hong Kong's domestic exports shrank and were partially replaced by more and more re-

---

[10] Gerald Segal, *The Fate of Hong Kong*, (New York: St. Martin's Press, 1993), p29.

[11] Regarding the legacy of the colonial administration of Hong Kong, the British prefer to emphasize personal freedoms, the rule of law, the independence of the judiciary, the efficiency of government, the competitiveness of business, the prominent status in international trade, the suppression of corruption, the quality of the engineering infrastructure, and the improving health and welfare provisions as essential characteristics of their legacy. However, their Chinese counterparts are much more likely to hark back to the bad old days of national humiliation and imperialist exploitation, and to emphasize the China factor in Hong Kong's prosperity. For a discussion of legacy of the British colonial administration of Hong Kong, see Brian Hook, "British views of the legacy of the colonial administration of Hong Kong: A preliminary assessment"; Ming K. Chan, "The legacy of the British administration of Hong Kong: A view from Hong Kong"; and Liu Shuyong, "Hong Kong: A survey of its political and economic development over the past 150 Years." *The China Quarterly*, No.151(1997), pp. 553-592.

[12] Anthony B.L. Cheung, "New interventionism in the making: Interpreting state interventions in Hong Kong after the change of sovereignty," *Journal of Contemporary China*, Vol.9, Iss.24(2000), pp291-309.

[13] Lau Siu-Kai, "Hong Kong's 'ungovernability' in the twilight of colonial rule," pp.297-298.

exports from China, most of which were actually produced by Hong Kong-invested companies. As a result, Hong Kong's economic structure was rapidly transformed into a service-dominated one (see Table 1 below). The share of secondary industry was around 32 percent in the early 1980s, was halved by 1995, and then fell to 11 percent in 2004. The share of tertiary or service industry rose steadily to 88.5 percent in 2004. Finance, shipping, tourism, and especially producer services, which complement South China's increasing production capacity, have served as the driving forces for Hong Kong's economic growth in the past two decades.

Table 1: Hong Kong economic indicators, 1980-2004

	1980	1985	1990	1995	2000	2004
Population (million)	5.04	5.46	5.71	6.16	6.67	6.90
GDP (HK$ billion)	135.04	255.42	563.52	1,041.07	1,228.90	1,282.00
-Primary (%)	1.0	0.6	0.3	0.2	0.1	0.1
-Secondary (%)	31.7	29.9	25.3	16.1	14.2	11.4
-Tertiary (%)	67.3	69.5	74.4	83.7	85.7	88.5
Per capita GDP (US$)	5,268	6,134	13,092	22,831	24,782	23,890
Exports (US$ billion)	19.10	30.15	82.04	172.32	201.63	259.70
Total trade (US$ billion)	40.80	59.82	164.41	363.49	414.19	527.41

Sources: Census and Statistics Department, Hong Kong Government

Hong Kong's role as a business center in Asia was strengthened significantly in the early 1990s. In the spring of 1992, Deng Xiaoping, China's prominent veteran leader, made his famous "southern tour" to Guangdong. This visit was marked by his blunt attempts to stress the need to forge ahead confidently with China's policy of reform and opening, which had fundamentally shifted China toward a market economy in the late 1970s and early 1980s. In response to Deng's urging, the expansion of China's economy accelerated and in combination with Southeast Asia's rapid development further strengthened Hong Kong's role as an international business center. Hundreds of foreign multinational companies were eager to set up their regional management centers in order to take advantage of the opportunities in booming China and Southeast Asia, and Hong Kong's economy was further internationalized. It was no exaggeration to classify Hong Kong as one of the most international cities in the world.[14] Hong Kong's international linkages have been vital not only to its own well-being, but also to its role as the gateway to an increasingly open Chinese economy.

The anticipated reversion of Hong Kong's sovereignty to China in 1997 had changed neither the above favorable conditions, nor Hong Kong's economic trajectory. The Chinese government promised to implement a policy of "one country, two systems," which was originally proposed by Deng in order to solve the Taiwan problem but was applied to Hong Kong when Beijing was negotiating the colony's future with London. During the transitional period from 1982 to 1997, Beijing considered Hong Kong's economy as an important asset for the Mainland's development,[15] and also perceived the

[14] Ezra F. Vogel, *One Step Ahead in China: Guangdong under Reform* (Cambridge: Harvard University Press, 1989), p56; and Gerald Segal, *The Fate of Hong Kong*(1993), p2.
[15] Brian Hook and Miguel Santos Neves, "The Role of Hong Kong and Macau in China's relations with Europe," *The China Quarterly*, No.169(2002), pp.120-122.

return of sovereignty as a symbol of regaining and rebuilding China's political prestige or "face." Though there were confrontations between Beijing and London from time to time on various issues such as the construction of a new airport, emigrant and passport arrangements for Hong Kong residents, and especially local elections, the two sides were deliberately dedicated to maintaining confidence in Hong Kong, albeit in quite different ways. For example, for those who tended not to trust Beijing, it was believed that there were two strategies that could help Hong Kong survive 1997.[16] The first centered on the development of a representative government that, as some argued, would be able to stand up to intervention from Beijing. The second focused on the further internationalization of Hong Kong's economy and the right of people to freely exit. Chris Pattern, a liberal Conservative and Hong Kong's last colonial governor, unfortunately chose the first strategy and was embroiled in furious confrontations with China for nearly his full tenure in the territory.[17] However, the second strategy was not opposed by the Chinese government and the internationalization of Hong Kong's economy was supported indirectly, if not welcomed openly, by Beijing.

With a large and constant influx of capital from the West into Asia and the further opening of China's economy in the early 1990s, Hong Kong's economy and stock market prospered, though the roots of the coming crisis that would harm the government's legitimacy lay in this very prosperity. The handsome return and high investment margin in the Mainland and the overall confidence in its future economic performance pumped up real estate prices. Although the Hong Kong government adopted some measures to dampen the rise of real estate prices around 1994[18] amid the East Asian economic boom, these limited efforts were to no avail.[19] The economy was so good in 1996 and the first half of 1997 that real estate market prices, which were treated as a "symbol of confidence," jumped by over 50 percent jump in one year, giving the impression that a bubble had been created. It could even be speculated that the optimistic mood was deliberately manipulated by both Beijing and London lest a drop in property prices disturb the smoothness of the upcoming sovereignty handover.

In addition to such external challenges to its development-based legitimacy, the government was facing a structural challenge: the growing private sector was competing with Hong Kong's government for talented human resources, and the various "brain drain" immigration programs offered by the governments of Canada, Australia, Singapore, and even the United States exacerbated the problem. In order to maintain civil servants' integrity, and to a lesser extent, their loyalty, the colonial government increased

[16] Yun-wing Sung, "The Hong Kong Economy-to the 1997 Barrier and Beyond," in Zhiling Lin and Thomas W. Robinson ed., *The Chinese and their future: Beijing, Taipei and Hong Kong* (Washington: The AEI Press, 1994), p323.
[17] For details, see Christopher Patten, *East and West: China, Power, and the Future of Asia* (New York: Times Books, Random House, 1998), pp.28-99.
[18] For example, in 1994, the Hong Kong government restricted bank lending by imposing a ceiling on property mortgage loans. See Y.Y. Kueh and Raymond C.W. Ng, "The Interplay of the 'China Factor' and US Dollar Peg in the Hong Kong Economy," *The China Quarterly*, No.170(2002), p.392.
[19] This was also why the Chief Executive in his first policy address, in October 1997, proposed an annual target of building 85,000 apartments for Hong Kong, though downward pressure had already been felt in the market in the wake of the Asian financial crisis.

their wages and welfare dramatically in a relatively short period of time. Therefore, in the last year prior to the handover, “bubbles” appeared in Hong Kong’s job market, stock market, and real estate market. Each of these bubbles can be seen as integral parts of the widespread inflating and overheating phenomena of Southeast Asian counties in the mid-1990s.

3. A challenge to the HKSARG: financial crisis and the bursting of the bubble

The transformation and internationalization of Hong Kong’s economy and the effective governance in the post-War era left two important legacies. First, its economic structure concentrated on the high-value end of the international supply chain, especially in sectors such as finance, tourism, logistics, and producer services. Most, if not all, of these sectors are highly sensitive to confidence in Hong Kong and the performance of its hinterland’s economy. Second, as noted above, the meritocratic Hong Kong government legitimizes itself primarily on economic performance. The sustainability of economic prosperity therefore becomes a vital precondition for effective governance in the future. In an attempt to preserve these legacies, the HKSARG was established with the principles of “one country, two systems,” “a high degree of autonomy,” and “Hong Kong people administering Hong Kong.” After the handover, when the government needed further economic growth to build its own legitimacy, the problem suddenly hit home. Amid the Asian financial crisis, the conditions that had fostered Hong Kong’s economic growth and effective governance quickly eroded.

On July 2, 1997, only one day after the handover, the Thai government devalued its currency and the regional disaster began. The baht devaluation swiftly infected all of Southeast Asia and soon spread to South Korea. In contrast to many of its neighbors, Hong Kong’s economy remained relatively unaffected by the furious attacks from international speculators on its currency and stock markets. This was due to sound corporate governance, good supervision in the banking and financial systems, a large foreign currency reserve, and indispensable backing from the Chinese government in the form of a commitment to stabilize the renminbi (RMB, China’s currency) rate in relation to East Asia generally and Hong Kong specifically. However, the interest hike and panic on the part of international investors, toward East Asia in general and Hong Kong’s stock market and real estate market in particular, burst Hong Kong’s bubble economy almost overnight.[20] Compared with a 6 percent increase in 1997, Hong Kong’s economy grew at minus 4 percent in 1998, its first negative growth recorded since the oil shock in 1973.

For the first two years after the 1997 collapse, people tended to believe that the economic slowdown was just a technical, cyclical, and externally-caused but reasonable adjustment. As growth recovered in 1999 and even accelerated to 10.5 percent in 2000, then the highest in the world, the cyclical factors faded but the structural problems surfaced. First, the continuous fall in real estate prices drove approximately 100,000 households who

[20] For Hong Kong’s economic performance in the Asian Financial Crisis, see Tsang Shu-Ki, “The Hong Kong Economy: Opportunities or of the Crisis?” *Journal of Contemporary China*, Vol. 8 Iss.20(1999), pp.29-45.

purchased their houses during the bubble into negative equity.[21] Secondly, the downward pressure of wages was so powerful, painful, and apparently perpetual that domestic consumption was severely damaged. In the meantime, as wages in the private sector dropped dramatically in accordance with the market mechanism, the high salary levels in the civil service became unsustainable in light of both the government's fiscal difficulties and public opinion. Third, Hong Kong's economy was plagued by deflation which had lasted 65 consecutive months, from March 1999 until July 2004, and had accumulated a significant price fall.

The essential reason behind this stagnation was that the favorable international conditions upon which Hong Kong's economy was constructed were abruptly reversed. First, as much as twenty percent of Hong Kong's economy was related to Southeast and Northeast Asia (excluding China), and the contagious financial crisis caused many Hong Kong companies exposed to those economies to suffer. For instance, Peregrine, a legendary Hong Kong-founded and -based investment bank, collapsed in 1998 due to the insolvency of its Indonesian private debt issuing. Hopewell, a top conglomerate that pioneered extra-large infrastructure projects throughout the region, recorded heavy losses from its investments in Indonesian power stations and Bangkok's mass transportation system, although the return from its investments in China, like the Guangzhou-Shenzhen superhighway, was still sound. The Japanese banks that supplied much capital into Hong Kong's financial market evacuated suddenly in 1999, although they were still making money. In short, Hong Kong had lost its Southeast Asia hinterland. Second, it failed to strengthen and profit from its economic ties with the Chinese Mainland, which were only lightly affected by the financial crisis after the handover (see later part). Third, it was speculated that a resurgent Shanghai would compete with Hong Kong directly or even partly replace Hong Kong's role in the course of China's future economic development.[22] Wariness of Shanghai's revitalization was amplified by the attention given to the city by then-top Chinese leaders like President Jiang Zemin and Premier Zhu Rongji, who endorsed and promoted ambitious plans and events for Shanghai such as the Fortune 500 and APEC summits. Jiang and Zhu also frequently met their foreign counterparts there, showcasing the city as the centerpiece of a developing China.

While the Mainland economy was largely immune from the financial turmoil, the crisis severely damaged confidence in Hong Kong's economic momentum. International investors treated East Asia as a single entity which practiced crony capitalism, criticizing its mismanagement and so-called "Asian values." Investors' temporary withdrawal from the Asian market eroded Hong Kong's role as the Asian business center. The highly internationalized sectors of Hong Kong's economy, such as investment banking, fund management, hotels, and tourism became extremely vulnerable and were severely hurt. Internally, the bursting of the real estate bubble, the resultant negative equity effect, and

---

[21] Negative equity is the difference between the value of an asset and the outstanding portion of the loan taken out to pay for the asset, when the latter exceeds the former. Negative equity can result from a decline in the value of an asset after it is purchased.

[22] Y.C. Richard Wong, *Shanghai: Another Hong Kong?* HK Center for Economic Research, University of Hong Kong, December 2002, <http://www.tdctrade.com/econforum/archive.htm>, (accessed December 28, 2004).

deflationary pressure lowered the confidence of local residents, further slowing the highly confidence-vulnerable economy. Therefore, the economic growth rates from 2001 to 2003 were only 0.1, 1.0, and 3.3 percent, respectively. Starting in 1998, the Hong Kong economy actually fell into a long-lasting downward cycle caused by a painful structural, rather than a tolerable technical, adjustment.

Furthermore, the bursting of the bubble economy not only led to economic stagnation, but also caused doubts about the HKSARG's ability to govern. The public, which for more than four decades had taken economic growth and prosperity for granted, hardly appreciated the performance of the HKSARG. In groping for a way out of stagnation, the HKSARG tried different conventional tactics individually or in combinations, including increasing public expenditures, cutting the income tax rate, and providing vocational training for unemployed people, but it was never able to settle on a consistent policy.

More importantly, attempts to combat the downturn through administrative reforms were only moderately successful, for two reasons. First, the new HKSARG, especially the Chief Executive, had insufficient experience and were not completely prepared to deal with the specific problems facing the Special Administrative Region.[23] Though the colonial authorities had maintained moderate to high political autonomy in administering the territory in the past, there never existed any comprehensive decision-making mechanism or convention on vital issues inside the colonial civil service system. Every important policy decision was made by the parachuting governor with the support of London's policy research team. Therefore, although civil service personnel were "transferred" almost en masse from the colonial government to the HKSARG, the bureaucrats lacked the experience necessary to govern a metropolis with a population of more than 6 million. As Ming K. Chan puts it, as the colonial expatriates dominated at the pinnacle and senior levels of the hierarchy, the local civil servants were "deprived of the opportunity to shoulder responsibility and gain greater experience."[24] The new Chief Executive, shipping tycoon C.H. Tung, also lacked governing experience; some attempts he made to create a smoother system of governance did not help the situation.[25] In the early post-handover era, the long- and highly-praised civil servants were as dedicated as ever to their daily operational work. To a great extent, however, efficiency suffered when the bureaucrats were forced to make decisions rather than carry out policies that had already been decided on. Thus the prestige of the civil service dropped appreciably after the handover. This is one reason for the Chief Executive's implementation of an accountability system among principal civil servants in his second term.

---

[23] For a complete assessment of Tung Chee-hwa and his government, see Lau Siu-Kai ed., *The First Tung Chee-hwa Administration: the first five years of the Hong Kong Special Administrative Region* (Hong Kong: The Chinese University Press, 2002).

[24] Ming K. Chan, "The Legacy of The British Administration of Hong Kong: A View from Hong Kong," *The China Quarterly*, No. 151 (1997), p571.

[25] There also existed differences or disagreements in terms of political values and policy agenda between Tung Chee-Hwa and Anson Chan Fang On-san, Administrative Secretary, who represented the civil service. See Lau Siu-Kai, "Tung Chee-hwa's governing strategy: the shortfall in politics," in Lau Siu-kai ed. *The First Tung Chee-hwa Administration: the first five years of the Hong Kong Special Administrative Region*(2002),pp.12-13.

Second, since the colonial government had enjoyed a monopoly on political power, government officials had experienced almost no external or internal political challenges; consequently, the HKSARG could hardly be expected to recognize and accommodate the need to share power in order to rule effectively.[26] Although faced with varying difficulties and strong criticism, the new government often presented a public image of self-confidence at best and complacency or arrogance at worst.[27] Criticism of Chief Executive Tung and the HKSARG was magnified by several other factors. One was the near-total freedom of the press. Another was the principle of "Hong Kong people administering Hong Kong." These two factors together released huge and unmanageable energy from the public, which demanded a better, more humble, and more accommodating government. The third factor was the political reforms that had been implemented by Chris Patten.[28] Governor Patten's reforms created a much more independent Legislative Council (Legco) and led to a quasi-opposition alliance inside the Legco that criticized Tung and his government but seldom offered constructive suggestions. Accustomed to the executive-led governing system inherited from the colonial era and despite the many factors involved, most Hong Kong people attributed all of the city's problems to Tung, the symbol of the governing power. Tragically, Tung bore most of the blame, although many allegations were unfounded.

The outbreak of Severe Acute Respiratory Syndrome (SARS) in the spring of 2003 seemed to be the final straw that broke the public's confidence in the HKSARG's governing effectiveness, particularly in Tung's ability to manage crises. The isolation of Hong Kong people and the warning against travel to Hong Kong and China by the World Health Organization and other countries made the territory nearly a "dead port." With only single-digit occupancy rates at hotels, the cancellation of flights, and the proliferation of surgical masks in the streets, Hong Kong's service-dominated economy almost collapsed, as did the government's performance-based legitimacy. This time, an appraisal of Hong Kong's governance was possible, in terms of both the effectiveness of the SAR government and Beijing's policies toward Hong Kong. The SARS crisis and its fallout was considered to be a problem not only for Hong Kong, but also a challenge to the Central Authority in Beijing, which would and should ultimately bear the responsibility of Hong Kong's failure.

4. Non-intervention: Beijing's policy toward Hong Kong after the handover

Hong Kong played a crucial role in China's open door economic strategy implemented in the early 1980s. First, it had the location, hardware, software, and expertise in dealing with the international economy to serve as the gateway for China's growing external economic activities. Second, Hong Kong's entrepreneurs and financial market were the

[26] Ming K. Chan, "The Legacy of the British Administration of Hong Kong: A View from Hong Kong," pp. 570-571.
[27] Anthony B.L. Cheung, "The Changing Political System: Executive-led Government or 'Disabled' Governance?" in Lau Siu-kai ed. *The First Tung Chee-hwa Administration: the first five years of the Hong Kong Special Administrative Region* (2002),pp.48-52.
[28] For details, see Suzanne Pepper, "Elections, political change and Basic Law government: The Hong Kong system in search of a political form," pp.424-428.

main source of China's badly-needed foreign direct investment. Third, Hong Kong was the Mainland's information source, a place to learn about western business practices as well as to make contacts. Finally, as one of the most free and vibrant economies in the world, Hong Kong's economic accomplishments, efficiency, and even its *laissez faire* philosophy blew like a "south wind," influencing the ways in which neighboring Guangdong officials planned and managed that province's trend-setting economy. For the Mainland, Hong Kong's influence might go far beyond trade and investment.

The continuous prosperity of Hong Kong during the transitional period and the seamless transfer of its sovereignty from Britain to China largely dispelled doubts about Hong Kong's future both inside and outside the territory.[29] Both Beijing and the new HKSARG expressed optimism for Hong Kong's future. President Jiang outlined Beijing's policy toward Hong Kong in his speech at the ceremony for the establishment of the HKSARG on July 1, 1997:

> "After the Chinese Government resumes the exercise of sovereignty over it, Hong Kong will continue to practice the capitalist system, with its previous socio-economic system and way of life remaining unchanged and its laws basically unchanged while the main part of the nation persists in the socialist system.
>
> As a special administrative region of the People's Republic of China, Hong Kong will enjoy a high degree of autonomy as provided by the Basic Law, which includes the executive, legislative, and independent judicial power, including that of final adjudication. The Central People's Government will administer foreign and defense affairs of the Hong Kong Special Administrative Region in accordance with law. We extend our sincere congratulations to Mr. Tung Chee Hwa, Chief Executive of the Hong Kong Special Administrative Region Government, who has been sworn in today. We have full confidence in the Hong Kong Special Administrative Region Government under his leadership and will give it full support. The Basic Law of the Hong Kong Special Administrative Region shall be observed not only in Hong Kong, but also by all departments of the Central Government as well as the provinces, autonomous regions and municipalities directly under the Central Government. No central department or locality may or will be allowed to interfere in the affairs which, under the Basic Law, should be administered by the Hong Kong Special Administrative Region on its own."[30]

It was clear that Beijing's top priority for Hong Kong affairs was the adoption and implementation of a non-intervention policy, which could hopefully convince international society and Hong Kong residents alike that the principle of "one country, two systems" would be followed strictly. It seemed that the main role of the State Council's Office of Hong Kong and Macao Affairs would be to serve as a firewall that

---

[29] On the other hand, there are some examples which raised concern about the integrity of the two systems concept. See, for example, Michael C. Davis, "Constitutionalism and Hong Kong's future," *Journal of Contemporary China*, Vol.8 Iss.21(1999), pp. 263-274.

[30] Speech of President Jiang Zemin of the People's Republic of China at the ceremony for the handover of Hong Kong held by the Chinese and British Governments, (accessed December 30, 2004), <http://www.fmprc.gov.cn/eng/ljzg/3566/default.htm>.

set Hong Kong apart from the rest of China, especially from central government departments and local authorities.[31] As a result, senior officials were discouraged and often even strictly forbidden by the Office to visit Hong Kong, regardless of necessity. For example, the then-Ministry of Foreign Trade and Economic Cooperation, the department responsible for China's external economic affairs, was able to obtain only a small number of multiple-entry passes (fewer than ten) to Hong Kong, making it very difficult and inconvenient for its ranking officers to travel to Hong Kong to perform their duties there. A well-known Mainland scholar joked that since the handover, Hong Kong was the most difficult place in the world for Chinese officials to go. After 1997, most task forces in the Mainland relating to policy research on Hong Kong were disbanded by the central government. In 2002, Hong Kong's autonomy had been perfectly protected, as President Jiang concluded in his speech that year at the celebration of the fifth Anniversary of Hong Kong's Return to China and the inauguration of the second-term government of the Hong Kong Special Administrative Region:

> "Today, the policies of 'one country, two systems,' 'Hong Kong people administering Hong Kong' and 'a high degree of autonomy' have been implemented in an all-round way, and the capitalist system and the lifestyle that Hong Kong residents are accustomed to have remained unchanged. Retaining the status as a free port and international center of trade, finance and shipping, Hong Kong continues to enjoy the reputation as one of the most dynamic regions in Asia and the world as a whole."[32]

Under the framework of "one country, two systems," an unprecedented ideological concept raised by Deng Xiaoping a quarter century ago, Beijing had tried to learn as much as possible about Hong Kong, but what it had learned was far short of enabling it to effectively and directly govern Hong Kong by itself. Therefore, the viable and reasonable way to maintain Hong Kong's capitalist system and lifestyle was a policy of non-intervention, which essentially was to let a trusted or loyal Chief Executive and his team administer the SAR. To this extent, it can be argued that Beijing actually adopted a "hands-off" policy toward Hong Kong, in consideration of the constraints of reality as well as its confidence, if not great optimism, in Hong Kong's developmental momentum. Since Hong Kong's economy was far more advanced than the Mainland's in 1997, no one in Beijing anticipated that a crisis would come from its economy.

However, Hong Kong's situation proved more complicated than expected. As a highly internationalized economy, Hong Kong is always sensitive to the international environment and, due to its increasing integration into China's economy since 1980, to its relationship with China. Thus, Hong Kong's economic climate is far more volatile than those of many other nations. For instance, both the Wall Street crash in 1987 and Beijing's June 4th incident in 1989 affected Hong Kong's economy abruptly and severely, but both times it soon rebounded after fundamental factors were restored. From a positive perspective, this kind of volatility and flexibility positioned Hong Kong for further

---

[31] Kuan Hsin-chi, "Hong Kong 1996: Structuring the Future," *Asian Survey* (Vol. 37 No. 1, 1996), p57.

[32] Speech at Celebrations of the Fifth Anniversary of Hong Kong's Return to the Motherland and Inauguration of the Second-term Government of the Hong Kong Special Administrative Region, (accessed December 30, 2004),< http://www.fmprc.gov.cn/eng/ljzg/3566/default.htm>.

globalization. From a negative perspective, even shrewd business leaders with extraordinary records of success foundered in Hong Kong when the market suddenly changed in ways beyond their abilities to anticipate or adapt to. Essentially, the long-lasting prosperity of the 1980s and 1990s caused the HKSARG and Beijing to underestimate the damage and challenges that would accompany any sort of financial turmoil.

To a large extent, in the late 1990s the HKSARG not only failed to recognize the structural transformation problem inside Hong Kong, but also failed to adapt to the changing atmosphere in East Asia in a timely fashion. To a lesser extent, Beijing overestimated Hong Kong's flexibility and adaptability to the changing environment, in terms of both its economic dynamics and governing apparatus. Beijing tended to believe that Hong Kong's economy, with a per capita GDP of more than US$23,000, was much more advanced than other parts of the country. There would be enough space and time for Hong Kong to adjust mainly through market means, as had happened in the past four decades. Consequently, Beijing could afford to let Hong Kong administer itself, as long as no anti-Beijing candidate could become Chief Executive. There was no sense of necessity for Beijing to reconsider its economic relationship with Hong Kong.

5. Economic affairs: the "one country, two systems" puzzle

It is widely recognized that the principle of "one country, two systems" was upheld and that, after the handover, the Basic Law was followed.[33] However, how was it that Beijing's hands-off policy contributed to Hong Kong's weak economic performance after the reversion and, in turn, to the low legitimacy of the HKSARG? Beijing's restraint was supposed to enable "Hong Kong people to administer Hong Kong" and prove the value of the "one country, two systems" model. The result, ironically, was the opposite.

The answer to this conundrum lies, in part, in how the Chinese leadership conceptualized what made Hong Kong a distinctive, second system within one country. When the principle of "one country, two systems" was applied to Hong Kong in 1984's Sino-British Joint Declaration, China had had limited experience in dealing with the outside world. Neither Deng nor his comrades in the Chinese government had a deep understanding of the dynamics of economic growth in a globalizing economy or of the

---

[33] Albert H.Y. Chen and Chris Yeung intensively examine the Hong Kong-Mainland relationship for the first five years after 1997 from different perspectives. Though there were controversies between the two sides, Albert Chen concludes that "Have the constitutional principles regarding Hong Kong's autonomy enshrined in the Basic Law been upheld in practice? I would give an emphatic 'yes' in answer to this question. The Beijing side has practiced utmost self-restraint in exercising its powers under the Basic Law." Chris Yeung argues, "Much to the credit of Beijing leaders for exercising great self-restraint uncharacteristic before 1997, the worst fears of Chinese interference with the internal affairs of the SAR after the handover had not come true. Opinion surveys conducted by various organizations show a high degree of public approval of the performance and trust in the Central Government." See Alber H.Y. Chen, "The Constitution and Rule of Law" and Chris Yeung, "Separation and Integration: Hong Kong-Mainland Relations in a Flux," in Lau Siu-kai ed. *The First Tung Chee-hwa Administration: the first five years of the Hong Kong Special Administrative Region* (2002), p84 and pp.237-238 respectively.

various ways in which Hong Kong would integrate with the Chinese economy in the future. Thus when Deng Xiaoping in 1982 delineated the essential difference between the Chinese system and the Hong Kong system, he chose to draw on traditional Marxism. To Deng, by and large, the basic criterion for distinguishing between Hong Kong and the Mainland was the ownership of the means of production.[34] In other words, ownership in China was socialist (firms were owned by the state) and in Hong Kong it was capitalist (firms were owned by the private sector). That Deng should use such a Marxist concept is understandable, yet it would have two limitations.

First of all, Deng did not anticipate the proliferation of types of ownership in China over the next fifteen years and the emergence of various forms of private or semi-private ownership forms. In effect, China was becoming less socialist. But the more profound weakness of Deng's distinction was that ownership is not the only feature of a capitalist economy. Three other elements are relevant to the case of the economies of Hong Kong and China: markets, division of labor, and institutional infrastructure.

It was a free-market economy open to the international system that mobilized Hong Kong's development through the 1950s, 1960s, and 1970s, in spite of being cut off from the Chinese hinterland. It was the liberalization of markets in China that drove China's boom beginning in the 1980s. And it was the market forces, particularly the freer flow of goods and investment and the emergence of a labor market in China, that were the key to Hong Kong's increasing interdependence with the Chinese economy after 1979.

Yet liberalization was only partial. Although the trade in goods and some services flowed in both directions for the last quarter of the century, production factors like capital flowed overwhelmingly from Hong Kong to China. This was due to the nature of China's transition economy, including the inconvertibility of the renminbi. When reversion came in 1997, moreover, the hands-off policy stopped cross-border liberalization. Theoretically, the handover should have removed the barriers that obstructed the two-way free flow of goods, services, and other production factors. Indeed, as the Basic Law articulates:

> "The HKSAR remains a free port, a separate customs territory, and an international financial center. Its markets for foreign exchange, gold, securities, and futures shall continue. There shall be free flow of capital. The Hong Kong dollar, as the legal tender in the HKSAR, shall continue to circulate. The authority to issue the currency shall be vested in the HKSAR. The HKSAR shall pursue the policy of free trade and safeguard the free movement of goods, intangible assets, and capital."[35]

---

[34] Another dimension of this Marxian analysis is the equation of capitalism with bourgeoisie rule. As Xu Jiatun, former director of the Hong Kong Branch of the New China News Agency, had unmistakably pointed out that the "political regime of the future Special Administrative Region should be composed chiefly of the bourgeois social classes, it however is basically bourgeois in nature." And, "the thinking of the [CCP] center is: 1) the bourgeoisie should have substantial influence on the regime of Hong Kong, 2) there should be political parties [to reflect the interests of] not merely the individual elements of the bourgeois class but the [politically] organized bourgeoisie." Lau Siu-kai, "The Hong Kong policy of the People's Republic of China," 1949-1997, *Journal of Contemporary China*, Vol.9, Iss.23 (2000) p94

[35] The full English-language text of the Basic Law is provided online by the HKSARG at <http://www.info.gov.hk/basic_law/fulltext/>.

To be sure, markets continued to liberalize within China, in part because of its accession to the WTO, and Hong Kong firms benefited. But because China wished to convince the international community that Hong Kong would remain highly autonomous, it undertook no new liberalization initiatives for Hong Kong after the handover.

In addition to free markets, capitalism also involves a division of labor. Hong Kong was able to establish a competitive advantage for itself in the post-World War II era in part because it was freer than any neighboring area. The greater the gap between Hong Kong and its regional competitors, the better its economy would be. The gap was later reduced as other Asian countries liberalized their economies since the mid-1980s, but Hong Kong could still benefit from their expanding external economic activities caused by liberalization, at least in the short term. More importantly, the narrowing free market gap was largely and effectively offset by the continual opening up of China. There had existed a huge gap between the Mainland and Hong Kong before the 1980s, and once China opened up, Hong Kong took advantage, as noted above. The transitional period from 1984 to 1997 was a prime opportunity for Hong Kong to cement both its geopolitical role as the gateway to China, as well as its active bilateral engagement with the Mainland.

Hong Kong's favorable advantages began to erode in the late 1990s. Globalization was so prevalent that almost all countries had to liberalize their economies as soon and as much as possible. The aftermath of the Asian financial crisis even forced many ASEAN countries like Thailand and Indonesia, as well as South Korea, to liberalize their domestic markets and institutions more thoroughly, under strong pressure from the International Monetary Fund (IMF) and advanced industrial countries who offered emergency loans. Therefore, the gap between the freedom of Hong Kong's economy and its neighboring economies was dramatically and abruptly reduced in the last few years of the twentieth century.

Furthermore, the bilateral agreement between the United States and China on China's accession to the WTO in November 1999, and China's actual accession to the WTO at the end of 2001, put more pressure than ever on Hong Kong. Originally, as it was the only window for the Mainland to "go west," Hong Kong was able to dominate a large portion of the Mainland's growing external trade in the 1980s. When China's economy continued to liberalize and internationalize in the late 1990s and in accordance with WTO protocols, China became more and more able to deal with outsiders directly, lessening Hong Kong's importance. The WTO's non-discriminatory principle would further deprive Hong Kong of its previous advantageous role in China's economy. Although Hong Kong could still benefit from China's rapidly increasing external economic activities, it was recognized that its privileged position would clearly be diminished and confidence in Hong Kong fell further.[36]

[36] For the positive impact of China's accession to WTO on Hong Kong's economy, for instance, see Yun-wing Sun, "Hong Kong Economy in Crisis," in Lau Siu-kai ed. *The First Tung Chee-hwa Administration: the first five years of the Hong Kong Special Administrative Region* (2002), pp.133-137. But Sung underestimates or even neglects its repercussions on Hong Kong economy, especially the psychological

Finally, although a capitalist economy is characterized by private ownership and markets, it also requires an institutional foundation – with both internal and external dimensions – that only governments can provide. Hong Kong's post-War success was based in part on the key elements of British colonial rule: the rule of law, sound fiscal management, a capable civil service, a sound educational system, and institutions to control corruption. After 1979, some institutional mechanisms were created to facilitate the broad and growing economic and social interaction with China. Yet due to Beijing's post-1997 hands-off policy, there has been little institutional development to reflect that the "two systems" are part of "one country," and to take account of rapidly growing private economic interaction.

Although some groups did work on an ad hoc basis, there was an obvious absence of formal or institutional coordination between Hong Kong and China in necessary areas and at various levels, such as the planning and construction of cross-border infrastructures, joint law enforcement on cross-border criminals, and customs clearance. Indeed, from 1979 through 2003, no official communication channels or mechanisms were built between Hong Kong and Shenzhen, the biggest Special Economic Zone (SEZ) in China and a buffer zone between Hong Kong and the Mainland. During this period, Shenzhen had grown from a small rural county into a metropolis with a population of nearly 10 million people from various parts of China. Hundreds of thousands of people were crossing the border at the Lowu Bridge every day. Tens of thousands of Hong Kong citizens were living in Shenzhen, where the living expenses are only one third of those in Hong Kong. The mayor of Shenzhen did not pay his first official visit to Hong Kong until the second half of 2004, when he signed a memorandum of cooperation to manage the relationship between these unique twin cities at an operational level, though Shenzhen and Hong Kong officials sometimes met in private and somewhat secretive ways.

The lack of an institutional infrastructure first became obvious during the Asian financial crisis, which temporarily deprived Hong Kong of its hinterland in Southeast Asia. As western capital withdrew from East Asia, Hong Kong badly needed to improve its economic ties with the Mainland, which directly or indirectly was involved in more than half of its economic activities. However, the non-intervention policy and the institutional barriers prevented this.

In sum, China successfully practiced non-intervention and Hong Kong maintained "a high degree of autonomy" in political and judicial affairs. However, because Hong Kong's economy was becoming increasingly intertwined with and integrated into the Mainland economy, non-intervention in this arena was ill-advised, and in fact had negative consequences. Frozen China-Hong Kong liberalization, the closing of Hong Kong's gap with its competitors, and the absence of an institutional and legal framework

---

effect on confidence in Hong Kong. For the analysis of repercussions, see Victor F.S. Sit, "China's WTO accession and its impact on Hong Kong-Guangdong cooperation," *Asian Survey*, Vol.44, No.6 (2004), p827. For lowered confidence in Hong Kong after accession, see Edmund R. Thompson, "Dangers of Differential Comprehensions of Hong Kong's Competitive Advantages: Evidence from Firms and Public Servants," *The China Quarterly*, No. 167(2001), p711.

for cross-border economic relations between the main body of a country and its Special Administrative Region on the one hand, and that between two equal customs regimes under the WTO framework on the other hand, confused and complicated Hong Kong's economic trajectory in the aftermath of the financial crisis. These factors also fostered a contentious debate on how to restore Hong Kong's economic vitality and the legitimacy of its government.

There are two contradictory schools of thought on the issue of "one country" versus "two systems" inside Hong Kong. One puts "one country" over "two systems"(the "one country school"), and was represented by the Chief Executive Tung, behind whom stood a combination of the lower classes of society, who usually tilt to the left, and most of the business class, who make money from integration with the Mainland and tend to be pragmatic. The other emphasized "two systems" over "one country" (the "two systems school"). This school included a large part of the former colonial elite, such as lawyers, other professionals, and so forth. They deeply believe that Hong Kong is by far superior to the Mainland in political, legal, social, and economic affairs. The "two systems school" includes a subgroup that lacked confidence in China's resumption of Hong Kong's sovereignty. They emigrated from Hong Kong from 1984 onward and then returned to Hong Kong around 1997, with foreign passports in hand, in order to make more money for a better life. A large portion of these "re-immigrants" missed out on the prosperity of the above-mentioned golden transitional period, while their former colleagues or subordinates multiplied their wealth; some even become their supervisors. Certainly most of the returnees suffered from negative equity in houses purchased during the "handover bubble."

As many economic indicators consistently deteriorated and the direction of its future economic development remained unclear, the mood in Hong Kong became apprehensive. Society was plagued by the two fundamentally different views: should Hong Kong move northward to further embrace the Chinese market, which the majority of the business sector argues is the only path to economic prosperity, although it might lose its uniqueness from the Mainland? Or should Hong Kong do whatever it takes to retain its distinctive position over China, lest it be "mainlandized"? "Two systems" proponents claim this is the only guarantee for Hong Kong to survive in the long run, but Shanghai, Shenzhen, and Guangzhou will pose themselves to better exploit the development of China's economy and eventually catch up with Hong Kong. Obviously, it is very difficult for the "one country school" to convince the "two systems school" of its position. But it is at least as difficult, if not more difficult, for the latter to persuade the former. Facing the resurgence of an ambitious Shanghai and the challenge from neighboring Shenzhen, which is a somewhat more "primitive capitalist" city, how and whether the magic capitalist system could benefit Hong Kong in the long run is a real dilemma to both schools. A related argument regarding these two schools of thought concerns Hong Kong's role in the international economic system: what is Hong Kong's niche in the world? Is it defined by its connection to the Chinese market or by its uniqueness in contrast to China's system?

This debate was argued among Beijing's policy makers as well. One school, which was central to the introduction of the hands-off policy, still believed that Hong Kong's value to China and its long-term prosperity lay in its distinctness from the Mainland. This school argued that the non-intervention policy should be maintained and Hong Kong's advantages would ultimately be recognized through the market mechanism. The other side sensed that something had gone wrong with Hong Kong and that assertive measures must be taken to make a change. Some of the latter even bluntly claimed that Hong Kong might eventually transform itself into a source of "negative equity" for the Mainland. It is not realistic for China, with a per capita GDP of only US$1,000, to rescue Hong Kong, with a per capita GDP of US$23,000. Though different voices surfaced and the situation in Hong Kong worsened significantly at the turn of 2002-2003, it was not yet the right time to reassess Beijing's policy toward Hong Kong. For example, the HKSARG proposed to establish a free trade arrangement with the Mainland, right after China's successful entry into the WTO. It was accepted by the central government, and subsequently named "Closer Economic Partnership Arrangement" (CEPA) at the beginning of 2002. But at that time, the attitude of some top authorities in Beijing was so ambiguous that virtually no progress was made in working level negotiations for the entire ensuing year, when Hong Kong's situation finally went into crisis.

6. Toward "an integrating market": redefining Hong Kong's role in China's economy

For a number of reasons, China's policy toward Hong Kong could not be adjusted until the new administration took power in Beijing in March 2003. First, by that time, the strict non-intervention policy had sufficiently demonstrated Beijing's adherence to the principle of "one country, two systems," and the prevailing suspicion and resistance to Beijing had largely faded. In fact, it was reported that "Instead of advising Beijing to stay away from Hong Kong affairs, people are asking for all sorts of assistance and favors from Beijing to help enliven the Hong Kong economy."[37] Second, there appeared some signs in Hong Kong that the dissatisfaction of some local residents had shifted from the Chief Executive and the HKSARG to the Central Authority, and that economic dissatisfaction might possibly evolve into a political demand. If Beijing failed to check this trend, the consequences might be undesirable and unmanageable. Third, the economic situation in Hong Kong was so bad and the mood was so negative amid the SARS crisis that moderate, reasonable, and positive involvement by Beijing in economic affairs might be accepted, or even welcomed, by the majority of local residents.

Beijing's policy adjustment gave impetus to the CEPA negotiations, as per HKSARG's wishes. Reflecting the new top leaders' deep concern over the situation, the negotiation of the first phase of CEPA was concluded in just three months. Premier Wen Jiabao assumed power on March 18, 2003 and waited only until June 29 to pay his first official visit to Hong Kong, where he witnessed the CEPA signing ceremony.[38] On the one hand, CEPA is a fitting supplement, albeit a little bit late, to the "one country, two systems"

[37] Chris Yeung, "Separation and integration: Hong Kong-Mainland relations in a Flux," p259.
[38] The second phase of CEPA was concluded on October 27, 2004 and took effect on January 1, 2005.

principle. It creates a framework according to which the corresponding parts of the Mainland and Hong Kong can interact in carrying out China's economic liberalization. On the other hand, from the perspective of international law, it is an international economic agreement, i.e. a free trade agreement (FTA), like the North American Free Trade Agreement (NAFTA), between independent customs regimes.[39] As CEPA clearly stipulates, "the conclusion, implementation, and amendment of the CEPA shall be consistent with the rules of the World Trade Organization." (The Mainland and Hong Kong submitted a joint notification of CEPA to the WTO on December 27, 2003.) Also, under CEPA, "From January 1, 2004, the Mainland and Hong Kong will start to implement the specific commitments in liberalization of trade in goods and services. The two sides will broaden and enrich the content of the CEPA through continuous and further reciprocal liberalization between them." This means that Hong Kong can start to exploit the Mainland market ahead of other WTO members. More importantly, with the FTA framework of CEPA, markets that China opens to Hong Kong are not necessarily obliged to be opened to other WTO members.[40]

CEPA is the legal document that Hong Kong's economy desperately needs, and it is widely believed that CEPA was a "big gift" to Hong Kong. The Mainland will gradually apply a zero tariff to imported goods originating in Hong Kong and will grant preferential treatment in 18 service sectors such as business, communications, distribution, financial, tourism and travel, transportation, and so forth, to Hong Kong "service suppliers." Other WTO members that are juridical persons established under the laws of Hong Kong, provided that they are engaged in substantive business operations as stipulated in the arrangement, will also receive preferential treatment. After CEPA was concluded, Hong

---

[39] CEPA's objectives are to strengthen trade and investment cooperation between the Mainland and the Hong Kong Special Administrative Region and promote joint development of the two sides, through the implementation of the following measures: 1) progressively reducing or eliminating tariff and non-tariff barriers on substantially all the trade in goods between the two sides; 2) progressively achieving liberalization of trade in services through reduction or elimination of substantially all discriminatory measures; 3) promoting trade and investment facilitation; <http://www.tid.gov.hk/english/cepa/files/main_e.doc> (accessed on January 8 , 2005).

[40] This is a point which could be easily misinterpreted. For example, Yun-wing Sung argues that China's "opening to Hong Kong in advance of (its) WTO commitments may compromise China's freedom of action. China's commitments are not set in stone. If the adjustment proves too painful, China may want to delay its opening and face possible litigation, which can buy time, as litigation is usually time-consuming. However, if the mainland has opened in advance to Hong Kong, China's freedom of maneuver will be compromised." Therefore, Sung concludes that "While such an FTA has some merits, the difficulties should not be overlooked," see Yun-wing Sung, "Hong Kong Economy in Crisis" (2002), pp. 136-137. But Sung's underestimation of the role of CEPA is based on his long term misunderstanding of and objection to "a formal Hong Kong-Mainland trade block." He claims that "Creating a common market would imply that Hong Kong had given up on regulating migration from China, and Hong Kong would immediately face unmanageable population pressure. An economic union would imply that Hong Kong had given up its independent currency, making it impossible for Hong Kong to function as an international financial center because the Chinese currency is far from freely convertible." See Yun-wing Sung, "The Hong Kong Economy through the 1997 Barrier," *Asian Survey*, Vol. 37, No.8 (1997), pp. 707-708. The fact is that an FTA or CEPA between Hong Kong and the Mainland has nothing to do with immigration regulation and currency issues, at least in the early stages. Also, CEPA is not directly related to opening China to Hong Kong in advance of its WTO commitments. Under the framework of an FTA, what one country opens to its partner(s) is not necessarily what it must open to the other WTO members later. Actually, this is exactly what China and Hong Kong want to achieve from the CEPA framework.

Kong's economy rebounded rapidly in the last quarter of 2003 and recorded an 8.1 percent growth rate in 2004, described by Chief Executive C.H. Tung in his January 2005 Policy Address as the SAR's healthiest economic performance since the Asian financial crisis.[41] CEPA is the first FTA ever concluded by China, which possesses the world's most promising market for the decade ahead, and is envied by many other economies hoping to improve their access.

However, CEPA's zero tariff and the Mainland's opening of markets to Hong Kong service sectors in and of themselves did not contribute much to the revitalization of Hong Kong's economy. For example, the volume of newly applied zero tariff products exported from Hong Kong to China in 2004 was merely over HK$1 billion, or US$130 million, and tariff savings were minimal. The opening up of service sectors is a time-consuming process and offered no immediate relief to Hong Kong's economy as a whole, at least in the year 2004. Therefore, CEPA contributed to Hong Kong's short-term recovery in other ways.

First, it restored confidence in Hong Kong's future. CEPA clarified and legitimized the economic ties between the Mainland, Hong Kong, and other WTO members. Because the arrangement allows China to open its doors to Hong Kong ahead of other WTO members without violating WTO rules, the dilemma of "one country" versus "two systems" is partly resolved. Since Hong Kong is an integral component of China's sovereignty, it is possible and practical for the Mainland to grant preferential concessions to Hong Kong, while maintaining both Hong Kong's uniqueness and the Mainland's economic system in parallel, which is called a "socialist market economic system with Chinese characteristics." Therefore, CEPA represents a good, if not perfect, application of "one country, two systems" in the economic arena. The more uniqueness the Hong Kong system develops, the more advantages it can build, and the more benefits Hong Kong can reap from the Chinese market. This chain reaction will contribute to Hong Kong's further integration into China's economy.

Another way in which CEPA aided Hong Kong's economy is that it facilitated freer movement of people. One objective of the arrangement was to speed up market liberalization and to facilitate an integrating market between the two sides, in accordance with market demand, as had been developing for the past quarter century. As noted above, Beijing's rigid execution of the hands-off policy blocked the sequential and natural liberalization of China's economy toward Hong Kong, contrary to market expectations. Both sides recognized this and therefore, unlike a conventional FTA, one of CEPA's main effects is to facilitate the semi-free movement of people and capital from the Mainland to Hong Kong. China began to allow individual residents of Guangdong Province to visit Hong Kong on a trial basis in late 2003. In 2004 this measure was expanded to the cities of Beijing and Shanghai, and to the provinces of Jiangsu, Zhejiang, and Fujian. The great influx of Mainland visitors directly propelled Hong Kong's economy in late 2003 and early 2004. Easing limitations on its citizens' overseas travel could also be treated as an important step for China's economic liberalization, as the

[41] <http://www.policyaddress.gov.hk/2005/eng/p2.htm>, (accessed May 29, 2005).

tourist boom was basically a market response to CEPA, through which Hong Kong could exhibit its uniqueness to Mainland travelers.

While CEPA kept Hong Kong's economy from declining in the short-term, it also created a longer-term, strategic effect for Hong Kong, especially against the background of Beijing's regional development policy adjustment for the whole of China. Still, the policy makers in Beijing and domestic opponents to CEPA in various parts of China raised several questions: Does Hong Kong have any real and long-lasting advantages over the Mainland? If so, how does one preserve and utilize these advantages for the sake of the whole nation?

The Chinese perception of Hong Kong's role and advantages in China's economic development can be divided into two parts: "hard power" and "soft power."[42] Hong Kong's hard power includes its skyscrapers, trade flows, investment, and 40 years of achievement, which have facilitated China's economic reform and opening for the past quarter century. However, as China's economy starts to self-reinforce, the skyscrapers of Shanghai, Beijing, and Guangzhou might be even higher and greater in number than those of Hong Kong, whose hard power will fade in relative terms, perhaps more quickly than anticipated. This is the reason why the above-mentioned school of thought in Beijing tends to treat Hong Kong more as a burden to China in the aftermath of the financial crisis. However, regarding Hong Kong's soft power, which includes the rule of law, the concept of a level playing field, a corruption-free government, the free flow of information, and free capital movement, it will definitely be a different matter.[43] Actually, all of these components of soft power that Hong Kong possesses are exactly the potential bottlenecks blocking further internationalization and globalization, as well as the long-term prosperity of China's economy. On the one hand, there are some political, cultural, social, and practical constraints on China's further economic liberalization. An all-at-once transition to convertibility of the renminbi and opening of its capital account, for instance, may impose some risks on China's future economic development. On the other hand, owing to fast-growing cross-border transactions, a freer flow of people and capital is becoming both desirable and inevitable. The relatively slow accommodation, if not intolerable mismatch, of China's soft infrastructure to its hardware development will surely damage the foundation upon which China's economic growth is built. Hong Kong's soft power is exactly what Hong Kong could contribute to China's future development. As for capital movement and financial market development, for example, CEPA states clearly that:

- "The Mainland supports wholly state-owned commercial banks and certain joint-equity commercial banks in re-locating their international treasury and foreign exchange trading centers to Hong Kong."

---

[42] This concept is borrowed from Joseph Nye's *Soft Power: The Means to Success in World Politics* (New York: Public Affairs, 2004).

[43] For example, Hong Kong is the only city in Asia endowed with such a highly liberal and diverse society under the rule of law, a mature market economy and world-class infrastructure, a clean government and a highly professional and dedicated civil service, a simple tax system and low taxes, and good social and public order.

- "The Mainland supports the full utilization of financial intermediaries in Hong Kong during the process of reform, restructuring and development of the financial sector in the Mainland."
- "The two sides shall strengthen cooperation and information sharing between their financial regulators."
- "The Mainland shall, in line with the principles of observing market rules and enhancing regulatory efficiency, support eligible Mainland insurance companies and other companies, including private enterprises, in listing in Hong Kong."[44]

Starting in late 2003, a transaction settlement was concluded between local banks and China's central bank, the People's Bank of China. Renminbi were allowed to circulate in Hong Kong and Hong Kong banks were allowed to take RMB deposits. Customers from China could electronically pay their bills in Hong Kong through their Mainland bank accounts. Besides, in view of the equity market, more and more Mainland enterprises are coming to Hong Kong for listing, partly owing to the collapse of the ill-regulated Shanghai and Shenzhen stock exchanges and the lack of rule of law there. CEPA therefore strengthened Hong Kong's position as an international financial center and in 2004 Hong Kong surpassed London and Tokyo in equity funds raised for the first time, becoming the third largest capital market in the world.

Obviously, the Mainland desperately needs Hong Kong to play such a role in the financial area. It is believed that the reform and opening up of the banking and finance sectors might be the most difficult aspect of the development of China's entire market economic system. There was a general consensus in China after the Asian financial turmoil that it would be dangerous to open China's capital account by making the RMB convertible before banking reforms are completed and before macro stability is achieved satisfactorily. Fortunately for China, an internationalized Hong Kong with a sound record on banking and financial regulation can fulfill this task. Therefore Hong Kong, instead of Shanghai, was chosen by the new administration in Beijing to gradually be established as China's international financial center, as an experiment as well as a stepping stone for China's opening up in general and the RMB's convertibility in particular. Furthermore, as Hong Kong sharpens its advantages over China's financial sector, it could even serve as a platform for China's upcoming financial reform. Eight of the ten largest companies filing IPOs on the Hong Kong Stock Exchange (HKSE) in 2004 were Mainland enterprises, mostly large state-owned enterprises. The Construction Bank of China and the Bank of China, two of China's four main state-owned commercial banks, are preparing to go public on the HKSE in the near future. There is no doubt that the HKSE listing status would substantially improve the corporate governance of these gigantic banks and lay a foundation for China's banking reform. This is the sort of soft power that illustrates Hong Kong's value in China's further opening up, echoing Guangdong's open door practice 25 years ago. With most of China's largest SOEs, such as SINOPEC, ChinaMobile, and China Southern Airlines, and with the most vigorous private companies listed on the

[44] The text of the agreement is provided in full in English by the HKSARG's Trade and Industry Department, <http://www.tid.gov.hk/english/cepa/>.

HKSE, Hong Kong might eventually emerge as the most important financial center for all of China.

In sum, it was the market response, rather than any administrative order from the Central Authority, that rescued Hong Kong's economy. The resurgence of confidence, the purchasing power of the increasing numbers of Mainland visitors, and the performance of Hong Kong's stock exchange are purely market-driven conditions. Without a favorable response from the market, the cost of such a "gift" could be enormous, unfair, unsustainable, and even unacceptable to Beijing. However, the Mainland doesn't pay much in comparison to what Hong Kong gains from CEPA, as well as what Beijing itself can gain from the utilization of Hong Kong's soft power. Therefore, a new and effective way was found by the new administration in Beijing to govern Hong Kong. The new means go far beyond simply rescuing Hong Kong's economy or "saving face" for Beijing, though there are still more challenges ahead.

7. Conclusion: Guiding Hong Kong toward sustainable prosperity

It will be a challenge to Beijing to govern the wealthy Special Administrative Region under relatively economically-underdeveloped socialist China's sovereignty; obviously, this will also pose challenges for Hong Kong. Four decades of post-War economic prosperity and the city's development into a global business center not only legitimized the colonial government, but also laid the basis for the newly-born HKSARG's capabilities. Any government that fails to sustain Hong Kong's prosperity will ultimately lose the support of its populace and therefore its governing effectiveness. The stagnation in the aftermath of the Asian financial crisis reflected not only the erosion of favorable conditions, but also the underestimation of the sensitivity and magnitude of Hong Kong's economic performance and, probably more importantly, the absence of an institutional framework within which the Mainland and Hong Kong economies could interact in appropriate and reciprocal ways.

There is one indisputable piece of evidence from the post-War era which indicates that the fate of Hong Kong depended on the policies pursued in China, as Gerald Segal put it.[45] It is even truer in the post handover era. Beijing's initial post-handover non-intervention policy was necessary and reasonable, in consideration of Hong Kong's political, legal, social, cultural, psychological, practical, and international situation. Most aspects of the non-intervention policy, especially in the political and judicial areas, worked very well after the handover and should even be strengthened in the future, for they served as the firewall protecting Hong Kong's uniqueness. If Hong Kong were to turn itself into another Shanghai or Guangzhou, it would surely be a loss for the whole of China and the world. However, while the non-intervention policy left a positive legacy, it was at first applied a bit too rigidly, harming Hong Kong's economy. In this light, the conclusion of CEPA and the redefinition of Hong Kong's role in China's economy under the new administration are pragmatic steps that will continue to enrich the Hong Kong-China relationship; they are not violations of the "one country, two systems" principle.

[45] Gerald Segal, *The Fate of Hong Kong*, (Simon & Schuster, 1993), p29.

The positive market response, the corresponding rebound of Hong Kong’s economy, and the restoration of confidence seem to indicate that the people of Hong Kong welcome these adjustments.

CEPA should not be treated as a “rescue package” for Hong Kong. On the contrary, it is a mutually beneficial arrangement, within which Hong Kong and the Mainland are able to take full advantage of each other’s competitive edges and to grow on combined strengths. Hence, Hong Kong’s future depends on what it contributes to China’s development rather than what kind of and how many privileges China grants her. Only from this convergence of interests of the two sides can the puzzle of “one country” versus “two systems” be resolved. As the Hong Kong system becomes more and more unique, it will be able to build more advantages. Hong Kong will be able to reap more benefits from the Chinese market, China can capitalize on Hong Kong’s soft powers, and both sides will grow in an accelerating cycle. Accordingly, with regard to the economic relationship between the Mainland and Hong Kong, the “one country, two systems” principle could be extended into and elaborated as “one country, two systems, and an integrating market (from two separate parts with a division of labor)”[46] In the foreseeable future, these two separate parts won’t be identical and will maintain some division of labor in accordance with market demand. The process of integration should be dynamic, taking into account a changing international economy and China’s economic growth.

It is the integrating process per se that brings about the benefits to two sides. How to manage this process, in terms of scope, speed, and depth, and how to maximize benefits from it are the core policy questions for economic interaction between Beijing and Hong Kong. As China’s economy continues to liberalize and internationalize, Hong Kong needs to sharpen is soft advantages accordingly, and maintain its position as the freest and the most vibrant economy in the global system in order to better pose itself between the Mainland and the rest of the world. With the concrete economic institutional arrangement manifested in CEPA, the driving force and dynamic of Hong Kong’s economy is still and always will be the market. Although the international economic tides may change from time-to-time, as with the Wall Street crash in 1987 or the fluctuation of the U.S. dollar in the mid 1980s, the vitality and flexibility of the market mechanism and entrepreneurship will pull Hong Kong through. From this point of view, it is hoped that the stagnation from 1998 to 2003 in Hong Kong may merely be an interlude in its long-lasting prosperity. The outcome of Beijing’s rigid non-intervention policy around the turn of the millennium serves as a useful lesson for strengthening the “one country, two systems” framework and for better governance of Hong Kong in the long run.

However, future challenges facing Hong Kong have already moved beyond the economic arena. The repair and recovery of the legitimacy that was lost by Hong Kong’s poor performance in the aftermath of the Asian financial crisis will be time-consuming, difficult, and frustrating, as the public demand for power sharing has been released and will march forward on its own feet.[47] Any underestimation of such a challenge is harmful

[46] The author thanks Richard Bush for his inspiration for this argument.
[47] For example, see Agnes S. Ku, “Negotiating the space of civil autonomy in Hong Kong: Power, discourses and dramaturgical representations,” *The China Quarterly*, No.179(2004), pp.647-664.

and even dangerous. Therefore, to Beijing's policy makers, further elaborating "one country, two systems" so as to increase governing effectiveness in Hong Kong and to maximize Hong Kong's potential are of vital importance. To Hong Kong, be it the HKSARG or the so-called voice of opposition, the question of how to formulate a reform agenda which can reconcile the "one country" principle with a greater power-sharing mechanism or more democratic practices within the society while maintaining the stability is unavoidable. Nevertheless, the lesson from the past eight years is self-evident: it is the convergence, instead of divergence, of both sides' interests which guarantees Hong Kong's future. Beijing's confidence in, or its tolerance of, Hong Kong comes from the sustainable prosperity of Hong Kong's population of seven million. As Donald Tsang, the new Chief Executive, comes to power, how to reach a consensus, or any kind of compromise, inside the territory and how to interact with Beijing appropriately so as to navigate Hong Kong into a brighter economic and political future are yet new challenges.[48]

---

[48] Jermain Lam and Ka-ho Mok, "Economic prosperity or democracy: Dilemma of development in Hong Kong and China," *Journal of Contemporary China*, Vol.6, Iss. 16(1997), pp 461-486.