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Hong Kong: One Country, Two Economies?

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Introduction

Since its colonial days, Hong Kong has been the port through which China has traded with the world, causing the city to now be the most important "financial entrepôt" in Asia. Hong Kong's rapid growth over the last century occurred mainly due to geographical reasons, as Hong Kong's Victoria Bay naturally forms a port. However, the key to Hong Kong's success has been its stability, as investors looked to Hong Kong to provide safety from political risk that Shanghai was not able to guarantee. Hong Kong has seen rapid changes during the last decade—both political and economic—that leave the city's future an educated guess at best. The new era, brought in by the 1997 return of the colony to the People's Republic of China (PRC) government, left local and foreign businessmen unsure of the political risks. The Asian Financial Crisis of the same year left the crippled local economy more reliant on the mainland than ever before. Now governed by the "One Country, Two Systems" philosophy, economic ties between Hong Kong and China are growing even stronger, specifically in the Pearl River Delta region. While closer economic times with the mainland are no doubt beneficial to the local Hong Kong economy, the involvement of the PRC government on Hong Kong's financial industry stands to threaten the city's status as a safe haven for investments and operations in Asia. Today, there are still many financial, political, and social issues waiting to be resolved. The Hong Kong population—both native and ex-patriot communities—continues to have concerns about its city's future.

A series of interviews were conducted on site in Hong Kong, including the director of an investment promotion government agency, two local professors, and a series of upper and middle management across the finance industry in Hong Kong. Local college students were also interviewed. The information and opinions in this article draw mainly from the interviews, as well as documents and written material from the Chinese University of Hong Kong's library system.

The Asian Crisis Hits Hong Kong: Instability Ensues

Deng Xiaoping's declaration of a new "Open Door Policy" in 1978 marked the beginning of Hong Kong's economic integration with mainland. Starting from this year, Hong Kong saw an average increase in visible trade of 28 percent leading up to the 1997 handover of the colony. However, there were negative shocks in terms of GDP growth in the 1980s due to political fears as the terms of Hong Kong's handover were being finalized. Much of the manufacturing sector

moved across the border into the Guangdong province. In fact, Hong Kong accounted for 80 percent of foreign direct investment in the Guangdong region during this time. This move of the manufacturing sector to mainland came with an increase in the financial services sector in Hong Kong in the 1990s, which continues to be the dominant sector in Hong Kong today (1).

Upon Hong Kong's handover, the new "One Country, Two Systems" ideology was put into practice, allowing Hong Kong to keep its own currency and a reasonably independent government. Despite this, Hong Kong began to experience unprecedented instability both financially and politically. With the Asian Financial Crisis occurring simultaneously with Hong Kong's handover, the newly formed "Special Administrative Region"(SAR) became more reliant on mainland China than ever before. Unlike most Asian countries that chose to deflate their currencies during the 1997 Financial Crisis, Hong Kong kept their dollar on par with the US. This action, coupled with the SARS outbreak, threw Hong Kong into a recession that led to an average rate of 6 percent unemployment (2). With Hong Kong's economy needing help, it was now the responsibility of the PRC government to intervene.

In June 2003, Hong Kong signed a free trade agreement with the mainland entitled the "Closer Economic Partnership Arrangement." This arrangement is intended to phase most barriers to trade and investment between mainland and its SAR. New trade and exchange restrictions were outlined, as well as restrictions on the movement of people between the SAR and the mainland. This system has continuously been debated throughout the past decade as Hong Kong strives to maintain a high level of independence both economically and politically. Its long-term implications on Hong Kong's principle industry of finance still remain only speculative.

The CEPA Solution

CEPA was originally viewed as a favor to Hong Kong from the PRC government. This "arrangement" allowed for Hong Kong to benefit from free trade with China by World Trade Organization (WTO) standards that other economies would not benefit from for at least two more years. Another statute of the agreement gives foreign companies that have acquired a Hong Kong company full CEPA benefits after only one year, which caused an increase in foreign direct investment into Hong Kong. The biggest benefits to Hong Kong, however, were in the banking industry. China's 2003 entry into the WTO came with a relaxation on banking operations policies for foreign banks, including Hong Kong's, in four main areas:

1. The holding of shares in a local bank by a foreign bank was raised from 15 to 20 percent. However, the total shares held by foreign banks in aggregate cannot exceed 25 percent.
 2. Operating capital requirement of a full-service foreign bank branch was lowered from RMB 600 million to RMB 500 million.
 3. Foreign banks were allowed to provide Renminbi business to Chinese enterprises.
 4. Foreign banks were allowed to extend their Renminbi business to four additional cities, namely, Jinan, Fuzhou, Chengdu, and Chongqing, bringing the total to 13. (Currently the cities that are opened up are Shanghai, Shenzhen, Tianjin, Talin, Guangchau, Zhuhai, Chingdao, Nanjin and Wukan).
- (3)

However, with many of the smaller Hong Kong banks still not qualifying, CEPA reached further to lower restrictions for Hong Kong by lowering the asset requirement to only US\$6 billion. This immediately qualified 8 Hong Kong banks: the Dao Heng Bank, Nanyang Commercial Bank, the Shanghai Commercial Bank, Ka Wah Bank, Wing Hang Bank, ICBC Asia Bank, Dah Sing Bank, and the Wing Lung Bank (1). In 2004, the UK-based Standard Chartered Bank registered its Hong Kong business as a Hong Kong subsidiary in order to benefit from CEPA.

Impact Today

The Issue of Currency

As a part of the Arrangement, the Hong Kong Monetary Authority (HKMA) granted permission for Hong Kong banks to hold Renminbi (RMB) denominated accounts, with the Bank of China (HK) serving as the clearing bank for all accounts. This created an efficient channel for recycling RMB back to mainland, which was originally done through currency exchange shops that would physically return the money to be deposited back into Chinese banks.

Another relaxation has been made in terms of RMB spending within Hong Kong. Previously, mainlanders were allowed only 6000RMB in spending money while visiting Hong Kong. However, they are now allowed to use RMB credit cards. This has made spending much

more flexible and stimulated an increase in economic growth traceable back to mainland consumption. Credit cards can be used for consumption expenditures only—excluding capital expenditures such as buying shares and property. Hong Kong banks are still unable to give RMB denominated loans if they are for use in Hong Kong, nor can they reinvest RMB deposits in Hong Kong. The RMB is especially important to Hong Kong because if it is to become convertible, Hong Kong will become the chief offshore RMB trading center. The discrepancy between mainland spending in Hong Kong and Hong Kong spending in the mainland is small enough that the HKMA does not currently view the RMB as a threat to the Hong Kong Dollar (HKD) in the short-term (4).

With the RMB's ever progressing infiltration into the Hong Kong banking system, the threat of RMB takeover should be considered. Recently RMB denominated bonds, "Dim Sum" bonds, have entered the market. Some believe that even select shares will be quoted using RMB in the near future. However, most consider the threat of the RMB replacing the HKD relatively small at this stage, as a full-scale replacement will never be realized unless the RMB becomes as convertible as the HKD. This RMB's move towards increased flexibility seems inevitable, but it does not mean that it is a definite threat to the HKD in the foreseeable future.

On the contrary, others see value in the possibility of a switch to RMB. The question of whether it is logical to maintain a separate currency in such a small place is extremely difficult to answer. The HKD interest rate in Hong Kong is dropping, but the RMB interest rate in Mainland is rising, suggesting that the RMB is nowhere near mature. However, it is inevitable that mainland companies will become more autonomous when dealing with foreign investment and will eventually move away from needing Hong Kong as the "go between." This calls into question whether it is in Hong Kong's best interest to keep the HKD pegged to the USD. Currently, Hong Kong's biggest trading partner is China. Every time there is a currency revaluation, the HKD weakens against the RMB. Rather than prevent the HKD from losing its value, an effort should instead be made to find positive ways to incorporate the RMB into the Hong Kong economy and even use RMB as the main currency in the future.

Road to Specialization

In August 2003, the Hong Kong/Guangdong Cooperation Conference was called for the goal of furthering the regional cooperation under CEPA. The Hong Kong government and Chinese government came to an agreement on the construction of the Hong Kong—Zhuhai—Macau Bridge (construction began in 2009 and is expected to be completed by 2016) (1). This is an important step in linking the Guangdong province with Hong Kong in order to create an "Economic Super-Zone" in the Pearl River Delta "PRD" with Guangdong acting as a powerful manufacturing base and Hong Kong serving a financial, logistics, and value-added services role.

These changes have also brought an increase in the number of sole proprietorship grants to Hong Kong residents in mainland, sparking a trend of “Hong Kong Cities” in different PRD cities.

As the Hong Kong government looks to its residents to step up to the task of assuming this new role, many Hong Kongese have willingly moved to the mainland. However, many still reserve their doubts on the legal protection in China, having seen improper handling of such cases as the Rio Tinto trial and the more recent death of Neil Haywood, a foreigner living in China who had a falling out with a Communist Party leader that still remains veiled in secrecy. On top of this, a lack of trust in the PRC government has begun to increase, especially due to the recent election of pro-Beijing candidate Leung Chun-Ying as the next Chief Executive of Hong Kong. The Hong Kong people are being forced into the mainland way of doing things while they are still unable to understand the typical mainland mindset. A social identity crisis is arising as young Hong Kong locals struggle to answer the question of whether they are Chinese or Hong Kongese. Many of the locals take pride in being from the former colony, but the SAR era has brought a wave of Chinese propaganda that threatens to narrow the gap between being Chinese and being from Hong Kong.

The root of the problem lies mainly in economics. It is widely thought that the government in Beijing has one goal: to raise the average per capita gross domestic product (GDP) of its citizens. Hong Kong’s per capita GDP is already at a rate that is comparable to industrialized Western countries. Beijing will not focus on Hong Kong until it has achieved a better GDP balance for the other 1.2 billion throughout the country.

Conclusion

Overall, Hong Kong has benefited greatly from the CEPA and banks are continuing to receive opportunities to capitalize on the mainland through new RMB options for stockbrokers and loan officers. However, if it is to remain competitive in its new role as an SAR, the finance industry will need to strive for the most advanced knowledge and expertise in their financial products and services. The industry will need to call upon new technology to become more efficient than Shanghai's or Singapore's. Furthermore, it will need to do all of this with a new mainland state of mind, as its existence from this time forward will be dependent on what the mainland market needs. Perhaps more importantly, however, Hong Kongese must establish their new identity as a SAR. They are now China, for better or for worse, but remembering their colonial roots will only strengthen their competitiveness.

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